BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal; of)
) No. 82A-1784-GO
HOMER V. BURKLEO, ET AL,.) 82A-464

For Appellants: Allen M. Nelson

For Respondent: Donald C. McKenzie
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests against: proposed assessments of additional personal income- tax for the year 1976 as follows:

	Proposed Assessment
Homer V. Burkleo	$ 1,348.27
Joseph D. and Cheryl A. DesNoyer	2,503.78
Donn R. and Shirlee R. Duncan	921.68
Ransford J. and Zelma L. Johnston	1,617.46
Roy s. Jordan	784.10
Charles and Fay Kramer	1,508.12
Craig L. and Mary A. Manning	1,459.00
Carl and Catalina Silva	1,472.70
P. J. and Mary Jane Zobel	417.10
James R. Olsen	4,091.62

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The central issue is whether appellants, all limited partners in a partnership, should be allowed to deduct partnership losses in the year in issue arising from expenditures made for research and development of a continuous circulation pump. If we should disallow such losses, appellant James R. Olsen argues that he is, nevertheless, entitled to a casualty loss arising out of his transaction with the partnership. Because of the identity of facts, issue, and legal principles involved in each case, these appeals are consolidated for purposes of this opinion.

T-R Research Group, LTD (hereinafter "T-R") was formed under the limited partnership laws of California in June of 1976. The private placement memorandum describing its activities noted that T-R was "formed to research, develop, manufacture and market oil and/or gas field production equipment generally and the Continuous Circulation Pump System prototypes specifically." (App. Br., Ex. C at 1.) The general partner of T-R was named as William A. Genoar, Jr. (hereinafter "Genoar"), who was in the business of bookkeeping and accounting, operating a business known as "Tax Factors." That same memorandum indicated that the objectives of T-R were as follows:

> 1. Research and develop the Continuous Circulation Pump (hereinafter "CC Pump") System Prototypes.
>
> 2. Manufacture a workable prototype that will operate reliably under field conditions.
>
> 3. Set up working relationships with manufacturers that will be able to mass-produce from the finalized prototype.
>
> 4. Market and distribute a reliable, low-cost, economical CC Pump System,
>
> 5. Realize profits from the world-wide marketing and distribution of the CC Pump system.

(App. Br., Ex. C at 1.)

To these ends, the memorandum indicated that Genoar obtained preliminary designs from Janebourne, LTD, of the United Kingdom (hereinafter "Janebourne") which

"indicate[d] that such a pump [was], feasible," (App. Br., Ex. C at 8.) Thereupon, Genoar assigned his option to develop such pump to T-R in return for an 11 percent participation in profits from sales through sub-licenses. T-R also entered into an agreement for the research and development of the pump system with Signheath, LTD. (hereinafter "Signheath") which provided as follows:

RESEARCH AND DEVELOPMENT PROJECT SCHEDULE

Contract Cost of Research and Development

PEASE	TITLE	COST	
IA.	Initial research and development	$ 350,000	
IB.	Laboratory testing of engineering prototypes	150,000	
	PHASE I TOTAL		$ 500,000
IIA.	Preliminary field evaluation of engineering prototypes	250,000	
IIB.	Production design refinement	100,000	
	PEASE II TOTAL		350,000
III.	Manufacturing systems, development and design testing	750,000	
	PHASE III TOTAL		750,000
	TOTAL RESEARCH AND DEVELOPMENT		$1,600,000

(App. B Ex. L at 5.)

However, no signed contract between these parties has been produced. (App. Br. at 10.) Moreover, there is no evidence in the record which would indicate what, if any, previous experience or ability Signheath had to enter into such an agreement. Production, manufacturing and marketing of the pump systems was to be carried out by Signheath, under a separate sub-licensing arrangement with T-R. By means of this arrangement, sales of the pump systems would "result in payment of

royalties or other fees to the Partnership, . . ." (App. Br., Ex. E.)

The private placement memorandum provided that the projected capitalization for the project was to be made by offering 500 partnership units at $1,000 per unit, for a total capitalization of $500,000, but that at the discretion of Genoar, the capitalization might be closed after $300,000 was raised. Appellants are persons who invested in T-R. The means for raising such capitalization by appellants appears to be somewhat indirect or roundabout- Apparently, each appellant applied for and was granted a loan of the amount to be invested in T-R from J. L. Lawver Corp. (hereinafter "Lawver"). (App. Br., Ex. AS.) Lawver, in turn, advanced these proceeds to T-R for the benefit of each appellant. One such loan indicated that the loan was to he solely collateralized by an assignment of mineral rights and repayment was to be made out of net revenues from such mineral interest. (Resp. Supp. Br., Ex. 1.)

During 1976, T-R indicated on its partnership return that it incurred substantial expenditures for research and development for the pump and each partner, some of whom are appellants herein, took his ratable share of such expenditures on his personal income tax return for 1976. Following the initial financing in December of 1976, the partnership apparently ceased all further activity and no pump was ever developed.

Upon audit, respondent disallowed such partnership deductions to each partner. In its brief, respondent indicates that it determined that the partners had failed to document their initial investment in the partnerhip and that they had failed to demonstrate that the partnership activities were more than those of an investor. (Green v. Commissioner, 83 T.C. 667 (1984).) Moreover., and more basically, respondent appears to contend that the only motivation for the formation of T-R was for tax purposes and that there was no genuine profit motive involved, (Resp. Br., Ex. A.) By document dated February 21, 1983, the following persons appealed respondent's determinations:

Homer V. Burkleo
Joseph D. and Cheryl A, DesNoyer
Donn R. and Shirlee R. Duncan
Ransford J. and Zelma L. Johnston
Roy s. Jordan
Charles and Fay Kramer
Craig L. and Mary A. Manning

Carl and Catalina Silva
F. J. and Nary Jane Zobel
Frank E. and Betty J. Watkins
William Genoar

In addition, the appeal of James R. Olsen was filed on November 15, 1982, and, because of the identity of facts and issues, it was subsequently consolidated with the other appellants. However, no appeals with respect to Frank E. and Betty J. Watkins or with respect to William Genoar were recorded because their assessments for the year 1976 had already become final. Moreover, listed on appellants' brief dated February i, i985, for the first time were the following additional limited partners:

Fred Blackwell
John Stelzmiller
Rodger L. Diggins
Kenneth L. Mason
Frank W. Majesky
Don E. Chaney

Respondent, however; argues that these appeals were also untimely since their assessment for 1976 had already become final. Moreover, while on June 29, 1984, Chaney paid his tax due and filed a timely claim. for refund on October 29, 1984, he did not file an appeal to this. board within 90 days of the denial of that claim on January 16, 1985. Appellants argue that including the phrase "unnamed as well as named" to the February 21, 1983, appeal letter served to include these later named persons in the instant appeals. Respondent, of course, disagrees.

Section 17223, subdivision (al (1), provides that '[a] taxpayer may treat research or experimental expenditures which are paid or incurred'b'y him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account." Section 17223 is substantially similar to its federal counterpart, Internal Revenue Code Section 174. As there are now no regulations of the Franchise Tax Board interpreting section 17223, regulations under the Internal Revenue Code would govern the interpretation of the conforming state statute, (Appeal of Peter Lavalle, Cal. St. Bd. of Equal., Feb. 5, 1985.) Moreover, cases interpreting section 774 of the Internal Revenue Code are highly persuasive as to the proper application of section 17223. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d

45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428], cert. den. 314 U.S. 636 [86 L.Ed. 5101 (1941); Union Oil Associates v. Johnson, 2 Cal.2d 727 [43 P.2d 291](1935).)Wefurther note that deductions are a matter of legislative grace and the burden is upon the taxpayer to show that he is entitled to the deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Thornton v. Commissioner, 47 T.C. 1 (1966); Appeal of Felix and Annabelle Chappellet, Cal. St. Bd. of Equal., June 2, 1969.)

As indicated above, respondent asserts that T-R's expenditures under the research and development agreement were merely those of an investor and, under the standard established in Green v. Commissioner, supra., those expenditures were not made in connection with any trade or business. Moreover, respondent appears to argue that the financing with which the partners financed their interests in T-R was not genuine indebtedness which indicates the tax avoidance motivation of the project. Appellants answer that all of the limited partners were already in the "oil business" which, they argue, is apparent from an examination of each of the partner's tax returns and that the subject expenditures for a pump which could be used in the "oil business" were made in connection with that husiness. (App. Br. at 4.) Moreover, appellants allege the financing obtained by the partners was genuine and transacted at arms-length and that, at least in one instance, was fully repaid even after the collapse of the T-R project.

Research and development expenses *are* deductible if paid or incurred in connection with a "trade or business" within the meaning of Internal Revenue Code section 174. (Hoerrner v. Commissioner, ¶ 85,347 T.C.M. (P-8) (1985); see also, Snow v. Commissioner, 416 U.S. 500 [40 L.Ed.2d 3361 (1974).) The provisions of Internal Revenue Code section 174 "apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization. ..." (Treas. Regs. § 1.174-2 (a) (2).) Accordingly, appellants' right to the subject deductions depends upon a showing by them that the activities from which the deductions arose constituted a "trade or business."

An activity does not constitute a trade or business unless it is engaged in with the predominant purpose and intention of making a profit. (Flowers v. Commissioner, 80 T.C. 914, 931 (1983); Siegel v. Commissioner, 78 T.C. 659, 698 (1982).) Indeed, in Snow v. Commissioner, supra, 416 U.S. at 504, in holding that Internal Revenue section 174 applied to allow the, research and experimentation deduction there at issue, the Supreme Court found that "the profit motive was the sole drive of the venture." Moreover, in Green v. Commissioner, supra, 83 T.C. at 687, the tax court held. that "the existence of a profit motive is an important factor because it distinguishes between an enterprise carried on in good faith . .. and an enterprise merely carried on as a hobby." The tax court also- stated that "[f]or section 174 to appiy, the taxpayer must still be engaged in a trade or business at some time, and we must still determine, through an examination of the facts of each case, whether the taxpayer's activities in connection with a product are sufficiently substantial and regular to constitute a trade or business for purposes of such section." (Green v. Commissioner, supra, 83 T.C. at 686-7.) While a reasonable expectation of profit is not required, the objective of making a profit must be bona fide. (Dreicer v. Commissioner, 78 T.C. 642 (1982).)

Like the taxpayers in Green v. Commissioner, supra, and Hoerrner v. Commissioner, supra, an examination of T-R's limited activity reveals that it functioned merely as a vehicle for injecting risk capital into the possible development and commercialization of the CC Pump. At best, its activities never surpassed those of an investor. It was not the up-and-coming business which section 17223 is intended to promote. (Green v. Commissioner, supra.)

A review of the private placement memorandum describing T-R reveals that the venture's major emphasis was the tax effect of the transaction. (Resp. Br., Exs. A, B, C.) Discussion of the tax aspects of the deal dominates the memorandum. In sharp contrast, there was no discussion with respect to the experience or qualifications of either Janebourne, the designer of the pump, or of Signheath, the organization which was allegedly to perform the research and development of the pump. There is no indication that the general partner Genoar obtained independent analysis or expert appraisals of the prospect for the pump prior to entering into the agreement. (See Hoerrner v. Commissioner, supra, ¶ 85,347 T.C.M. (P-8) at

85-1550 (1985).) Moreover, there is no evidence that the funds allegedly spent for research and development bore any results. Indeed, since T-R ceased any activity after 1976 and since no pump was ever developed, any research endeavors were totally ineffective. In addition, there is absolutely no evidence in the record which would indicate that the partnership was operated in a business-like method, At best, during the brief period of its existence in 1976, T-R's activities were purely ministerial. We are convinced that Genoar's primary purpose was to garner tax benefits for his partners. (See Hoerrner v. Commissioner, supra.) Accordingly, based on the entire record, we find that appellants have not shown that the predominant purpose or objective of Genoar was to make a profit for the T-R partners.

Notwithstanding the above finding, even if the invention had been eventually developed and marketed, T-R would have had to collect royalties due under the license agreements and thereafter make further payments to the inventor and distribute any profits to its partners. T-R itself would never be able to produce or market the inventions. The management of investments is not a trade or business, regardless of the extent of the investments or the amount of time required to perform the managerial functions. (*Green* v. Commissioner, supra, 83 T.C. at 866.) Thus; appellants have not *shown* that the subject research and development expenditures incurred by T-R were incurred in connection with any trade or business. In this light, we find that it is irrelevant that the appellants may or may not have already been engaged in the "oil business." Accordingly, because of our determination that T-R's research expenditures were not incurred in connection with a trade or business, we hold that appellants are not entitled. to any deduction as to partnership losses in the year at issue arising out of the expenditure for research and development.

Appellant James Olsen raised the additional issue that. if we should find that the research and development expenses aren't deductible as such partnership losses, he should nevertheless be allowed a deduction, apparently identical in amount, for a casualty loss presumably pursuant to section 17206 since he allegedly was "the victim in the sale of a false investment by his tax consultant, ..." (App. opening memorandum.1

Section 17206 provides, in pertinent part:

> (a) There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> * * *
>
> (c) In the case of an individual, the deduction under subsection (a) shall be limited to--
>
> * * *
>
> (3) Losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, . . . (Emphasis added.)

The provision allowing the deduction of Losses that arise from "other casualty" has been part of the federal tax law since the enactment of the Revenue Act of 1916. However, there is neither statutory definition of the phrase "other casualty" nor legislative history clearly expressing congressional intent as to its meaning. In general, the federal courts have derived the meaning of the phrase from its use in statutory context with the terms fire, storm, and shipwreck. Thus, losses have been considered as arising from "other casualty if they involved partial or complete destruction of property caused by a sudden event similar in nature to a fire, storm, or shipwreck. (Matheson v. Commissioner, 54 F.2d 537 (2d Cir. 1931); Shearer v. Anderson, 16 F.2d 995 (2d Cir. 1927); Durden v. Commissioner, 3 T.C. 1 (1944).)

Although application of the phrase "other casualty" has been consistently broadened to encompass events of a less catastrophic nature than fire, storm, or shipwreck, close examination of the federal decisions in this area indicates that certain established criteria must be met to support the deduction of a property loss under the phrase. Specifically, the loss must result from an identifiable event that is sudden, unexpected, and unusual in nature. (See generally, Rev. Rul. 72-592, 1972-2 C.B. 101.) Moreover, the loss must be the direct and proximate result of the application of a sudden, destructive force of the subject property, (Appeal of William J. and Doris M. Griffiths, Cal. St. Bd. of Equal,, July 26, 1978.)

It is clear then that in order to qualify for a loss pursuant to section 17206, a taxpayer must show that

he sustained a loss during the taxable year and that such loss resulted from an identifiable event that is sudden, unexpected, and unusual in nature. Appellant James Olsen has provided no evidence of either of these elements and we must accordingly find that he is not entitled to a casualty Loss in the year in issue.

Because of the resolution of the substantive issues in favor of respondent, no discussion of whether certain of the limited partners of T-R failed to make timely appeals is required. Accordingly, based an. the above, respondent's actions in these matters must be affirmed.

Appeal of Homer V. Burkleo et al.

ORDER .

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on tie protests against proposed assessments of additional personal income tax for the year 1976 as follows:

	Proposed Assessment
Homer V. Burkleo	$ 1,348.27
Joseph C. and Cheryl A. DeNoyer	2,503.78
Donn R. and Shirlee R. Duncan	921.68
Ransford J. and Zelma L. Johnston	1,617.46
Roy S. Jordan	784.10
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Carl and Catalina Silva	1,472.70
F. J. and Mary Jane Zobel	417.10
James R. Olsen	4,091.62

In these appeals, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day Of November , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9