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Pre-Operating Expenses and Section 174: Will "Snow" Fall?

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PRE-OPERATING EXPENSES AND SECTION 174: WILL SNOW FALL?

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Section 174 permits a taxpayer to elect a current deduction for research or experimental expenditures paid or incurred by him during the taxable year "in connection with his trade or business." Expenditures to develop new products unrelated to existing product lines of a trade or business may qualify.¹ But for over a decade the Tax Court and lower federal courts have interpreted section 174 to require that the taxpayer be engaged in a going trade or business.² In Snow v. Commissioner ³ the Tax Court and Sixth Circuit recently held that the going trade or business requirement is not met unless the taxpayer holds himself out to others as providing goods or services. Under this view, there would be no deduction for expenditures for research and development ("R & D") that is undertaken when the taxpayer is just beginning his operation and does not have any products to sell. Thus, a small enterprise undertaking R & D for its first invention, which is unrelated to any mainline trade or business, would not be entitled to a section 174 deduction, but a venture already engaged in the business of experimentation and development of new products, i.e., inventing or general business, would be able to deduct R & D expenditures for new products even though not related to current product lines or manufacturing processes.

In Snow the taxpayer was a limited partner in three partnerships each of which was formed to carry on R & D for a particular invention. In addition to investing in the partnerships, the taxpayer rendered advisory and management services to them. By 1966, the tax year at issue, two of the partnerships had developed their inventions to the stage of being ready for sale, and one of these partnerships had in fact applied for a patent. The third partnership was just beginning its operations in 1966 and could not offer to sell any of its products during the year. It had no patent issued or pending on its invention (a trash burner), nor did it have income from the sale of licenses or any other source. On these

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2 John F. Koons, 35 T.C. 1092, 1100 (1961); accord, Stanton v. Comm’r, 399 F.2d 326, 329 (5th Cir. 1968) (existing trade or business); William Tiffin Downs, 49 T.C. 533, 540 (1968); Martin Mayrath, 41 T.C. 582 (1964), aff’d, 357 F.2d 209 (5th Cir. 1966); Eugene J. Magee, 32 TCM 1277, 1279 (1973); Charles H. Schafer, 23 TCM 927 (1964).

3 482 F.2d 1029, 1031 (6th Cir. 1973), cert. granted, 94 S. Ct. 846 (Jan. 7, 1974) (No. 73-641).

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facts, the Tax Court and the Sixth Circuit held that the third partnership was not engaged in any trade or business, including that of inventing or development of inventions, so that there was no trade or business for its 1966 R & D expenditures to be paid in connection with.\textsuperscript{4} The Circuit Court further concluded that the taxpayer-limited partner's investment activities in the three partnerships were not sufficiently continuous or regular to represent his engaging in a trade or business, and that under \textit{Whipple v. Commissioner} \textsuperscript{5} the furnishing of managerial services did not constitute a trade or business. Accordingly, it held that the 1966 R & D expenditures were not paid in connection with the limited partner's business either.\textsuperscript{6}

The Supreme Court has granted certiorari in \textit{Snow}. The case presents four distinct issues upon which the Supreme Court's decision could rest:

(1) Whether section 174 requires a distinction between trade or business expenses and expenses preparatory to engaging in a trade or business;

(2) Whether the trade or business concept includes a requirement of holding one's self out to others as providing goods or services;

(3) Whether the trade or business of a partnership is imputed to a limited partner, and, if so, whether that treatment affects the character of the partner's activities in another separate partnership; and

(4) Whether a tax shelter motive should affect the timing or deductibility of expenses.

\textbf{SECTION 174 AND PREPARATORY EXPENSES}

Prior to 1926, the regulations permitted the optional expensing or capitalization of expenditures for experiments intended to improve facilities or products.\textsuperscript{7} In 1925, however, the Board of Tax Appeals ruled in \textit{Gilliam Manufacturing Co.}\textsuperscript{8} that amounts expended to acquire patents were capital expenditures and that a taxpayer had no option to deduct them currently. Accordingly, the Treasury deleted the option from the regulations in 1926.\textsuperscript{9} The Internal Revenue Service continued generally to permit taxpayers to deduct expenditures paid in connection with regular and continual research activities,\textsuperscript{10} but on those unpredict-

\textsuperscript{4} Edwin A. Snow, 58 T.C. 585, 597 (1972); \textit{aff'd} 482 F.2d 1029, 1031 (6th Cir. 1973).

\textsuperscript{5} 373 U.S. 193, 202-03 (1963).

\textsuperscript{6} 482 F.2d 1029, 1034 (6th Cir. 1973).


\textsuperscript{8} 1 B.T.A. 967, 970 (1925).


\textsuperscript{10} Address by Commissioner of Internal Revenue Dunlap, to the Joint Committee on Internal Revenue Taxation on April 4, 1952, 5 CCH 1952 STAND. FED. TAX REP. ¶ 6170 [hereinafter cited as Address by Commissioner Dunlap]. See Swanson, \textit{Tax Treatment of Research and Experimentation Expenditures}, 34 TAXES 541 (1956) [hereinafter cited as Swanson].
able occasions when it challenged such deductions the court approved the disallowance. For instance, Goodell-Pratt Co., an early Board of Tax Appeals decision frequently relied upon in such cases, reasoned that R & D expenditures must be capitalized because "[t]hey were expended expressly for the purpose of increasing the earning capacity of the enterprise in acquiring something of permanent use in the business." In 1951, Representative Camp, a member of the House Ways and Means Committee, inserted in the Congressional Record a summary explanation of a Proposed Revenue Revision Act of 1951 submitted by the American Bar Association. That explanation, in describing a provision quite similar to section 174, stated as follows:

In order to clarify the existing confusion in respect to the tax treatment of such expenditures, and to prevent tax discrimination between large businesses having continuous programs of research and small or beginning business enterprises, Section 154 provides generally that expenditures made in industrial or commercial research and development or improvement of industrial or commercial products, service or processes may, at the election of the taxpayer, be deducted as expenses or capitalized and charged off over a period selected and designated by the taxpayer.

The House and Senate Committee reports on the 1954 Code recognized the uncertainty in the existing law and made clear that the purpose of section 174 was jointly to eliminate the uncertainty and to encourage taxpayers to carry on research and experimentation, by allowing them the election of either a current deduction or a deferred deduction of R & D expenditures until the invention is first put to an income-producing use, followed thereafter by amortization of such deferred expenditures over a sixty-month period. (If no election for deduction or sixty-month amortization were made, the taxpayer would capitalize the full amount of the expenditure and presumably amortize it over the useful life of any resulting invention, provided that such life was determinable, or deduct it as a loss incurred in a transaction entered into for profit when the project was abandoned.) The Chairmen of the

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12 3 B.T.A. 30 (1923).
13 Id. at 36.
14 97 CONG. REC. A4326 (1951) (remarks of Representative Camp) (Appendix).
16 Swanson, supra note 10, at 542. Recent developments, particularly Harris W. Seed, 52 T.C. 880 (1969), have settled that a taxpayer is entitled to an abandonment loss as to pre-operating expenses as a loss in a transaction entered into for profit under
Congressional tax committees repeated in their explanations of section 174 to their respective Houses of Congress that it was intended to eliminate the competitive disadvantage under the current law to small businesses that attempted to develop new products without established research programs since they were frequently not permitted to deduct their expenses, unlike large and well-established competitors with expansive regular research budgets.\footnote{17}

In 1961, the Tax Court ruled in \textit{John F. Koons} \footnote{18} that the term "trade or business" in section 174 was used in the sense of a "going" trade or business. The taxpayer in \textit{Koons} had contracted with a research laboratory that was to develop an invention, then in a primitive state, to the stage of commercial acceptance. The court held that development activity of this type was preliminary to the existence of a trade or business of the taxpayer and that section 174 applied only to R & D expenditures made in connection with an existing trade or business, \textit{i.e.}, expenditures for development or improvement of existing products or services or development of new products or services in connection with an existing business. Ironically, the facts in \textit{Koons} are virtually identical to those in \textit{Hart-Bartlett-Sturtevant Grain Co.}, \footnote{19} a 1939 Code decision which \textit{Koons} recognized as one of the line of cases treating R & D as capital expenditures, a result which section 174 was intended in alleviate.

The Tax Court in \textit{Koons} looked to the decisions under section 162 on business investigation \footnote{20} and concluded that expenditures made in investigating a potential business or preparatory to entering into a business were not made in connection with an existing trade or business, and hence were not deductible.\footnote{21} Business investigation expenses consist of costs incurred in investigation of a prospective business prior to reaching a firm decision whether to acquire it.\footnote{22} These expenditures are commonly distinguished from pre-operating expenses (also called start-up or pre-opening costs), which are paid during the time between the decision to establish or acquire a new business and the beginning of actual business operations.\footnote{23} The term usually refers to expenses which would be currently deductible if they had been incurred after business operations had begun in full flower. Typical examples of pre-operating

\footnote{section 165(c)(2) provided that "the taxpayer be committed—at least mentally, if not legally—to the accomplishment of the business venture." Wilberding, \textit{An Individual's Business Investigation Expenses: An Argument Supporting Deductibility}, 26 \textit{TAX LAWYER} 219, 241 (1973) [hereinafter cited as Wilberding].}
expenses are costs of advertising and promotion, training of employees, lining up suppliers and potential customers or distributors, and legal and accounting services in setting up books and records. Expenditures for R & D, although capital, are pre-operating and not investigatory expenditures. Distinctions analogous to investigatory, pre-operating, and operating expenses also exist in the areas of farming and mining.

The Sixth Circuit in Snow relied heavily on the landmark Fourth Circuit decision in Richmond Television Corp. The Richmond Television case arose under section 162 and was the first major decision to extend the investigation precedents to the pre-operating stage of an enterprise (while recognizing that the problems were not identical), thereby requiring capitalization of start-up costs. It also laid the foundation for government reliance, when advocating application of a preparatory to engaging in a trade or business doctrine, on the definition of a trade or business as "holding one's self out to others as engaged in selling." Mr. Justice Frankfurter first offered this definition in his concurring opinion in Deputy v. DuPont, an investor expense case arising prior to the enactment of the predecessor of section 212. The Sixth Circuit in Snow noted that the Tax Court below had applied the term trade or business "as that phrase had been construed at the time


[25] Preparatory expenses (typically clearing, leveling or conditioning land, planting trees, installing irrigation systems) which are incurred prior to raising agricultural commodities in order to begin the growing process must be capitalized. Treas. Reg. § 1.180-1(b). Developmental expenditures are incurred so that the growing process once commenced, may continue in the desired manner. The taxpayer may expense or capitalize such expenditures at his option. The productive stage is reached when the farm becomes a fullfledged operating business. Preparatory expenses can never be deducted, and developmental expenses can no longer be capitalized after the productive stage is met. Developmental expenditures like start-up costs are expenses that if incurred after the enterprise becomes fully operative are currently deductible.

[26] Exploratory expenditures correspond to investigatory expenditures, consisting of expenditures for the purpose of ascertaining the existence, location, extent of quality of ore and mineral deposits. I.R.C. §§ 616, 617. Developmental expenditures correspond to pre-operating expenses and agricultural developmental expenditures because after the mine reaches the "producing" or full operating stage similar expenditures such as the costs of shafts, tunnels, etc. required to maintain the output of the mine are currently deductible. Alexander & Grant, Mine Development and Exploration Expenditures, 8 TAX. L. REV., 401, 403, 409 (1953) [hereinafter cited as Alexander & Grant]. Prior to the Revenue Act of 1951, both exploration and development expenditures had to be capitalized. Id. at 403. Thereafter both could be deducted subject to complex recapture or recoupment and limitation rules applicable to exploratory expenditures. See I.R.C. of 1939 § 23(ff); I.R.C. §§ 615, 617. Developmental expenditures, also described as operating expenses, S. REP. NO. 91-552, 91st Cong., 1st Sess. 188 (1969), have also been deductible since 1951 without limitation or recapture. I.R.C. of 1939 § 23(cc); I.R.C. § 616. The parallel between development costs and R&D was noticed early on. Alexander & Grant, supra at 409.

[27] 345 F.2d 901 (4th Cir. 1965), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965).


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of the Congressional enactment of Section 174.\textsuperscript{29} It concluded that the above-quoted comments by Representative Camp could not set aside such "settled interpretation" of trade or business as used in section 174.\textsuperscript{30} Similarly, the Tax Court in \textit{Koons} had read the Committee Reports relating to section 162 as manifesting approval of this doctrine.\textsuperscript{31}

The legislative history to section 162 relied upon by the court in \textit{Koons} establishes that in fact the 1954 Code concept of a trade or business did not differ from the 1939 Code concept.\textsuperscript{32} Surveying the relevant business expense cases decided prior to the 1954 Code reveals that none of them relied upon the taxpayer's failure to hold himself out to others as a seller, nor had they established any going trade or business test which would preclude deduction of pre-operating expenses.\textsuperscript{33} Indeed, virtually none of these decisions, including the landmark \textit{Morton Frank} decision,\textsuperscript{34} involved pre-operating expenses, but rather dealt only with investigatory expenses incurred prior to a firm decision to enter into a particular business.\textsuperscript{35} A possible exception, \textit{Mid-State Products Co.},\textsuperscript{36} involving, in

\textsuperscript{29} 482 F.2d 1029, 1031 (6th Cir. 1973).

\textsuperscript{30} \textit{Id.} at 1032. Strangely, the Sixth Circuit did not mention the remarks of Representative Reed, Chairman of the Ways and Means Committee, who also noted the (discriminatory) tax preference given to "large and well-established competitors" as to deduction of R & D in his presentation of the 1954 Code to the House. \textit{100 Cong. Rec.} 3425 (1954). The taxpayer cited both the 1951 and 1954 legislative history to the Court. Brief for Appellant at 33, \textit{Snow v. Comm'r}, 482 F.2d 1029 (6th Cir. 1973).

The point is brought out very clearly in the comments of Senator Millikin in introducing the 1954 Code to the Senate, \textit{100 Cong. Rec.} 8998 (1954):

\begin{quote}
Many large businesses with regular research and experimental budgets have as a practical matter been able to secure the current deduction of most of these expenses. Many small businesses, however, which have not been able to afford a large regular budget for research have been at a disadvantage because of uncertainties concerning the deductibility of their expenditures. . . . The bill corrects this impediment by providing a definite option for the taxpayer to deduct such expenses or to capitalize them and write them off over a period of not less than 5 years.
\end{quote}


\textsuperscript{33} \textit{See}, e.g., \textit{Mid-State Prods. Co.}, 21 T.C. 696 (1954) (promulgated on February 15) \textit{acquiesced in}, 1955-2 C.B. 7; Dwight A. Ward, 20 T.C. 332, 343-44 (1953), \textit{acquiesced in}, 1956-1 C.B. 6; \textit{aff'd}, 224 F.2d 547 (9th Cir. 1955); \textit{Morton Frank}, 20 T.C. 511 (1953); George C. Westervelt, 8 T.C. 1248, 1254 (1947); Robert S. Seese, 7 T.C. 925, 927 (1946); James M. Osborn, 3 T.C. 603, 605 (1944); Benjamin Miggins, 8 TCM 82 (1949).

\textsuperscript{34} 20 T.C. 511 (1953).

\textsuperscript{35} \textit{See} Fleischer, \textit{The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment}, 14 TAX L. REV. 567 (1959) [hereinafter cited as Fleischer].

\textsuperscript{36} 21 T.C. 696, 714-17 (1954) (decided on February 15, 1945). This decision could be classified as both an investigatory and pre-operating expense decision. Investigation for expansion into a related manufacturing venture began halfway through taxpayer's fiscal year ending November 30. Around September 15 after an option on another production facility lapsed, taxpayer acquired a lease and began remodeling. Production contracts and special war-time permits were acquired by the middle of Octo-
part, pre-operating expenditures as well as investigatory expenditures, was handed down three weeks prior to the publication of the House Report on the 1954 Code. Mid-State Product rested on Goodell-Pratt Co.'s theory that expenses which were intended to increase earning power must be capitalized and not on the theory based upon a failure to hold one's self out as a seller. Significantly, Goodell-Pratt was also relied upon by most of the pre-1954 R & D decisions which section 174 was intended to overrule.\textsuperscript{37} Frank, too, has been analyzed by subsequent decisions as being based upon this reasoning.\textsuperscript{38} In short, the Sixth Circuit would have Congress in 1954 intending to incorporate into section 174 a theory under section 162 that was simply not present or "settled" in the then-existing cases. The court's error was no doubt induced in part by the case-law use of the term "preparatory expenses" to describe both business investigation expenses and pre-operating expenses. Clarity would have been attained more easily had the term "preparatory expenses" been limited to investigatory expenditures and pre-operating costs been categorized as "development expenditures."

What then was the Congressional intent in incorporating a trade or business requirement into section 174? It is submitted that Congress only contemplated imposition of profit motive and continuity requirements—that the R & D activities must be carried on with an expectation of economic return as an end product of the R & D,\textsuperscript{39} and that the taxpayer must devote a substantial portion of his time to the activities or there must have been extensive or repeated activity over a substantial period of time. Production began in December with the first deliveries in January. The taxpayer initially charged the expenditures at issue (consisting of salaries, travel expenses, telephone, office supplies, etc.) to a "deferred development and pre-operating expense account," and capitalized them. The Tax Court disallowed the taxpayer's later attempts to deduct the expenses, which it agreed were usually currently deductible on the grounds that they increased the taxpayer's earning capacity by setting up a new business and because the costs were "more nearly comparable to the costs of surveys preliminary to the organization of any business corporation or venture" and hence were preliminary to entry into the new business. 21 T.C. 714, 716-17. It is submitted that at least under the rationale of York v. Comm'r, 261 F.2d 421 (6th Cir. 1958), the expenses were deductible as ordinary and necessary to the existing, related business. The increase in earning capacity rationale is criticized at note 53 infra.\textsuperscript{37} See, e.g., Hart-Bartlett-Sturtevant Grain Co., 12 T.C. 760, 766 (1949), aff'd, 182 F.2d 153 (8th Cir. 1950); Hazeltine Corp., 32 B.T.A. 110, 122 (1935), aff'd, 89 F.2d 513 (3d Cir. 1937); John F. Canning, 29 B.T.A. 99, 107 (1933), acquiesced in, XII-1 C.B. 3; Forest Prods. Chem. Co., 27 B.T.A. 638, 641 (1933), acquiesced in, XII-1 C.B. 5, aff'd, Dec. 18, 1954 (6th Cir.).

\textsuperscript{38} See, e.g., Robert J. Wallendal, 31 T.C. 1249, 1251 (1959); Miron Kroyt, 20 TCM 1655, 1668 (1961).

\textsuperscript{39} See, e.g., Mayrath v. Comm'r, 357 F.2d 209, 212 (5th Cir. 1966); William Tiffin Downs, 49 T.C. 533, 540 (1968), acquiesced in, 1968-2 C.B. 2; Industrial Research Prods., Inc., 40 T.C. 578, 590 (1963), acquiesced in, 1966-1 C.B. 2; Eugene J. Magee, 52 TCM 1277 (1973); Johan A. Louw, 30 TCM 1421 (1971); Nicholas A. Dodich, 30 TCM 248 (1971); Joe H. Cunningham, 27 TCM 1219 (1968); Myron E. Cherry, 26 TCM 557, 560 (1967); Charles R. Rhoades, 23 TCM 2056 (1964); Charles H. Schafer, 23 TCM 927 (1964); Ervin G. Bailey, 22 TCM 1255 (1963).

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time.\textsuperscript{40} As the Fifth Circuit noted in \textit{Stanton v. Commissioner},\textsuperscript{41} Congress was probably attempting to correlate the tax treatment of the cost of producing a given type of income with the tax character of the income produced.\textsuperscript{42} In short, it did not want a taxpayer to take a current ordinary deduction for his R & D expenditures under section 174 and then later rely on the arguments frequently made under the 1939 Code, \textit{i.e.}, that any gain on the sale of his invention or process produced by the R & D was entitled to capital gains treatment because his development of the property was a hobby\textsuperscript{43} or that his activities were sufficiently sporadic so that he did not hold the property for sale to customers in the course of a trade or business.\textsuperscript{44} In none of the significant 1939 Code cases did the inventors seeking capital gains treatment rely upon a failure to hold one’s self out as providing goods or services.\textsuperscript{45}

With the exception of \textit{Koons}, which introduced under section 174 the concept of expenses preparatory to engaging in a trade or business, and \textit{Snow}, which turned solely on a failure to hold one’s self out as providing goods or services, all of the noteworthy section 174 and related section 162 cases decided adversely to the taxpayer could have been decided on a profit motive or a continuity basis.\textsuperscript{46} In fact most were decided on such bases, at least in the alternative. Moreover, a recent Tax Court opinion explains both \textit{Koons} and \textit{Mayrath}, the landmark Tax Court R & D decisions prior to \textit{Snow}, as resting on a continuity theory,\textsuperscript{47} which was the usual determinative factor in the pre-1954 Code capital gains cases.\textsuperscript{48}

According to the statement of the Commissioner of Internal Revenue to the Joint Committee on Internal Revenue Taxation on April 4, 1952,
the Service at that time permitted large research laboratories and businesses with continuing R & D programs to expense R & D on the theory that over a period of years the expensing of numerous projects would "not appear to create a materially different tax result from the capitalization of all such items and the later allowance of deductions for abandoned or worthless projects . . . and the allowance of depreciation on successful ones . . ." 49 Materially different tax results would obtain, however, when small or beginning businesses first begin to deduct R & D expenses of a single project, and in such circumstances the Service was apparently hesitant to allow the deduction of R & D expenses. For as Representative Reed, Chairman of the Ways and Means Committee, pointed out in addressing the House during consideration of the 1954 Code:

\[V\]ery often, under present law, small businesses which are developing new products and do not have established research departments are not allowed to deduct these expenses despite the fact that their large and well-established competitors can obtain the deduction. . . . [Section 174] will be particularly valuable to small and growing businesses.50

Currently, deductions are permitted under section 174 for R & D which in itself does not constitute a "going business" where a corporation is seeking to develop a new product unrelated to its past line of products. Thus, expenses of a continuing R & D program of a large business, or of any established business, come within section 174.51 Consequently, the Snow decision resurrects the discrimination against beginning businesses that section 174 was in large part intended to prevent.

The above discussion establishes that at the time of the Congressional enactment of section 174 cases had not yet "settled" whether the preparatory to engaging in a business concept applied to pre-operating expenses as well as business investigation expenses, nor had they justified that concept on the argument that a taxpayer had to hold himself out as a seller to be engaged in trade or business. Thus, neither the opinion of the Tax Court nor the appellate decision in Snow were founded upon

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49 Address by Commissioner Dunlap, supra note 10.
51 In Best Universal Lock Co., 45 T.C. 1, 9-10 (1965), acquiesced in, 1966-2 C.B. 4, the Court held that the corporate taxpayer had a continuing history of experimentation and efforts to develop new products and these projects were an integral part of its trade or business, so that section 174 covered its R & D expenses in developing a new product unrelated to its past line of products. Cf. York v. Comm'r, 261 F.2d 421 (4th Cir. 1958). Rev. Rul. 71-162, 1971-1 C.B. 97, does not appear, however, to limit the availability of section 174 as to development of new products or processes unrelated to current product lines or manufacturing processes to corporate taxpayers with established research departments, as was the case in Best Universal Lock.
any pre-1954 construction of the phrase trade or business, despite the claims of the Sixth Circuit. In any event, such an approach to statutory construction seems too narrow. If the post-1954 developments under section 162 properly deny trade or business status to a pre-operating venture because it has no goods or services to sell, then the same restrictions are likely to be applied to section 174 regardless of Congress’ intent in 1954. Otherwise, the meaning of terms taken from one statutory provision and incorporated into another would be forever frozen as of the time of incorporation.\(^{62}\) It is submitted, however, that a lack of a current product or service to offer should not preclude attainment of trade or business status under either section 162 or 174. Furthermore, the other justifications raised from time to time in the cases to support the application of the preparatory doctrine to pre-operating expenses are equally invalid.\(^{63}\)

\(^{62}\) Certainly judicial construction of statutes “demands, on occasions, the projection of their expressed purpose to situations not precisely in the minds of those who enacted them.” Warren R. Miller, Sr., 51 T.C. 755, 761 (1969). Freezing “trade or business” in section 174 as of 1954 is hardly consistent with this principle. Nevertheless, incorporation of a statutory phrase into another provision “calls for practical and sensible interpretation in fitting the provisions of the adopted statute into the scheme of the adopting one.” Id. A strong argument may be made that incorporation of the preparatory doctrine with its discrimination between businesses with existing research departments and beginning businesses and its remedy of capitalization is not consistent with the purposes of section 174. In essence, although not articulated in these terms, this was the principal argument made by the taxpayer in Snow to the Sixth Circuit and raised in the application for certiorari. The taxpayer conceded that the “preparatory” versus “existing” test was logical and proper in terms of the “ordinary and necessary” requirement of section 162, but asserted that it was illogical as applied to R & D under section 174, which presupposes a product which is not yet in a marketable condition. Brief for Appellant at 39-40, Snow v. Comm’r, 482 F.2d 1029 (6th Cir. 1973). cert. granted, 94 S. Ct. 846 (Jan. 7, 1974) (No. 73-641); Petition for a Writ of Certiorari, at 10-11. In his reply brief, the taxpayer refined his argument, maintaining that the holding one’s self out doctrine was derived from the verb “to carry on” which was not used in section 174. Reply Brief for Appellant at 4, Snow v. Comm’r, 482 F.2d 1029 (6th Cir. 1973), cert. granted, 94 S. Ct. 846 (Jan. 7, 1974) (No. 73-641); accord, Petition for a Writ, supra.

\(^{63}\) The other major rationale is that pre-operating expenses must be capitalized because they increase future earning power and thereby provide benefits to future years. Mid-State Prods. Co., 21 T.C. 696, 714 (1954). This reasoning is contradicted by the advertising cases, see notes 159-64 infra and accompanying text, and its conceptual basis was fatally eroded by the Supreme Court’s rejection in Comm’r v. Lincoln Savings & Loan Ass’n, 403 U.S. 345, 354 (1971), of the “future benefit” definition of capital expenditures. The Government’s frequent reliance on absence of gross receipts, Brief for Respondent at 35, Edwin A. Snow, 58 T.C. 585 (1972); Brief for Appellant at 12, Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965) [hereinafter cited as Brief for Appellant, Richmond Television] is negated by the authorities cited in note 100, infra. A few preparatory decisions have capitalized pre-opening expenses on the ground that they are an integral part of the total cost of such assets. See, e.g., Herbert Shainberg, 33 T.C. 241 (1959), acquiesced in, 1960-1 C.B. 5. But where such expenses, if incurred after the venture is in full flower, would be deductible, deductibility during the developmental period should be allowed. D. Joseph St. Germain, 18 TCM 335 (1959); cf. Suckow Borax Mines Consol., Inc., 12 TCM 786 (1958); Dixie Frosted Foods, 6 TCM 586 (1947). See generally Ellentuck, Tax Aspects of Organizing and Operating Hotels and Motels, 29 N.Y.U. INST. ON FED. TAX 887, 900 (1971) [hereinafter cited as Ellentuck].
PREPARATORY TO ENGAGING IN A TRADE OR BUSINESS

The status of pre-operating activities was litigated in the late 1920's and early 1930's under the net operating loss provisions of the early Revenue Acts. These provisions required that in order for a loss carry forward to be deductible against business income it must result from the "operation of a trade or business regularly carried on by the taxpayer." The Board of Tax Appeals held in *Harrisburg Hospital, Inc.* that a taxpayer which constructed a hospital during the two tax years in which losses arose and did not receive income until the completion of construction in the following year, was not actually engaged in carrying on a trade or business, but was merely making preparations to do so. The Board followed *Harrisburg Hospital* in cases where a taxpayer during the loss years had been constructing an office building that was not ready for occupancy until the following year, and where a taxpayer acquired land and prepared for subdivision and marketing but made no sales before the close of the loss year. The Board also followed *Harrisburg Hospital* in determining that the development stage of a mine prior to producing status did not constitute a trade or business regularly carried on. Only the office building decision, *379 Madison Avenue, Inc.*, was appealed. The Second Circuit there reversed the Board of Tax Appeals on the grounds that the corporate taxpayer, by improving real estate, negotiating leases, and incurring ground rents, interest and taxes, was regularly carrying on its business for which it was chartered, even though that business was not yet at full flower.

After this brief flurry, the next significant development, not considering *Deputy v. DuPont,* was the Supreme Court's decision in *McDonald v. Commissioner.* In *McDonald,* the Court denied deductibility of campaign expenses of a state court judge serving an interim appointment who was seeking election for a full term, on the grounds that they

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54 Revenue Act of 1921, § 204(a), 42 Stat. 227. See I.R.C. of 1939, § 122(d)(5); Revenue Act of 1939, § 211(b), 53 Stat. 862.
55 15 B.T.A. 1014, 1018 (1929).
56 379 Madison Avenue, Inc., 23 B.T.A. 29, 44 (1931), rev'd, 60 F.2d 68 (2d Cir. 1932).
59 379 Madison Avenue, Inc. v. Comm'r, 60 F.2d 68, 69 (2d Cir. 1932).
60 Id. However, the precedential value of 379 Madison Avenue may have been eroded by Higgins v. Comm'r, 312 U.S. 212 (1941), for 379 Madison Avenue relied upon decisions such as Flint v. Stone Tracy Company, 220 U.S. 107 (1911), dealing with whether certain corporations came within provisions levying an excise tax on corporations "carrying on or doing business." Higgins held, however, that such cases were not controlling as to whether the taxpayer, an individual, was carrying on a business under the predecessor to section 162. Nevertheless, it is quite possible that the distinction lies between individual and corporate taxpayers, with Flint v. Stone Tracy possessing continuing vitality as to corporate taxpayers under section 162.
61 See note 28 supra.
62 325 U.S. 57 (1944).
were not "incurred in being a judge but in trying to be a judge for the next ten years." Therefore, the Court concluded, the expenses were not incurred in his business of judging. The Supreme Court also relied heavily, however, upon the powerful considerations of public policy involved in permitting the deductibility of campaign expenses for public office. Some, but not many, of the subsequent decisions on activities preparatory to engaging in a trade or business read the above quotation from McDonald as supporting the conclusion that expenses incurred in preparation for entering a trade or business were not deductible, i.e., they apparently read the Supreme Court as reasoning that until elected to a full term, McDonald was not engaged in the business of being a judge, and thus, the campaign expenses were incurred in preparation of such business. In so doing, they overlooked the preceding sentence: "He could, that is, deduct all expenses that related to the discharge of his functions as a judge." In short, the taxpayer in McDonald was engaged in the business of being a judge, but the campaign expenses were not ordinary and necessary expenses of that business since they had no relation to the performance of judicial duties. Most of the campaign expense progeny of McDonald either relied upon that rationale, public policy, or the theory that campaign expenses were personal. Indeed, it has been noted that the McDonald briefs framed the issue in terms of public policy. Thus, McDonald properly should have no impact upon either the investigatory or pre-operating expense issues.

The first investigatory expense decision was the 1947 Tax Court opinion in George C. Westervelt. That case denied the taxpayer any deduction for traveling expenses incurred on trips to collect data, investigate lands and cattle breeding methods, seek a foundation herd, and acquire bulls. The court, without citing McDonald or the prior net operating loss decisions, held that the taxpayer was not yet engaged in carrying on a cattle business. "The trips were preparatory to entering

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63 Id. at 60.
66 See note 62 supra, at 60.
68 See Maness v. United States, 237 F. Supp. 918, 919 (M.D. Fla. 1965), aff'd on other grounds, 357 F.2d 357 (5th Cir. 1966); Horace E. Nichols, 60 T.C. 236 (1973).
69 See Mays v. Bowers, 201 F.2d 401, 403 (4th Cir. 1953).
70 James B. Carey, 56 T.C. 477, 488 n.2 (1971) (dissenting opinion).
the cattle business." Westervelt was followed in 1953 by several "preparatory" decisions decided before the House proposals for the 1954 Code, all of which involved investigatory expenses. The same was true of the frequently cited preparatory expenses cases, such as Frank B. Polachek and Henry G. Owen, decided later in 1954. The only rationale offered in any of these opinions, other than the mere conclusion that the expenses were in preparation for a potential business, was that they were incurred in order to maintain or acquire an asset that would produce future income and, hence, were capital expenditures. Moreover, this was the reasoning of Mid-State Products Co., the only decision during this period which applied the preparatory expense doctrine to the pre-operating expenses of a taxpayer who had made a firm decision to enter a business which was not yet productive. As pointed out in the prior discussion, in view of the then existing state of the law, Congress could not possibly have intended in 1954 to incorporate into the term "trade or business" a well-settled pre-operating expense doctrine which turned on whether the taxpayer was yet holding himself out to others as providing goods or services.

For the rest of the decade, with minor exceptions, the preparatory concept was judicially applied only to investigatory expenditures and expenses of seeking a new job. Then, in the early sixties, the doctrine began to be raised frequently in two areas where the taxpayer's activities had progressed beyond the investigatory stage: farm or hobby loss decisions and R & D cases. The courts at first did not appear aware that there was any distinction between investigatory and pre-operating expenses, but, particularly in the farm loss area, articulated the rationale

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72 8 T.C. at 1254.
73 Dwight A. Ward, 20 T.C. 332, 343 (1953), aff'd, 224 F.2d 547 (9th Cir. 1955); Morton Frank, 20 T.C. 511, 514 (1955).
74 22 T.C. 858, 863 (1954) (taxpayer merely had plans for a potential business; the plans never materialized and were still in a formative stage when abandoned). See Allan Cunningham, 22 T.C. 906, 911 (1954).
75 23 T.C. 377, 381 (1954) (expenses preparatory to resumption of business and, therefore, foundation for future income); accord, Raymond L. Collier, 13 TCM 857 (1954) (overruled by Primuth).
76 Henry G. Owen, 23 T.C. 377, 381 (1954); accord, James M. Osborne, 3 T.C. 603, 605 (1944). See Frederick A. Purdy, 12 T.C. 888, 893 (1949). The Tax Court in Robert S. Seese, 7 T.C. 925, 927 (1946), described as preparatory certain clearly personal expenses, which it disallowed as such. Cf. Vincent W. Eckel, 33 TCM 147, 155 (1974). Indeed, one commentator has suggested that many of the investigatory expense decisions are explainable as a reaction to deductions claimed for dubious expenses. Note, Investigation Costs: An Analysis and a Proposal, 41 TEMPLE L. Q. 81 (1967).
78 Cohn v. United States, 57-1 USTC ¶ 9457 (W.D. Tenn. 1957), aff'd on other grounds, 259 F.2d 371 (6th Cir. 1958) (relied upon erroneous definition of capital expenditure as non-recurring).
that preparatory expenditures constituted capital expenditures because 
"[t]hey were analogous to the amassing of the capital assets such as 
the plant and machinery of a manufacturing business, preparatory to the 
actual beginning of business operations." 81 Against this background the 
Fourth Circuit decided the landmark pre-operating expense decision, 
*Richmond Television Corporation v. United States*, 82 over 10 years after 
the enactment of the 1954 Code.

At issue in that case was the deductibility of the costs incurred prior 
to receipt of an FCC license in training a staff to operate a television 
station. The Government argued on brief that the expenditures had to be 
capitalized because (a) they created a reservoir of skills necessary for 
television broadcasting that would extend beyond the year paid, and 
(b) they would contribute to the production of income over a number of 
years so that charging them off against the income of a single year 
would result in a gross distortion of that year's income. 83 The taxpayer 
countered with the argument that there is no legal requirement that 
expenditures must produce income in the year that they are incurred. In 
addition, it raised the pre-operating expense issue itself by challenging the 
Government to produce a case or ruling that denied the deduction of 
start-up costs. 84 The Fourth Circuit, while holding in the alternative, as 
the Government had argued, that the expenditures were capital because 
they constituted the cost of acquiring an asset benefiting the taxpayer 
for more than one year, took up that challenge. It stated that the precise 
question was the deductibility of "pre-opening" expenses incurred 
between the decision to establish a business and the actual beginning of 
business operations (although in fact this had not been the "precise 
question" argued by the Government). 85 Noting that there was little

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81 Edwin H. Miner, 21 TCM 1173, 1177 (1962). This analysis has been expressly 
rejected, however, by subsequent decisions due to the "special" farm tax accounting 
rules. See Maple v. Comm'r, 440 F.2d 1055, 1056 (9th Cir. 1971); Whitman v. 
82 345 F.2d 901, 905-07 (4th Cir.), vacated and remanded per curiam on other 
grounds, 382 U.S. 68 (1965).
83 Brief for Appellant at 11-12, Richmond Television Corp., supra note 53. The 
Government did not rely upon any preparatory argument. See Solomon, *Tax Treatment 
of Pre-opening Expenses*, 46 TAXES 521, 523 n.12 (1968), [hereinafter cited as 
Solomon].
84 Brief for Appellee at 9, 13, Richmond Television Corp. v. United States, 345 F.2d 
901 (4th Cir. 1965).
85 The Government had stated the questions as follows: "1. Whether the sums 
expended in training prospective employees of a television station prior to the station's 
receipt of a construction permit and broadcast license are capital expenditures. 2. 
Whether, for tax purposes, the useful life of a television broadcast license issued by 
the Federal Communications Commission is of indefinite duration." Brief for Appellant 
at 2, Richmond Television, *supra* note 53. Similarly, the Solicitor General, in arguing 
against the grant of certiorari, focused on the capital expenditure argument and referred 
merely in passing and then in only two sentences to the pre-operating expense holding 
of the court below. Memorandum for the United States in Opposition, at 3, Richmond 
Television Corp. v. United States, 382 U.S. 68 (1965). Moreover, on remand, the
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discussion in the case law as to when, in point of time, a trade or business begins, the court turned to (a) one of the transitional investigatory pre-operating expense decisions,\(^{86}\) (b) a number of cases dealing with acquisition of a television broadcasting license, only one of which, \textit{Petersburg Television Corp.}, involved when a business began, while the others turned on whether expenditures incurred in connection with procurement of an FCC television license were capital expenditures,\(^{87}\) and (c) \textit{Cohn v. United States} a pre-operating expense decision, which rested in part on an erroneous definition of capital expenditures.\(^{88}\) The Fourth Circuit summarized its survey with the following frequently cited statement:

The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into business and over a considerable period of time spent money in preparation for entering that business, he still has not "engaged in carrying on any trade or business" within the intention of section 162(a) until such time as the business has begun to function as a going concern and performed those activities for which it was organized.\(^{89}\)

Without debating the accuracy of the survey, it may be noted that \textit{Richmond Television} was one of the first preparatory decisions to refer to the \textit{Deputy v. DuPont} definition of trade or business as "holding one's self out to others as engaged in the selling of goods or services."\(^{90}\) In addition, the Fourth Circuit appears to have deliberately ignored the reliance by both the taxpayer and the district court below\(^{91}\) upon Treasury Regulation section 1.248-1(a)(3), which provides that a corporation is deemed to have begun business as soon as its activities have advanced to the extent necessary to establish the nature of its business operations.\(^{92}\)

\(^{86}\) Frank B. Polachek, 22 T.C. 858 (1954). \textit{Polachek} is transitional in that while the taxpayer was planning a new business investment advisory service, which was never formally organized, his solicitation of potential initial clients was similar to the solicitation he would have carried on after the business became productive.


\(^{88}\) 57-1 USTC \(\#9457\) (W.D. Tenn. 1957), \textit{aff'd on other grounds}, 259 F.2d 371 (6th Cir. 1958). \textit{See note} 78 supra.


\(^{90}\) 308 U.S. 498, 499 (1940).

\(^{91}\) Brief for Appellee at 15, Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965); Richmond Television Corp. v. United States, 66-2 USTC \(\#9589\) (E.D. Va. 1963).

\(^{92}\) See also Treas. Reg. \S 1.1371-1(c)(2)(ii).

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The major developments in the preparatory doctrine after Richmond Television have been many:

(1) Employees have come to be regarded as being engaged in a trade or business that is broader than their particular job. The result is that an employee's expenses of investigating a job or position similar to the one currently or recently held are deductible on the ground that they are incidental to his existing trade or business rather than being preparatory to entering a new job. This concept may also be seen in the 1967 shift in the educational expense regulations. There the Treasury has abandoned the former "new position" nondeductibility test in favor of narrowing the nondeductible category of education expenses to those which would lead to qualification of the taxpayer for a new trade or business.

(2) A trade or business status may continue during a hiatus, so that expenses of resuming it are not nondeductible pre-operating expenses.

(3) The deduction of investigatory and pre-operating expenditures has been permitted where they can be viewed as related to another trade or business. For instance, section 174 authorities permit deduction of R & D expenditures connected with any trade or business (and not just one relating to invention activities).

(4) The pre-operating expense concept of Richmond Television has been rejected in more recent farm loss cases.

(5) Recent decisions have begun increasingly to rely upon the holding one's self out rationale as the foundation for the pre-operating expense doctrine.


95 See, e.g., Harold Haft, 40 T.C. 1, 6 (1963). The same principle is at work in the net operating loss authorities holding that a temporary suspension of a corporation's business does not of itself constitute a failure to carry on substantially the same business. Treas. Reg. § 1.382(d)-1(n)(6) example 2; Glover Packing Co. v. United States, 328 F.2d 342, 348 (Ct. Cl. 1964); cf. Penton v. United States, 259 F.2d 536 (6th Cir. 1958). See generally Lee, Functional Divisions and Other Corporate Separations Under Section 355 After Rafferty, 27 Tax L. Rev. 453, 470 n.66 (1972). The hiatus situation has occurred most frequently in the context of educational expenses. See Furner v. Comm'r, 393 F.2d 292 (7th Cir. 1968); John C. Ford, 56 T.C. 1300, 1304 (1971), aff'd 73-2 USTC ¶ 9798 (9th Cir. 1973). See generally Note, Investigatory Expenses, supra note 93, at 1170-71.


97 See note 81 supra.

developments are the most significant, but a broad brush decision by the Supreme Court on basis of the meaning of the term "trade or business" could have a ripple effect upon all of these trends as well as the over sixty Code provisions utilizing some form of the term. The relationship to another trade or business aspect is discussed below in Trade or Business Status of a Limited Partner.

In the farm loss area, the Government has attempted to apply a pre-operating expense doctrine under the rationale that, in developing his agricultural commodities, the taxpayer is amassing capital assets preparatory to entering the farming business. Recent farm loss decisions have rejected this approach. They reason that under the special farm tax accounting rules, farmers can elect to deduct currently development expenditures (which resemble start-up or pre-operating costs in other industries, since they are incurred before the farmer has a farm commodity available for sale, but manifest "ordinary" characteristics since they constitute the type of expenditures that must be deducted currently once the farm is in full operation), despite their similarity to capital expenditures in that they may be viewed as part of the process of acquiring, i.e., growing, a capital asset or asset used in the farmer's trade or business. Therefore, any pre-operating expense doctrine based upon an amassing of capital assets or increase in earning capacity directly conflicted with the theory permitting deduction of development expenditures. Similarly, it may be argued that pre-operating R & D expenditures can not be capitalized under any preparatory to engaging in a trade or business concept that is founded on an amassing of capital assets or increase in earning power rationale. For this was the precise rationale espoused by the decisions that section 174 was designed to overrule.

In short, where special tax accounting rules permit optional deduction of capital expenditures, a taxpayer should not be forced to capitalize them

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284 (1972) (Bruce, J., decided Snow in Tax Court); C. Fink Fisher, 50 T.C. 164, 171 (1968) (Featherston, J., decided Kennedy); Myron E. Cherry, 26 TCM 557, 560 (1967). Many district court farm loss decisions illustrate the term "trade or business" by declaring that a taxpayer engaged in a trade or business generally holds himself out as selling either goods or services. Hicks v. United States, 72-1 USTC § 9383 (S.D. Miss. 1972); Cavender v. United States, 71-2 USTC § 9723 (S.D. W.Va. 1971). This broad definition has been described as "inadequate in resolving the variety of factual situations which have faced the courts." Martin C. McGowan, 23 TCM 1459, 1442 (1964), aff'd, 347 F.2d 728 (7th Cir. 1965).


100 Maple v. Comm'r, 440 F.2d 1055, 1056-57 (9th Cir. 1971); Herbert D. Wiener, 58 T.C. 81, 88 (1972); Estate of Richard R. Wilbur, 43 T.C. 322, 327-28 (1964). See also United States v. Catto, 284 U.S. 102, 106 (1966).

101 See note 37 infra.

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on the theory that they are capital expenditures, even if that theory is dressed up as a preparatory doctrine. If that doctrine is to be applied to pre-operating R & D expenditures, it must be justified on some other rationale, such as a requirement that a trade or business does not commence until the taxpayer has goods or services available for sale. And if that requirement is erroneous, then application of a preparatory to engaging in a trade or business concept to pre-operating R & D expenditures is erroneous as well.

The genesis of the definition of trade or business as involving "holding one’s self out to others as engaged in the selling of goods or services" is a concurring opinion of Mr. Justice Frankfurter in Deputy v. DuPont. There, however, the Supreme Court was engaged in distinguishing between trade or business expenditures and investment or "non-business" expenditures later made deductible under the predecessor to section 212. For example, an investor in securities, in managing his own investments, does not provide services to another; services are rendered or goods are sold only through the business activities of the corporation, a separate tax entity, whose securities the investor holds. Thus he is at the end of the investment economic chain and neither creates a market nor provides services to another. Accordingly, it is significant that Mr. Justice Frankfurter preceded his "holding out" definition with the observation that active concern over one’s financial interest, i.e., investments, did not constitute a trade or business. By way of contrast, the pre-operating enterprise ultimately will hold itself out as providing goods or services. Indeed, there is no inherent reason why a taxpayer should not satisfy Mr. Justice Frankfurter’s definition if he has a present intent to hold himself out at some future date when goods will be ready for sale.

The alternatives in the tax treatment of pre-operating expenses are current deduction or capitalization. Yet the original "holding one’s self out" doctrine as promulgated in Deputy v. DuPont was not intended to make this distinction but was intended instead to distinguish between expenses which were deductible under the predecessor to section 162 and those which, prior to the enactment of the predecessor to section 212, were simply nondeductible. As the oft-cited decision of the Second Circuit in Trent v. Commissioner points out:

102 302 U.S. 488, 499 (1940) (Frankfurter, J., concurring opinion).
103 See Lee, "Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business, 25 Tax Lawyer 317, 323 (1972) [hereinafter cited as Lee, "Active Conduct"].
105 Section 1.513-1(b) of the regulations, which declares that it is following the meaning of "trade or business" under section 162, states that generally the term "includes any activity carried on for the production of income from the sale of goods or performance of services." A production of income purpose does not normally require current income. Treas. Reg. § 1.513-1(b). Cf. Treas. Reg. § 1.212-1(b).
Throughout the Internal Revenue Code there runs a distinction between those expenses and losses incident to the endeavor to earn a livelihood by "holding one's self out to others as engaged in the selling of goods or services," Deputy v. DuPont, 1940, 308 U.S. 488, 499, 60 S. Ct. 363, 369, 84 L. Ed. 416 (concurring opinion of Mr. Justice Frankfurter), those incident to other activities that are pecuniarily motivated, Higgins v. C.I.R., 1941, 312 U.S. 212, 61 S. Ct. 475, 85 L. Ed. 783, and those incident to activities that are not. Deductions of the first class are usually allowed fully, some of the second and third only under limitations, and some, especially of the third class, not at all. 106

In short, the "holding one's self out" definition was intended to distinguish between a trade or business and investment activities, and not to determine when a trade or business had commenced. Following Deputy v. DuPont faithfully, the taxpayer in the pre-operating enterprise, who as yet has no products to offer, incurs his "ordinary" expenses for the production of income (section 212 does not require current income). 107 Assuming, as most commentators do, that a corporation's trade or business encompasses investment activities, 108 the only areas in which the failure to hold one's self out would ever be determinative as to deductibility of pre-operating expenses, if a valid prerequisite, are those provisions which only incorporate the trade or business standard of section 162, but not the production of income criterion of section 212, and, then, only as to individuals. The inconsistency in permitting a corporation to deduct its pre-operating R & D expenses while preclud-

106 291 F.2d 669, 670-71 (2d Cir. 1961).
107 Treas. Reg. § 1.212-1(b); Rev. Rul. 74-28, 1974-1 I.R.B. 7. See S. Rep. No. 1631, 77th Cong, 2d Sess., 87 (1942). Morton Frank, 20 T.C. 511, 514 (1953), disallowed investigating expense claimed in the alternative under the predecessor to section 212 on the grounds that "[t]here is a basic distinction between allowing deductions for the expense of producing or collecting income, in which one has an existent interest or right, and expenses incurred in an attempt to obtain income by the creation of some new interest." This "existing interest" rule has been severely criticized. See Fleischer, supra note 35, at 581-84. But in any event, the taxpayer, once he has made the firm decision to enter a new business and taken steps towards that goal, has the requisite existing interest in his pre-operating business so that section 212 is applicable. Moreover, any other rule would leave a taxpayer in the non-business, non-deductibility limbo that section 212 was designed to fill. Finally, the Tax Court recently allowed a deduction for a would-be author's preparatory expenses under section 212 while denying that the taxpayer was yet engaged in the trade or business of being an author. Marian B. S. Crymes, 31 TCM 4 (1972).

108 See Bittker & Stone, Federal Income Estate and Gift Taxation 232 (4th ed. 1972); Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders § 5.03, n.8 (3d ed. 1971): "During the 1942 hearings on § 212, a taxpayer representative recommended its enlargement to include corporations. The recommendation was not adopted, probably because it was thought to be unnecessary. At any rate, it has been generally assumed since 1942 that a corporation can deduct under § 162(a) any expenses that could be deducted under § 212 by an individual. . . ." But cf. Richmond Television Corp. v. United States, 345 F.2d 901, 908 (4th Cir. 1965), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965) (section 212 inapplicable to corporations).

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ing an individual in similar circumstances from deducting his R & D expenses, although under section 212 he could deduct "ordinary" or non-capital pre-operating expenses such as advertising, illustrates the absurdity of basing the test for determining when a business commences on the moment that the taxpayer first has products or services ready to sell.

To require a taxpayer to hold himself out to others as selling goods or services, particularly when inventing activities are involved, is to require in many instances an economic return to be produced currently. If the taxpayer must have a commercially acceptable invention to offer, he must of necessity have completed his research and experimentation before he has entered into the trade or business at issue. Yet in the hobby loss area, in which the issue of whether a taxpayer is engaged in a trade or business has arisen most frequently, the cases commonly have not expressly required the taxpayer to hold himself out to others as currently selling goods or services, to have a product ready for sale, or to produce an immediate economic return. Furthermore, in the context of section 174, "experimental activity often shows little, if any, return during developmental stages. It was to encourage this kind of activity that Congress authorized the current deduction of research and experimental expenditures." In summary, the "holding one's self out to others" rationale is not a supportable basis for the pre-operating expense doctrine, nor are the other justifications raised from time to time in the cases.

The Solicitor General, in his memorandum in opposition to the petition for a writ of certiorari in Snow, asserted, as had the Commissioner in the Tax Court below, that the partnership "which had no plant, no separate office or facility, no telephone and no marketing activity during the year in question, did not meet the accepted definition of a 'trade or

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109 See, e.g., Mercer v. Comm'r, 376 F.2d 708 (9th Cir. 1967); Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1968) (no sales of cattle during developmental period); DuBose v. Ross, 66-2 USTC ¶ 9672 (N.D. Ga. 1966) (in growing timber no receipts until pine trees reach a certain stage of development); Harold M. Clark, 28 TCM 1260 (1969) (no successful crop of Oregon Myrtle bushes in three successive years, no gross income); D. Joseph St. Germain, 18 TCM 355 (1959) (tree farm, no sales until maturity). Moreover, several decisions treat a failure to hold one's self out as selling goods and services as merely a factor which, standing alone, might not negative any intention to engage in a business activity for profit. Joseph v. Curran, 29 TCM 696 (1970); see also American Properties, Inc., 28 T.C. 1100, 1112 (1957), aff'd per curiam, 262 F.2d 150 (9th Cir. 1958); James E. Ashe, 26 TCM 791, 795 (1967).


112 See note 53 supra.
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The Service frequently has pointed to similar facts in asserting that a corporation was not engaged in an active trade or business.\(^{113}\) The uniform judicial response has been that a business may be conducted through agents and the crucial question is whether the taxpayer bears the economic risk of the activity.\(^{115}\) In 1966, the partnership in Snow paid for 500 hours of management services performed largely by its 50 percent general partner (who also had a 34 percent interest as a limited partner). In addition the partnership paid for substantial R & D services performed by a corporation that carried on machining and fabrication shopwork.\(^{116}\) Thus, the partnership was engaged in a trade or business under the above standard, through the activities of its agents who performed the R & D on its behalf. Furthermore, the regulations apply section 174 to R & D carried out on behalf of the taxpayer by a research institute, foundation, engineering company, or similar contractor.\(^{117}\) Consequently, affirmation by the Supreme Court on this ground could provoke a flood of litigation under provisions such as sections 61, 355, 482 and 921(a), where existing case law attributes business activities of an agent to his principal.

Since Deputy v. DuPont does not, and was never intended to, provide guidelines as to when a trade or business commences, but only as to whether business or investment activities are involved, guidance must be sought elsewhere. Numerous provisions in the regulations state that a corporation commences its business as soon as its activities have advanced to the extent necessary to establish the nature of its business operations, e.g., acquisition of the necessary operating assets.\(^{118}\) Thus,


\(^{114}\) Hanson v. United States, 338 F. Supp. 602, 610 (D. Mont. 1971) (section 355 active business test is met despite absence of telephone, separate business address, and advertising; was not held out to third persons as a separate entity); American Savings Bank, 56 T.C. 828, 839 (1971) (similar facts not dispositive where business conducted through agents).

\(^{115}\) See, e.g., Frank v. Int'l Canadian Corp., 308 F.2d 520 (9th Cir. 1962) (section 921(2)); United States Gypsum Co. v. United States, 304 F. Supp. 627 (N.D. Ill. 1969), rev'd on other grounds, 452 F.2d 445 (7th Cir. 1971) (section 921(2)); American Savings Bank, 56 T.C. 828, 839 (1971) (section 61); Barber-Greene Americas, Inc., 35 T.C. 365, 387-88 (1960). See generally Lee, "Active Conduct", supra note 103, at 330-31. Thus, the Commissioner's argument that ["t]he only activity which can be characterized as 'business' was the action taken by Burns to have Crossbow, Inc. perform the research and development work on the incinerator concept," misses the mark. Brief for Respondent at 34-35, Edwin A. Snow, 58 T.C. 585 (1971).

\(^{116}\) 58 T.C. at 590-91.

\(^{117}\) Treas. Reg. § 1.174-2(a)(2).

\(^{118}\) E.g., Treas. Reg. §§ 1.248-1(a)(3) and 1.1371-1(c)(2)(ii). See Mandell, Deductibility of Pre-Operating Expenses: Successful and Unsuccessful Ventures, 25 N.Y.U. Inst. on Fed. Tax. 1235, 1235-36, 1246 (1967) [hereinafter cited as Mandell]; Note, Investigatory Expenses, supra note 93, at 1164 n.28. This objective
the conduct of a restaurant business can commence in the taxable year in which construction of the restaurant facility is undertaken or when real property is purchased or leased for such use.\footnote{119} While the Service has ruled that investigatory expenses in search of a campsite for a proprietary boys' camp, and promotional expenses incurred prior to signing the lease, were preparatory capital expenditures,\footnote{120} it has also ruled (possibly under the rationale that a firm decision had already been made) that developmental planning, negotiating for financing, and readying of property for construction constitutes being engaged in the active conduct of a trade or business.\footnote{121} The Solicitor General argued in opposition to the granting of a writ of certiorari in \textit{Snow} that "[t]he term 'trade or business' has a single meaning in all sections of the Code."\footnote{122} Logically then, the point in time when a business commences should be determined from the same factors under all sections of the Code. The regulations consistently look at the objective facts which establish the character of the business and not at whether the corporate taxpayer holds itself out to others as currently providing goods or services. These factors, therefore, should be followed in all Code sections in which the term "trade or business" appears. Under these authorities, the partnership's inventing business in \textit{Snow} had commenced in 1966. Furthermore, the Tax Court stated that the R & D expenditures were profit-motivated,\footnote{123} and the facts manifest sufficient continuity by the identification approach is closely paralleled by the "commitment to the business venture" trend in the transaction entered into for profit area, discussed in Wilberding, \textit{supra} note 16. The first explicit judicial consideration given to Treas. Reg. § 1.248-1(a) (3) subsequent to the opinion in \textit{Richmond Television} was in an individual hobby loss case, Justin A. McNamara, 32 TCM 11, 16 (1973), where the taxpayer unjustifiably relied upon the regulation as relevant to profit motive and the court broadly dismissed its relevance as to whether an individual has commenced a trade or business assuming that the prerequisites of profit motive and continuity are met.

\footnote{119}Treas. Reg. §§ 1.955-5(a) (3) and 1.1372-4(b) (5) (ii) (b).
\footnote{121}Rev. Rul. 72-220, 1972-1 C.B. 365.
\footnote{122}Brief for Respondent in Opposition to Petition for a Writ of Certiorari at 3, \textit{Snow} v. Comm'r, 482 F.2d 1029 (6th Cir. 1973), cert. granted, 94 S. Ct. 846 (Jan. 7, 1974) (No. 73-641). The taxpayer pointed out to the Sixth Circuit that, in the legislative history of section 513, the provision relied upon for that statement [Cooper Tire & Rubber Co. Employees' Retirement Fund v. Comm'r, 36 T.C. 96 (1961), aff'd per curiam, 306 F.2d 20 (6th Cir. 1962)], specifically referred to section 162 for the content of the term 'trade or business.' Reply Brief for Appellant at 5-6, \textit{Snow} v. Comm'r, 482 F.2d 1029 (6th Cir. 1973).
\footnote{123}The headnote in \textit{Edwin A. Snow}, which is usually prepared by the Tax Court judge who decides the case, states that each of the three limited partnerships was formed to carry on R & D upon a particular invention "with a view to profit." Prior to 1970 a corporation was organized to produce and market the leaf burner invention of Burns. 58 T.C. at 591. Neither the Tax Court nor the Sixth Circuit opinion discloses whether the invention was licensed by the partnership to the corporation or transferred to it in a tax-free exchange. If the latter, and the taxpayer had always intended an incorporation of the invention when perfected (to deflect ordinary income to a lower-bracket taxpayer), he would have had no intent to realize a direct profit from operation of the invention. However, profit for this purpose encompasses unrealized appreciation

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partnership through its agent to satisfy the traditional trade or business criteria. It is well established that sustained and profit-motivated inventive activities constitute a trade or business, separate and apart from the business of commercially exploiting an invention. In short, the partnership was engaged in the trade or business of inventing with which the claimed R & D expenses were connected.

TRADE OR BUSINESS STATUS OF A LIMITED PARTNER

The taxpayer in Snow argued in the Tax Court that he actively participated in the R & D and overall management of all three partnerships and (a) that as a member of such partnerships, he held developed products for sale or licensing, and (b) by virtue of his participation in such partnerships, he was engaged in the business of developing and obtaining patents on new products for commercial exploitation. The Tax Court acknowledged that an individual may be engaged in a business by being a partner in such business, but it apparently concluded that the first two partnerships had not progressed into a trade or business status because there were no sales or evidence of efforts to sell (but cf. Treas. Reg. § 1.183-2(b)(4)), and presumably the value of the stock in the new corporation would reflect the value of the invention, and, if in excess of the taxpayer's R & D write-offs, would satisfy the profit-motive test under sections 162, 212 and 183. Yet if the taxpayer's intention had always been to ultimately possess valuable appreciated stock in a corporation owning the leaf burner invention, the Service could have argued that the claimed R & D expenditure constituted the "acquisition cost" of such stock and therefore a capital expenditure. Cf. George L. Schultz, 50 T.C. 688, 697-98 (1969), aff'd, 420 F.2d 890 (3d Cir. 1970). See generally Allington, Farming as a Tax Shelter, 11 S.D. L. REV. 181, 202-05 (1969); Young, The Role of Motive in Evaluating Tax Sheltered Investments, 22 Tax Lawyer 275, 283-84 (1968).

In Cleophus L. Kennedy, 32 TCM 53, 55 (1973). Judge Featherston similarly reasoned that a shareholder's "pre-opening expenditures were incurred in creating a business which would ultimately produce income taxable to Riverside [his subsequently formed corporation] after incorporation. These expenditures, therefore, should be treated as contributions to the capital of Riverside and reflected in the basis of the corporation's stock." Assuming that this is a valid approach, the Court would have to remand Snow to determine whether the taxpayer (and possibly a majority in interest of the other partners as well) had an intent from the beginning to incorporate, so that it may be reasoned that he incurred the R & D expenditures to acquire the stock. On the one hand, it is clear that the taxpayer or the limited partnership had sophisticated advance tax planning, e.g., in practical effect there was a special allocation of the R & D deductions to the "moneymen" limited partners since initial losses were allocated according to contributed cash capital with a charge back of income, see Treas. Reg. § 1.704-1(b)(2) (example 5). Thus, the taxpayer, a four percent limited partner, was allocated 25 percent of the R & D deductions in 1966, 58 T.C. at 590-91. On the other hand, the taxpayer was only a four percent limited partner. The general partner who had an 81 percent interest in the partnership, probably had the determinative say on such matters.

124 Johan A. Louw, 30 TCM 1421 (1971); accord, Eugene J. Magee, 32 TCM 1277 (1973).

their inventions in 1966.\textsuperscript{126} The Sixth Circuit, on the other hand, shifted ground and concluded that the taxpayer's management and advisory activities as to the three partnerships were not sufficiently continuous or regular to constitute carrying on a trade or business.\textsuperscript{127} It further relied upon \textit{Whipple v. Commissioner} \textsuperscript{128} as precluding the taxpayer from being engaged in a trade or business as an investor in inventions.

The shortcomings in the Sixth Circuit's reasoning are numerous. Under its equation of "holding one's self out" with "having a product to offer," the first two partnerships were probably engaged in the trade or business of developing inventions. Some decisions hold that a partner, including a limited partner, is engaged in the trade or business of his partnership because its activities are carried out on his behalf, and, therefore, imputed to him.\textsuperscript{129} This principle would distinguish \textit{Whipple}, which in essence rests on the doctrine that a corporation and its shareholders are distinct tax entities and a shareholder is not engaged in the trade or business of his corporation. The Tax Court so held in \textit{A. L. Stanchfield}.\textsuperscript{130} Thus, the taxpayer was arguably engaged in the invention business carried on by the first two partnerships. Furthermore, R & D expenditures for a new product, such as the trash burner developed by the third partnership, may be deducted as incurred in connection with the trade or business of developing other inventions or products. Consequently, the taxpayer's argument that he individually was engaged in a trade or business deserved better consideration than the Sixth Circuit's \textit{Whipple} analysis.

This line of argument does, however, raise two further significant issues: (1) is a partnership's trade or business status imputed to the partners, or does partnership profit or loss merely maintain the same trade or business status for tax return purposes in the partner's hands as it had in the hands of the partnership, and (2) assuming that a partner has obtained trade or business status either through attribution from another partnership, or independently through his own individual activi-

\begin{enumerate}
\item \textsuperscript{126} 58 T.C. 585, 596 (1972). The Tax Court apparently ignored its own finding that in 1966 the products of the other two partnerships had been developed to the stage of being ready for sale, that the partners hoped to license some manufacturers to build and market them, and that a patent on one of the products was filed in 1966. \textit{Id.} at 588. Furthermore, the Government did not disallow the 1966 R & D expenses of the other two partnerships. \textit{Id.} at 592.
\item \textsuperscript{127} 482 F.2d 1029, 1033 (1973).
\item \textsuperscript{128} 373 U.S. 193 (1963).
\item \textsuperscript{130} 24 TCM 1681 (1965). See generally Lee, "Active Conduct," \textit{supra} note 103, at 323.
\end{enumerate}
ties, does this status affect the character of his distributive share of partnership income or loss which, in the hands of his partnership or in the hands of another partner, would not be incurred or earned in a trade or business? The answers to these two inquiries have consequences in contexts other than section 174. For example, a question has currently been raised whether profit motive for purposes of section 183 is determined at the partnership or partner level. If the former, would a partner's motive override that of his partnership? Commentators have also frequently discussed whether a taxpayer who is a dealer, for example, in real estate may obtain capital gains treatment for a sale by a non-dealer partnership in which he is a partner. These issues in essence turn on the competing "entity" and "aggregate" theories of partnership taxation, which the Supreme Court recently declined to address in Basye.

The question is usually stated as whether character of income is to be determined at the partnership or partner level. Section 702(b) provides that the character of income or loss included in a partner's distributive share of such income or loss which he reports separately in his individual return shall be determined "as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." Unfortunately, this ambiguous language does not meet the source of the problem; namely, whether for this purpose, the partnership is to be treated as an "entity" or an "aggregate" of individual partners. If the former, character would be determined at the partnership level and continue into the individual partner's hands under the transmission or "conduit" approach of section 702(b). If the latter, character would be determined as if the partner realized the item directly, apart from the partnership. While the "aggregate" theory is also referred to as the "conduit" approach, use of the latter term is confusing since it also refers to the transmission of the taxpaying obligation to the individual partners. Thus, to say as the Supreme Court recently did in United States v. Basye that "partnerships are entities for purposes of calculating and filing informational returns, but that they are conduits through which the taxing obligation passes to the individual partners in

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131 See, e.g., Prospectus, DLJ PROPERTIES/73, 46 (Oct. 18, 1973) ("Although the Internal Revenue has never indicated that section 183 is applicable to limited partners, it is conceivable that it may take such a position notwithstanding any 'profit objective' which the partnership may be deemed to have"). Cf. Valentine Howell. 41 T.C. 13, 17, 19 (1963) aff'd, 332 F.2d 428 (3d Cir. 1964).


134 Wolfman, supra note 132, at 289-92.

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accord with their distributive shares" does not signify at which level character of income or trade or business status is to be determined.

As noted above, a hypothetical often posed by commentators is that of a real estate dealer who is a partner in a partnership that would qualify for capital gains treatment if character were determined solely at the partnership level. Under the entity theory, the partner would have capital gain; but under the aggregate theory, he has ordinary income. The legislative history to section 702(b) is somewhat contradictory, but on the whole, appears to adopt an aggregate approach. The General Explanation in the Committee reports takes the entity approach, stating that "items required to be segregated will retain their original character in the hands of the partner as though they were realized directly by him from the same source from which realized by the partnership and in the same manner." The Technical Explanation, on the other hand, seems to take an aggregate approach, stating that "[s]ubsection (b) contains a 'conduit' rule which makes clear that the character of any item realized by the partnership and included in a partner's distributive share shall be the same as though he had realized such item directly, rather than through his membership in a partnership, from the source from which it was realized by the partnership and in the same manner." Counterbalancing this expression of the Congressional intent is the fact that section 702(a) speaks of the partner's distributive share of "the partnership's" various items of gain or loss, and subsection (b) refers to the character of the items listed in subsection (a). A partnership could have items of gain or loss only under an entity theory.

The regulations seem to determine character at the partnership level, with such income or loss retaining the same character in the hands of the partner. Moreover, on occasion the Service has expressly announced that character of an item of income or loss is determined at the

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135 410 U.S. 441, 448 n.8 (1973). In text accompanying the footnote, the Court explained that:

[While the partnership itself pays no taxes, 26 U.S.C. § 701, it must report the income it generates and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay a tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed.


139 Anderson & Coffee, supra note 136, at 291; Wolfman, supra note 132, at 291.

140 Treas. Reg. § 1.702-1(b).
partnership level, and in litigation has argued for that result where a partner, if realizing a gain directly, would be entitled to capital gains treatment. But it appears that the Government argues for the aggregate theory as well, where to do so is to its temporary advantage. This may well be part of the reason why the matter was still being discussed in 1972 before the Supreme Court in Basye. A number of recent decisions, relying upon language in section 702(a) referring to the "partnership's" gains or losses, have determined character of income at the partnership level, where the partnership was a dealer in the property sold but the taxpayer partner was not and the issue was whether to allow the partner capital gains treatment.

Under the entity approach, in order for the taxpayer in Snow to deduct his distributive share of the R & D incurred by the third partnership on its trash burner, the partnership would have to be engaged in the trade or business of inventing in 1966. Under the aggregate theory by itself, the taxpayer would probably not be able to deduct the R & D since both the Tax Court and the Sixth Circuit held that his individual activities did not qualify as a trade or business. While the Government has usually argued for the entity approach to section 702(b), it may advocate before the Supreme Court in Snow adoption of an aggregate approach. The Solicitor General's memorandum in opposition to the petition for a writ of certiorari in Snow raised the following arguments:

During the year in question, the partnership, in which petitioner was merely an investor, was not holding itself out to others as engaged in the selling of goods and services.

... Thus, the aim of section 174 was to equalize the treatment of small business vis-a-vis large businesses and not, as petitioner asserts (Pet. 9-12), to extend the deduction to mere investors who cannot meet the "trade or business" qualification.

The description of investor hardly fits the partnership, and as applied to the limited partner, is relevant only under an aggregate approach. The Government's Brief in the Sixth Circuit manifests that its investment intent argument rests on determination of trade or business status at the partner level. The Commissioner asserted there that the vehicle of a partnership "permitted the limited partners to engage in private investments while strictly limiting their liability, thus avoiding the risks cus-
tomarily attendant to trade or business activities.” Thus, the Government was implicitly arguing for the aggregate approach.

Many decisions under the 1939 and 1954 Codes impute partnership business activities to the partners, including limited partners, so that they are engaged in the same business as their partnership. The rationale is that a partnership acts only on behalf of the partners, and that trade or business activities of an agent are imputed to his principal in determining the latter’s business. The Advisory Group on Subchapter K viewed the imputation doctrine as a corollary to the aggregate approach, stating in 1957 that:

Although the character of the income items is to be determined at the partner level, account must be taken of the fact that the partnership is acting for the partners and thus that they are engaged in whatever business the partnership is. Thus, where there is a sale of property being used in a trade or business at the level of the partnership . . . the partnership character of any gain from such a sale would be attributed to the partners since they individually would be considered as engaged in the partnership business.

Under the aggregate-imputation approach it could be argued that the taxpayer in Snow was engaged in the business of inventing through imputation from the first two limited partnerships, which had inventions ready to offer for licensing or sale in 1966, and thus his distributive share of the third partnership’s R & D losses would be deductible by him under the aggregate approach to section 702(b). While the Tax Court held in George A. Butler that a limited partner was engaged in the trade or business conducted by his partnership, a commentator has concluded that Butler would not seem to support a rule that a partner is always engaged in the trade or business of his partnership. Since the imputation concept is not derived directly from section 702, but is based upon the principle that a taxpayer may conduct a business solely through activities of an agent, whether a partner is engaged in the business of his partnership should be resolved on the basis of analogy to principles of agency law. If a partner, general or limited, exercises sufficient con-
control over the partnership, or has such authority that it acts as his agent, then the partnership business activities should be imputed to the partner in determining whether he is engaged in the trade or business conducted by the partnership. The reported facts do not disclose whether the taxpayer in Snow exercised such control over the first two partnerships or had the right to do so. Furthermore, his interests in these two partnerships appear to have been only that of a trustee.

It is submitted that the "entity" approach should apply here, and that the imputation theory is inconsistent with the entity approach. Viewing the partnership as a separate entity with character of income determined at the partnership level and under the conduit approach such character together with the tax liability being transmitted to the partner, the trade or business of the partnership should not be imputed to the partner, just as a corporation's business as a separate entity is not imputed to its shareholders. Under this approach, the Sixth Circuit's reliance upon Hippie was not erroneous, but there is no indication that the appellate court was even aware of the entity versus aggregate issue. Should the aggregate approach prevail, however, as to characterization of income under section 704, then the imputation doctrine should apply as well. For if a partnership is only an aggregate of individuals for this purpose, it in effect acts only on their behalf and is their agent. Therefore, determining trade or business status at the partner level, the premise of the Commissioner's investment arguments in Snow, requires consideration of the imputation theory as well. Only the Supreme Court or Congress can now resolve whether the "entity" or "aggregate" approach is to apply here. The legislative history, a slight majority of commentators, and the imputation cases militate towards the aggregate approach. But the language of section 702(a) and the recent decisions relying on that language hold for an entity approach. The Government has blown both hot and cold for the entity approach, albeit heretofore usually hot.

**TAX SHELTER MOTIVE**

The Sixth Circuit in Snow noted that the taxpayer had income in 1966 in excess of $200,000, so that his investment in the partnership was made as a high bracket taxpayer. It then concluded that two laudable public purposes were therefore in direct conflict: (1) stimulation of R & D by inventors and small businessmen, and (2) "the desirability of strict interpretation of tax laws so as to prevent unintended tax shelters." As shown in the preceding sections, not just strict, but erroneous interpretation as well of section 174 is necessary to support the

154 482 F.2d 1031.

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result reached in Snow. The Government's arguments to the Fourth Circuit in Richmond Telel'iJion were more explicit. There it asserted that the expenses at issue were not expected to produce income in the years incurred and that to charge them off (through net operating loss deductions) against the income of a single year would result in a gross distortion of that year's income.

The Fourth Circuit accepted this argument as the basis for its alternative capitalization holding. The Government did not seem bothered by the fact that capitalization of pre-operating expenses frequently results, as was the case in Richmond Telel'iJion, in equal distortion of income. There, deduction or amortization of such capitalized expenditure was deferred indefinitely, and in many instances capitalized start-up costs would be amortized at best over a long duration unrelated to the period in which they produced income.

It appears clear from Richmond Telel'iJion and Snow that the desire to match deductions with related future expected income underlies the Government's attack on pre-operating or start-up costs. The goal appears laudable: a tax shelter deduction, or "accelerated deduction" in the terminology of the Administration's 1973 proposals for tax reform, consists of "a deduction which clearly relates to some future expected profit and has little or no relation to income reported in the current year." But there is currently no overt tax principle that requires a matching of related income and deductions, and the remedy of capitaliza-

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155 Brief for Appellant at 13, Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965).

156 Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.), vacated and remanded per curiam on other grounds, 382 U.S. 68 (1965).

157 The same policy apparently underlies recent threatened application of the "profit motive" test to tax shelters. See Remarks by the Honorable Donald C. Alexander, 27 TAX LAWYER 173 (1974). Indeed, the Service often asserts alternative preparatory and hobby loss contentions. See, e.g., Edwin H. Miner, 21 TCM 1173 (1962).

158 Administration's Proposals for Tax Change with Treasury Explanation 96-97 (1973) [hereinafter cited as Proposals for Tax Change]. Technically, the Limitation on Artificial Accounting Loss ("LAL") proposals define an "accelerated deduction" as a deduction relating to future expected profit, but unrelated to current income. An "artificial accounting loss" is defined as the amount by which accelerated deductions exceed "associated net related income" for the taxable year, computed without regard to the accelerated deductions. Id. at 97. Since accelerated deductions are allowed up to the amount of net related income, the latter becomes a pivotal term. Feinschreiber, 1973 Tax Reform: The Administration's Proposals, 51 TAXES 398, 399 (1973). In disfavored tax shelters it is limited to income from the particular investment or business property that is generating the accelerated deduction. For instance, related income for non-residential or commercial real estate includes only the rental income from the particular property to which the accelerated deductions, such as accelerated depreciation, are attributable. Proposals for Tax Change, supra at 99. On the other hand in favored tax shelters such as residential real estate or oil and gas drilling, related income includes rental income from all residential real estate and mineral income from oil and gas properties, respectively. Id. at 98-99. The device by which accelerated deductions are matched with their related income is the Deferred Loss Account ("DLA"). An artificial accounting loss, or accelerated deduction in excess of net related income, is deferred by adding it to the DLA, to be taken as a deduction (and subtracted from the DLA) against the first net related income in subsequent tax years or to be taken into account upon a sale or other disposition of the property. Id. at 97. This differs from
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The tax treatment of advertising expenditures perhaps best illustrates that income and deductions need not be matched under current law. "[C]urrent deductibility has normally been permitted for advertising expenditures and for educational expenditures to improve one's skills utilized in existing employment, even though there were indications that some general benefit would in all probability last beyond the year of expenditure." 159 Early decisions held that advertising and promotional expenditures could not be charged to future years either as deferred charges, or by amortization of capital investment, where the taxpayer failed to show that the future benefits could be determined precisely and were not of indefinite duration.160 Subsequent cases concluded that since advertising expenses could not be capitalized in such circumstances and spread over future years, they were properly deducted currently. 161

Recently the Tax Court in Briacliff Candy Corp.162 turned back to the earlier authority, ignoring the intervening development, to hold that advertising expenditures which would ordinarily be currently deducted must be capitalized when made for the cultivation or development of future business. This has been the usual rationale under which the Government has sought to capitalize start-up costs. The Second Circuit reversed the Tax Court, reasoning that under the Supreme Court's decision in Commissioner v. Lincoln Savings and Loan Ass'n, 163 the presence of benefits which will be realized in future years is not controlling; "many expenses concededly deductible have prospective effect beyond the taxable year." 164

The inappropriateness of capitalization of start-up costs may be seen in Richmond Television, where the taxpayer was permanently deprived of capitalization in that the deduction is not taken ratably over the life of the asset producing the accelerated deduction, but is instead deferred completely until net income is generated and then offsets such income in full. The closer analogue would be the net operating loss carryover under section 172(b)(1)(B), without the five year limitation.


162 31 TCM 171, 176 (1972), rev'd, 475 F.2d 775 (2d Cir. 1973).

163 403 U.S. 345 (1971).

164 475 F.2d 775, 782 (2d Cir. 1973). The Second Circuit also scored the Tax Court decision for its unjust and unequal interpretation of the law in permitting retail-

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of the benefits of using such costs in its annual tax equation because they were added to the basis of its FCC television license which lacked a reasonably ascertainable useful life. Thus it was left only with an increased cost basis, usable when and if ultimately disposed of the business or lost the license. Similarly, taxpayers are frequently forced to add start-up costs to their stock basis in the corporation which ultimately operates the business. Distortion of income can arise as well when pre-operating expenses connected with an apartment project, such as advertising for initial tenants and management expenses during this period, are capitalized since they would probably be spread over the useful life of the apartment buildings.

In addition to the lack of a sound conceptual framework for capitalization of pre-operating expenses and the inappropriateness of capitalization itself to match income and expenses, attacking tax shelters through pre-operating expense glosses on the term "trade or business" can only lead to disturbing and probably unintended side effects throughout the tax law in all of the areas noted previously in which preparatory contents have surfaced in the past: job-seeking expenses, educational expenses, farm losses, start-up costs, R & D expenditures, and
ters to deduct advertising and promotional expenses, but denying similar tax treatment to a wholesaler whose customers are retailers. A similar case of discriminatory tax treatment between established and beginning businesses would arise under Snow.

See Richmond Television Corp. v. United States, 334 F.2d 410 (4th Cir. 1965). Surely the majority of those employees trained in 1952 through 1956 were not still employed in 1974, but at the date of this writing Richmond Television Corporation still has its FCC license and broadcasts without being permitted to amortize or deduct one cent of its employee training expense incurred twenty years ago. Frequently, "preparatory" or investigatory expenses are attributable to assets without limited lives and hence cannot be amortized. Mandell, supra note 118, at 1238.

Cf. Herbert Shainberg, 33 T.C. 232 (1955), acquiesced in, 1956-1 C.B. 6; aff'd, 224 F.2d 547 (9th Cir. 1955); Roy L. Harding, 29 TCM 789 (1970). See generally Comment, The Deductibility of Pre-Incorporation Expenses, 20 CATH. U. L. REV. 463 (1970). The inequity of such increase in basis has been judicially noted. See Davee v. United States, 444 F.2d 557, 568 (Ct. Cl. 1971); Cleophus L. Kennedy, 32 TCM 52, 55 (1973), which noted that some pre-opening expenditures were for assets which subsequently formed corporation could depreciate.

See note 93 supra.

See note 94 supra.

See note 91 supra.
the active business requirement of section 355.\textsuperscript{172} The effect of a narrow definition by the Supreme Court in Snow of "trade or business," excluding a pre-operating business could be enormous in these areas, some of which have only recently arrived at new resolutions of the preparatory to engaging in a trade or business arguments of the Government.

It is clear that section 174 was in part intended to help small businesses without established research departments, but it may be argued that such intent would not extend to instances where there is no business at all except for the R & D. In such circumstances, allowance of a current deduction under section 174 permits a taxpayer to shelter unrelated income and thereby defer payment of income taxes on such income until some later date when the process or invention produces income that is fully taxed because deduction of the related R & D expenditures, which would otherwise offset such income, instead had been accelerated to prior years. Yet it appears that Congress contemplated that taxpayers could offset R & D expenditures against substantial income from other sources and that a temporary loss of revenue (the deferred taxes) would result. Representative Camp's comments on the ABA prototype to section 174 pointed out that

\[ \text{merely providing for deductibility of such expenditures probably would be satisfactory to most large businesses. However, a small business which has unusually large expenditures in connection with a research program, or a new or beginning business enterprise, must be allowed the right to capitalize such costs and recover them by amortization deductions over the estimated useful life, in order to insure equality of treatment with large businesses which can and usually do deduct the full amounts of such expenditures from current income. . . . } \]

\text{[It is provided that the taxpayer may designate the period over which the capitalized costs of a specific research project or undertaking shall be amortized. Any temporary loss of revenue resulting from a taxpayer's selection of an unreasonably short amortization period will ordinarily be recovered in later years when no amortization deduction will be allowable.}\textsuperscript{174}

Representative Camp appears to have visualized that large corporations would benefit principally from current deduction of R & D against unrelated income. But the interest free loan\textsuperscript{175} arising from the deferral of taxes through deducting R & D expenses against current unrelated income rather than future related income from the invention was just as valuable, for example, to the corporate taxpayer in Best Universal


\textsuperscript{174} 97 CONG. REC. A4326 (1951) (Appendix).

\textsuperscript{175} See Calkins & Updegraff, Jr., \textit{Tax Shelters}, 26 \textit{TAX LAWYER} 493, 507 (1973); Proposals for Tax Change, supra note 158, at 16, 95.
Lock Co., as it would have been to the individual taxpayer in Snow. While the Tax Court thought that the business of the corporation in Best Universal Lock Co. included experimentation and efforts to develop new products as well as manufacturing locks, the Service clearly did not so limit the decision in Revenue Ruling 71-162. If a corporation which is carrying on inventing activities that are not yet producing income can offset current unrelated income with its R & D expenditures, then an individual's or partnership's R & D activities which are profit-motivated and sufficiently regular and continuous should qualify as a "trade or business" as well so that expenditures in connection with such activities would be deductible under section 174 against unrelated income.

The narrow construction by the Tax Court and the Sixth Circuit in Snow of the term "trade or business" would make current deduction by an as yet unsuccessful bona fide full-time inventor difficult, if not impossible. Yet the legislative history to section 183, enacted in the Tax Reform Act of 1969, manifests an intent that a bona fide inventor be entitled to a current deduction even though his expectation of profit might be unreasonable. Under current section 174 the part or full-time individual inventor, the corporate inventor, and the inventing partnership with investor limited partners should all be treated equally as to offsetting R & D expenditures against unrelated income. All are equally undeserving of interest-free loans from the Government in the form of deferral of taxes. If Congress resolves to distinguish between these classes of taxpayers, it could easily do so by limiting the current deduction privilege to taxpayers with limited amounts of unrelated non-inventing income. Section 1251 constitutes a close analogy. There Congress reacted to the similar problem of use of accelerated farm deductions against non-farm income by providing for a limited recapture of otherwise capital gains farm gain as ordinary income if an individual had offset substantial amounts of farm losses against high bracket non-farm income.

Representative Camp in 1951, and presumably Congress in 1954, were not unaware of the "temporary" loss of revenue inherent in current deduction of R & D expenditures. However, Congress does not appear to have been as conscious in 1954 of the permanent loss of revenues from "loss interest" during the period taxes are deferred through "artificial accounting losses," i.e., accelerated deductions which offset current unrelated income. It is submitted that such revenue loss should be curbed

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170 45 T.C. 1, 9-10 (1965).
172 S. REP. No. 91-552, 91st Cong., 1st Sess. 103-04 (1969). See Treas. Reg. § 1.183-2(c) (example 6) (although no income yet realized, several patents obtained and extensive efforts to "market" inventions).
173 Proposals for Tax Change, note 3 supra, at 96-97.

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regardless of the class of taxpayer involved, but capitalization of pre-operating expenses, including R & D before an invention is commercially acceptable, is neither conceptually justifiable nor the appropriate means to accomplish that goal. Either an overall limitation on artificial accounting losses as proposed by the Administration in 1973 \(^\text{180}\) or a mandatory capitalization of all pre-operating expenses with the right to then amortize them over some fixed period, such as sixty months, should be enacted. Both section 174 and the current narrow section 248 amortization of corporate organizational expenses \(^\text{181}\) offer a pattern for the latter approach. Unless the Supreme Court decides to fashion a requirement that start-up costs are to be deferred until their related income is produced and are then deductible against such income as earned, which is not the same as capitalizing them, it should reverse Snow.

CONCLUSION

The demand for reform of the current treatment afforded tax shelters through limiting the deduction of accelerated deductions against unrelated income \(^\text{182}\) has been growing. Undoubtedly the tax administrators, and possibly the courts as well, are feeling the pressure to curtail such deductions within the existing tax structure. Apparently, the areas in which the Service has determined to seek such limitations are section 183, which disallows, not capitalizes, deductions claimed in an activity that is not engaged in for profit, and the preparatory stages to engaging in a trade or business concept. Section 183 is an awkward tool for this task since "profit," which excludes a mere intent to reduce taxes, encompasses a bona fide intent to achieve an ultimate economic profit in addition to tax savings. Similarly, the term "trade or business" together with the remedy of capitalization of "ordinary" pre-operating expenses are inappropriate to defer the deduction of accelerated expenses until the related income is realized. But if Congress does not act quickly with respect to accelerated deductions, the courts may be sorely tempted to use these approaches to match expenses and income, however roughly and inequitably. Unfortunately, any precedents thus created would undoubtedly

\(^{180}\) See note 158 supra.

\(^{181}\) One commentator has suggested that all corporate pre-opening expenses should be treated as organizational expenses under section 248. Carruthers, Jr., How to Treat the Expenses of Organization, Reorganization and Liquidation, 24 N.Y.U. INST. ON FED. TAX. 1055, 1062 (1966). While equitable and as a policy matter possibly the approach that should be legislatively adopted, this argument ignores the narrow definition of organizational expenditures promulgated in the regulations. See Treas. Reg. § 1.248-1(b)(2). Pre-opening expenditures might come closer to the statutory language of section 248(b), but query whether they are incident to the creation of the corporation. In any event the regulations faithfully track the Committee Print Technical Explanation. See H.R. REP. NO. 1337, 83d Cong., 2d Sess., A64 (1954).

\(^{182}\) See note 158 supra.
be extended to situations in which there was no tax shelter intent.\textsuperscript{183} Conversely, the tax collector should be aware that implementation of make-shift judicial remedies will probably lessen the pressure for true and equitable reform by Congress.

\textsuperscript{183} See Spheeris v. Comm'r, 461 F.2d 271 (7th Cir. 1972) (denial of section 355 on preparatory theory).