Federal Income Taxation: Case Notes

Thompson, Larry R.

http://hdl.handle.net/1811/69598

Downloaded from the Knowledge Bank, The Ohio State University's institutional repository

Taxpayer, Edwin Snow, was a limited partner in a venture known as the Burns Investment Company [hereinafter called Burns or the partnership]. The general partner was one Trott, with whom Snow had previously joined in other partnership arrangements involving the development and marketing of new products. According to the partnership agreement, Burns' purpose was to develop a special incinerator for trash or leaves for the consumer and industrial markets. Trott had conceived the idea for the incinerator in 1964, and between then and 1966 he constructed and tested a number of prototypes. On discussing these prototypes with counsel and others, Trott was advised that the incinerator design appeared to have a number of patentable features, but he was also told that the device had not yet demonstrated sufficient performance for it to be marketable. To obtain the funds necessary for further modification and development of the incinerator, Burns was formed in July, 1966. Snow and two others contributed the capital and Trott contributed his right, title, and interest in the incinerator.

Between July, 1966, and December 31, 1966, the partnership was engaged solely in research and development work on the incinerator. Burns reported no sales of the incinerator or of any other product during this period. Nor did the partnership attempt to sell any product or service. Its total outlay for research and experimental costs during the period was $36,780.44, which it elected to deduct for the current taxable year (1966) pursuant to § 174(a)(1) of the Internal Revenue Code of 1954 [hereinafter referred to as Code]. As a result the partnership return for 1966 showed a loss in that amount. Snow deducted his distributive share of the partnership loss ($9195.11) on his individual return pursuant to § 702(a)(9) of the Code. The Com-

1 Burns was subsequently incorporated prior to 1970 under the name of Burns Investment Corporation, which currently produces and markets the incinerator under the name "Trash-Away."

2 INT. REV. CODE OF 1954, § 174(a)(1) provides: "A taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account. The expenditures so treated shall be allowed as a deduction."

3 INT. REV. CODE OF 1954, § 702(a) provides: "In determining his income tax, each partner shall take into account separately his distributive share of the partnership's— ... (9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection."
missioner of Internal Revenue disallowed Snow's deduction and assessed a deficiency on the ground that the § 174 deduction taken by the partnership was inappropriate. Snow disputed the Commissioner's determination and pursued his claim in the Tax Court.

These facts presented to the Tax Court the question of whether the research and experimentation expenditures were paid or incurred by the partnership in connection with its trade or business. The expenditures were unquestionably research expenses, as the Commissioner conceded, but the Tax Court denied the § 174 deduction on the ground that the enterprise was not yet holding itself out to others as engaged in the selling of goods or services. Since Burns was not carrying on a trade or business in 1966, in the view of the Tax Court, the partnership's research expenditures "were not paid 'in connection with' the trade or business of the partnership."4

Thereafter, the taxpayer appealed to the United States Court of Appeals for the Sixth Circuit. The Sixth Circuit affirmed the decision of the Tax Court, characterizing the research expenditures as "pre-operating" expenses, not deductible under § 174.6 In so holding, the Sixth Circuit's construction of § 174 appeared to conflict with the result in Cleveland v. Commissioner,7 in which the Fourth Circuit had indicated that a joint venture could deduct its "pre-operating" research costs under § 174. The Supreme Court granted certiorari to resolve the apparent conflict between the circuits.8

The underlying question for the Supreme Court was the proper test to be applied in determining when, for purposes of § 174, a research or experimental expense has been paid or incurred "in connection with" a taxpayer's trade or business. In holding against Snow, the Tax Court and the Sixth Circuit had both read into § 174 a test developed under § 162,9 that to be carrying on a trade or business one had to be holding himself out to others as engaged in the selling of goods or services. However, the Fourth Circuit, in Cleveland, had implied that in light of the policy of § 174 a more liberal standard should be used.

---

5 Id. at 595.
6 Snow v. Comm'r, 482 F.2d 1029 (6th Cir. 1973). Alternatively, Snow could have capitalized the research expenditures pursuant to § 263(a)(1) and if a determinable useful life was shown, Snow would be able to amortize the expenditures over that useful life pursuant to 167(a)(2).
7 297 F.2d 169 (4th Cir. 1961).
9 INT. REV. CODE OF 1954, § 162(a) provides in part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."
In a unanimous decision, the Supreme Court, in an opinion written by Justice Douglas, reversed the Sixth Circuit's decision and allowed the taxpayer to deduct his distributive share of the partnership's 1966 research and development expenditures under § 174. In so doing, the Court established that the "holding out" test developed under § 162 for determining whether a taxpayer is "carrying on any trade or business" is not appropriate for deciding under § 174 when a taxpayer has incurred expenses "in connection with" his trade or business. This decision is significant because the Court, for purposes of § 174, declined to differentiate between established business taxpayers and taxpayers who are preparing to actively engage in business. Thus, in the aftermath of Snow, the tax consequences of research expenditures incurred by a partnership which is established in a commercial market and of like expenditures incurred by a fledgling partnership in anticipation of marketing its first product are equalized.

The phrase "trade or business" is nowhere defined in the Code or Treasury Regulations, but the terminology has appeared in § 162 and its predecessors since the enactment of the first Revenue Act. Because of this long history, there are many cases on the question of what constitutes "carrying on any trade or business" for purposes of that section. Prior to Snow, lower courts used the tests developed under § 162 to decide cases under § 174. The two principal tests used to determine the existence of a trade or business are the "profit motive" test and the "holding out" test.

Generally, personal expenses are not deductible. Thus, if a taxpayer incurs expenses in a non-business activity for his own pleasure or needs, the expenses are ordinarily not deductible. For one to take advantage of the § 162 deduction one must incur the expenses "in carrying on any trade or business." At the minimum, to be in a trade or business, the taxpayer must have a bona fide intent to earn a profit. If that intent is absent, no deduction is allowed pursuant

---

10 Mr. Justice Stewart took no part in the consideration or decision of this case.
12 INT. REV. CODE OF 1939, § 23(a); REVENUE ACTS OF 1938, 1936, 1934, 1932, 1928, § 23(a); REVENUE ACTS OF 1926, 1924, 1921, 1918, §§ 214(a)(1) and 234(a)(1); REVENUE ACT OF 1916, § 12(a), Corporations; REVENUE ACT OF 1913, § II(6)(b), Corporations.
13 Section 183(b) authorizes limited deductions for activities not engaged in for profit. See note 48 infra and accompanying text.
14 The reason for the good faith profit motive requirement is to deny a deduction for those expenses which have no relation to the generation of income. Whether the bona fide intent to earn a profit actually exists is a question for the trier of fact. Although it is essential that a taxpayer who wishes to avail himself of the benefits of § 162 truly intend to eventually make a profit, generally there is no requirement that the intention be objectively reasonable. Mercer
This test has been applied to cases arising under § 174. Individuals engaged in inventing as a hobby have been denied § 174 deductions for expenses incurred because the requisite profit motivation was lacking. In Charles H. Schafer, for example, the taxpayer, a salesman for a lumber company, became interested in developing a new type of power application for heavy earth-moving equipment. In denying a § 174 deduction for Schafer's expenses, the Tax Court stated: "There has been no profitable exploitation of inventions and any expectation of profit borders on the brink of speculation." Because the taxpayer's conduct was not consistent with his having a good faith profit motive, the taxpayer's research expenses were held to have been incurred for personal reasons and not "in connection with" a trade or business. Similarly, in Joe H. Cunningham, an electrical engineer who sold plastic signs was denied a § 174 deduction for expenses relating to the development of mathematical theories. In denying the § 174 deduction, the Tax Court found that the taxpayer's sole motivation for developing the theories was to acquire personal and professional recognition. Since the taxpayer was not motivated by a hope of earning a profit, the expenses were not incurred "in connection with his trade or business."

Under § 162, even if the requisite profit motive exists, the lower courts have used a second test to determine if one is engaged in a trade or business. This test is known as the "holding out" test. The nomenclature comes directly from Justice Frankfurter's concurring opinion in Deputy v. Dupont. Interpreting the meaning of § 23 of the Revenue Act of 1928, the predecessor of § 162 of the Internal Revenue Code of 1954, Justice Frankfurter stated: "'[C]arrying on any trade or business' . . . involves holding one's self out to others as engaged in the selling of goods or services.' Thus, if one is in the preliminary or preparatory stages of developing a business, the expenditures of such an enterprise are not deductible under § 162.


15 See, e.g., Godfrey v. Comm'r, 335 F.2d 82 (6th Cir. 1965); Wiles v. United States, 312 F.2d 574 (10th Cir. 1962); Valentine Howel, 41 T.C. 13 (1963), aff'd, 332 F.2d 428 (3d Cir. 1964); Henry P. White, 23 T.C. 90 (1954); Justin A. McNamara, P-H Tax Ct. Mem. ¶ 73,003 (1973).

17 Id. at 929.
19 308 U.S. 488, 499 (1940).
20 Id.
Prior to *Snow*, the lower courts, without using this explicit language, applied the § 162 “holding out” test to § 174 expenditures. In *John F. Koons*, the taxpayer, a promoter and financier of new enterprises, purchased an undeveloped invention and thereafter incurred laboratory expenses to perfect the invention before attempting to market it. The Tax Court denied Koons a § 174 deduction on the ground that there was no existing business to which the research expenditures were proximately related. The court in holding against the taxpayer reasoned that the trade or business concept was not intended to include all activities engaged in for profit, but was to be used in the sense of a *going* trade or business. Since the court viewed the activity as “preliminary to the coming into existence of a business . . . [t]he research and development expenditures could not be ‘in connection with’ a business which did not exist.” The Tax Court similarly denied a deduction to the taxpayer in *William S. Scull*. The § 174 expenditures involved in that case were incurred by a taxpayer paying money to a chemist under a “loose knit” arrangement. The chemist was developing a process to enhance the taste of instant coffee. Despite the fact that the taxpayer had presented samples of the processed coffee to a number of manufacturers, the court held these expenditures for the process to be preliminary to the possible formation of a business. Citing Koons, the court held that at the time the taxpayer was trying to deduct the expenses, there was not yet a going trade or business.

Prior to *Snow*, then, a taxpayer usually needed to show that he was already holding himself out as being engaged in a going concern in order to take advantage of the § 174 deduction. However, if a trade or business existed in the “holding out” sense, the expenses incurred in developing new products unrelated to the goods one was already selling were deductible under § 174. Thus, in *Best Universal Lock Co.*, a corporation engaged in the business of selling locking systems was allowed to deduct its expenditures incurred in developing an air compressor system. The court declined to limit the § 174 deduction to only those expenditures related to the existing product line of the company, reasoning that such a limitation would contravene the express purpose of § 174—“to encourage taxpayers to carry on research and experimentation.” The same reasoning was applied in the case

---

22 Id. at 1101.
25 45 T.C. at 10.
of an individual taxpayer. A taxpayer already engaged in the trade of painting was allowed a deduction for his expenses in developing a portable scaffold. Despite the fact that there was no economic return on the invention, the expenditures were found to be in connection with the taxpayer's existing business of painting.

Snow relied heavily in each court on the Fourth Circuit's decision in Cleveland v. Commissioner. In that case the taxpayer, an attorney, had loaned money to a client named Kerla, an inventor trying to develop an inorganic liquid binding material. For ten years prior to the enactment of § 174, Kerla and Cleveland had an informal agreement concerning their interests in the binder enterprise. In April, 1956, the taxpayer and Kerla entered a written trust agreement made retroactive to December 31, 1954, which delineated their interests in the venture. Pursuant to § 174, the taxpayer deducted the portion of advances made by him in 1955 and 1956 which were attributable to research expenditures. The Tax Court held that the amounts claimed were not deductible, characterizing the advances as mere loans to the inventor. The Fourth Circuit reversed the Tax Court's holding with regard to the expenditures incurred after April, 1956. Although the court did not include supportive discussion in its opinion as to why a trade or business relationship existed, the court indicated that after they entered the written agreement Cleveland and Kerla were engaged "in the trade or business of promoting the commercial development of the invention in which Cleveland was the owner of a participating one-half interest." The court also noted that the purpose of § 174 was "to encourage expenditures for research and experimentation."

Because the court failed to fully discuss the basis of its decision, an analysis of the Cleveland case is difficult. One commentator has suggested that the court may have found the relationship on one of two grounds: (1) a distinct entity (the partnership) having a profit-making intent had been created upon the execution of the agreement; or (2) Cleveland's partner, Kerla, was an inventor by profession. Nowhere in the Cleveland opinion are the § 162 "profit motive" or "holding out" tests mentioned.

This uncertainty led the Commissioner to argue in Snow that Cleveland might not be followed even by the Fourth Circuit. The

---

26 297 F.2d 169 (4th Cir. 1961).
27 34 T.C. 517 (1960).
28 297 F.2d 169, 173 (4th Cir. 1961).
29 Id.
30 Id.
Sixth Circuit found this argument especially persuasive because of the Fourth Circuit's subsequent decision in *Richmond Television Corp. v. United States.* In that case the court held that the employee training expenses incurred by a television company before it was engaged in the business of broadcasting were not deductible under § 162. The expenses were deemed preparatory to entering the business of broadcasting. Although *Richmond Television* did not deal with § 174, the Sixth Circuit thought that *Cleveland* had been implicitly overruled because the Fourth Circuit adopted the "holding out" test in *Richmond Television.* The Sixth Circuit refused to apply a different trade or business test to § 174, but used the language from *Richmond Television,* characterizing the Snow expenses as "preoperating" expenditures.

In *Snow* the Supreme Court refused to apply the § 162 "holding out" test in construing the language of § 174. Noting the difference between the phrase "in connection with [the taxpayer's] trade or business" used in § 174 and the "in carrying on any trade or business" phraseology of § 162, the Court ruled that § 174 was more broadly written than § 162. After discussing the "holding out" test and the more narrowly written language of § 162, the Court dismissed a § 162 analysis for § 174 by saying: "[That § 162 and] other sections are not helpful here . . . ." The Court held that Burns' research and experimental expenditures, incurred in anticipation of entering a trade or business, were deductible under § 174. In reaching its conclusion the Court looked to the legislative history of § 174 and the policy considerations underlying that section.

Section 174 was enacted because taxpayers incurring research expenditures were unable to take advantage of the ordinary and necessary business expense deduction of the Code. Because these expenditures are typically for the development of processes, formulae or products with a useful life of more than one year, the courts, prior to the passage of § 174, generally held the expenses to be capital in nature. Thus the only way to obtain any tax benefit was to amortize the costs over the economic or legal life of a patent (if one was obtained) or by deducting the expenses as a loss when the research

---

32 345 F.2d 901 (4th Cir. 1965).
33 482 F.2d 1029, 1032 (6th Cir. 1973).
33 See Judge Woodruff's remarks in *Hart-Bartlett-Sturtevant Grain Co. v. Comm'r,* 182 F.2d 153, 156 (8th Cir. 1950), saying that "it has been consistently held that experimental and research expenditures incurred in the development of new processes of formulae or patents are capital expenditures." See e.g., Hazeltine Corp., 32 B.T.A. 110 (1935), aff'd on this issue, 89 F.2d 513 (3d Cir. 1937); Claude Neon Lights, Inc., 35 B.T.A. 424 (1937); Gilliam Mfg. Co., 1 B.T.A. 967 (1925); Goodell-Pratt Co., 3 B.T.A. 30 (1925).
project was abandoned. If the project proved to be successful and if a determinable useful life could not be established, no tax benefit would accrue until the business was sold.

Only in the rare case were taxpayers permitted to currently deduct research expenditures rather than capitalize them. In *Universal Oil Products Co. v. Campbell*, the taxpayer was permitted to deduct seventy-five percent of his annual research costs of $1,000,000 while capitalizing the remainder. The court appeared to be influenced by the fact that nine years prior to the tax year in question, the taxpayer and the Internal Revenue Service had agreed to this formula in settling a prior tax dispute. The Internal Revenue Service before 1954 was aware of problems taxpayers faced in the research and development area. Recognizing that it was difficult to allocate specific costs to particular research projects and that if the taxpayer was engaged in ongoing research it was a common accounting practice to expense the costs, Commissioner Dunlap issued a policy statement before the Joint Committee on Internal Revenue Taxation in 1952. Dunlap declared that the policy of the Internal Revenue Service was to allow current deductions of research expenditures under the predecessor to § 162 if the taxpayer had established an accounting practice of expensing research costs. Because it was uncertain whether Dunlap's policy statement which in effect, permitted an election by the taxpayer, would be upheld by the courts, Congress enacted § 174 in an effort "to eliminate uncertainty and to encourage taxpayers to carry on research and experimentation. . . ."

In addition to the desire to resolve any uncertainty and to encourage experimentation, the legislative history reflects a third concern—that of the problems the small and growing businesses faced in this area. As the Supreme Court pointed out in *Snow*, the remarks of Congressman Reid, Chairman of the House Ways and Means Committee in 1954, reflect this concern:

---


37 Currently, procedure for treating research and experimental expenditures for accounting purposes is changing. Effective January 1, 1975, the Statement of Financial Accounting Standards promulgated by the Financial Accounting Standards Board declares that for accounting purposes there is no longer an option of capitalizing or expensing research costs, but the research and development costs must be charged to expense when incurred. A copy of this statement can be found in 138 J. ACCOUNTANCY 81 (1974).


39 Commissioner Dunlap's statement was held not to be supported by the language of the Code in *Red Star Yeast & Products Co. v. Comm'r*, 25 T.C. 321 (1955). This case was decided subsequent to the enactment of § 174 but involved tax years prior to 1954.

Research and Development Expenditures:
Present law contains no statutory provisions dealing expressly with the deduction of these expenses. The result has been confusion and uncertainty. Very oft \( \text{a} \), under present law small businesses which are developing new products and do not have established research departments are not allowed to deduct their expenses despite the fact that their large and well-established competitors can obtain the deduction. . . . This provision will greatly stimulate the search for new products and new inventions upon which future economic and military strength of our Nation depends. It will be particularly valuable to small and growing businesses.\(^4\)

Given these three considerations found in the legislative history of § 174—resolution of uncertainty for taxpayers, encouragement of research and experimentation, and the special problems of the small and growing businesses—the Supreme Court had to determine whether Congress would have allowed an enterprise preparing to enter the market to deduct its research expenditures. If the Court had focused on the evolution of § 174 from the predecessor of § 162, it could have reasonably interpreted § 174 differently. Under this analysis, since § 174 evolved from taxpayers' inability to use the ordinary and necessary business expense deduction, § 174 should be read as an expansion of § 162. It would then follow that the trade or business tests developed under § 162 should be applied. For the Court to apply this analysis, it would have been necessary to disregard the difference in phraseology between § 174 and § 162 ("in connection with" as opposed to "carrying on"), ascribing that difference to imprecise draftsmanship. Furthermore, this analysis would not altogether contravene the purpose of encouraging research expenditures, but would limit the encouragement to existing businesses meeting the § 162 "holding out" criterion. It could then be reasoned that the concern over the "small and growing" businesses expressed by Congressman Reid was directed at those small businesses which are established in the "holding out" sense. That is, so long as these growing businesses meet the § 162 criteria they would be entitled to the same deduction as the large and well-established enterprises.

However, the Court reasoned that § 174 was not merely an extension of § 162, but was subject to an independent analysis based upon its own policy considerations. It properly focused on the policy

\(^4\) 416 U.S. 500, 503-04 (1974) quoting 100 CONG. REC. 3425 (1954) (emphasis added by the Supreme Court). It is unclear from Reid's remarks whether he was concerned with a difference in the treatment of large, well-established businesses and smaller, well-established businesses or with the different treatment of established businesses and those enterprises in the pre-operating phase.
of encouraging research and experimentation by taxpayers reflected in the legislative history, saying:

We read § 174 as did the Court of Appeals for the Fourth Circuit in Cleveland 'to encourage expenditure for research and experimentation.' . . . That incentive is embedded in § 174 because of 'in connection with,' making irrelevant whether petitioners were rich or poor.42

Clearly, this policy is more strongly effectuated by allowing taxpayers to deduct research and experimental expenses incurred prior to entering the marketing stage. Viewed from this perspective, the difference in language between the two sections does have significance. That is to say, the use of the phrase "in connection with" was not a result of imprecise draftsmanship, but the result of an intent to include broader language than § 162. So read, these words reflect a purpose on the part of Congress to expand, not limit, the tax benefits of this section in order to give broader effect to the encouragement of experimentation policy. Finally, read in this light, Mr. Reid's remarks reflect a concern for small and growing but established businesses as well as the small and growing enterprises preparing to enter the market.

The Court's conclusion is especially defensible in light of considerations of "horizontal equity." As the Court aptly stated, reading the § 162 "holding out" test into § 174 "[W]ould defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market by perpetuating the discrimination created below and urged upon us here."43 Under the prior § 174 case law, an established company could deduct any research expenditure related to developing its existing products, and after Best Universal Lock Co.44 such a company could deduct expenses related to developing a new product wholly unrelated to its past product line. But the taxpayer without an established trade or business could only capitalize its research expenses, regardless of the purity of its commercial intentions in incurring those expenses. Under the Snow decision, the tax benefits with respect to research expenses of the existing enterprise and the enterprise not yet ready to market its new product are equalized. The tax laws should not force inventors to market products which have not yet been perfected. If the Court in Snow had denied the deduction, the expenses

---

43 Id. at 504.
could have been capitalized by the new enterprise, but to so decide would have revitalized the inequities reflected in Reid's remarks. That is to say, the existing business (large or small) would have been able to currently expense its research costs whereas the developing enterprise (necessarily small) would have been required to capitalize similar expenditures.

Under the *Snow* decision, research and experimental expenditures incurred in anticipation of entering a trade or business are deductible pursuant to §174. It seems reasonable to predict that the case will provide a spur to investment for research and experimental purposes. With proper planning, funds spent for research and experimental purposes by a limited or general partnership in the process of developing a product may be deducted against the investor's current ordinary income. Schemes similar to the Burns limited partnership arrangement in *Snow* will henceforth be more attractive to investors looking for tax deductions.

Although *Snow* involved a limited partnership evidenced by a detailed written agreement, there is no apparent reason to conclude that the impact of this case will be limited to this type of an arrangement. In light of the Court's expansive view of the policies underlying §174, the reasoning employed in *Snow* would appear to be equally appropriate to other types of research endeavors, whether organized as proprietorships, partnerships, corporations, or any other form of business association.

Section 174, by its terms, applies only to research and experimental expenditures. The only explanation of what constitutes a research and experimental expense is given in the Treasury Regulations under §174. There, the expenses are described as those incurred in the "laboratory or experimental sense." 45 Although examples are provided in Regulation §1.174-2(a)(1) of what is and what is not a

---

45 *Treas. Reg.* §1.174-2(a)(1) provides:

The term 'research or experimental expenditures', as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising or promotions. However, the term includes the costs of obtaining a patent such as attorneys' fees expended in making and perfecting a patent application. On the other hand, the term does not include the costs of acquiring another's patent, model, production or process, nor does it include expenditures paid or incurred for research in connection with literary, historical, or similar projects.
research expense in the "laboratory or experimental sense," controversy can be expected to arise in construing this language. Given the liberal construction of § 174 under Snow, businesses not yet meeting the § 162 "holding out" criterion can be expected to attempt to classify many of their pre-operating expenditures as research expenses. If successful, the taxpayer will obtain a current deduction and bypass the more restrictive § 162 "holding out" test.

Unanswered by the Supreme Court in Snow is exactly what trade or business standard, if any, should be applied in a § 174 analysis. While the Supreme Court dismissed the "holding out" test of § 162 as being inappropriate when applied to § 174, it failed to fashion any other standard by which future controversies can be decided. It appears that the Court did not intend to allow research and experimental expenditures incurred by any taxpayer to be deductible. The Court mentioned that its decision is intended to equalize the tax benefits of ongoing businesses and those that are upcoming and about to reach the market. Presumably, then, there is some point where a taxpayer is not yet upcoming and about to reach the market. Implicit in that language is the notion that some trade or business standard still exists and is to be applied in analyzing § 174 controversies. Because of the Court's focus on the policy of encouraging research and development expenditures it is unlikely that the Court intended to draw the line at businesses which have products close to the marketable stage. If that were the case, the research venture which proved to be unsuccessful would be denied a tax benefit. Pursuing this approach would tend to discourage rather than encourage experimentation in unexplored areas because by definition, a research endeavor into an undiscovered area has an uncertain future with respect to its potential marketability.

If a trade or business test of product marketability would contravene the purpose of § 174 as expressed by the Court, what trade or business standard is envisioned? It seems reasonable to conclude that the trade or business criterion to be used in the aftermath of Snow will be the "profit motive" test. Although such a position was argued by the amicus curiae briefs submitted on behalf of the taxpayer, the Court refused to explore this avenue because it found that a bona fide profit motive was clearly the impetus for the Burns ven-

---

46 Congress may at times in its wisdom discriminate tax-wise between various kinds of business, between old and oncoming business and the like. But we would defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market by perpetuating the discrimination created below and urged upon us here. 416 U.S. at 504 (1974) (emphasis added).
Since the "holding out" analysis and the "profit motive" test were, prior to Snow, alternative grounds to deny taxpayers research deductions incurred while in the preparatory stage, one can easily infer that by expressly discarding the "holding out" criterion in the §174 context and by failing to fashion a separate test for that section, the Court has implicitly sustained the "profit motive" test for a §174 trade or business analysis. Viewed from this perspective, the "upcoming and about to reach the market" language of the Court can be construed as relating to new ventures having an expectation of future profit. Such an approach would be in accord with the general policy of the tax law—allowing a deduction only for expenses which have some relation to the generation of income. Also, in most cases, such an interpretation would promote the policy of encouraging research by taxpayers.

If the courts accept the conclusion that the §174 trade or business determination is to be based on the "profit motive" test, they might be expected to look to the Treasury Regulations promulgated under §183 of the Code to help decide in a given case whether the requisite profit motivation exists. Section 183, a relatively recent addition to the code, applies to individuals and electing small business corporations and permits the deduction of certain expenses of activities "not engaged in for profit" in the limited circumstances delineated in §183(b). The activity "not engaged in for profit" is defined as those activities which do not qualify for deductions pursuant to §162 or §212. The regulations under §183 provide nine objective standards by which a determination as to the taxpayer's bona fide profit motivation can be made. The test under those regulations is not whether there is a reasonable expectation of profit, but whether the profit intent is genuine. The factors, none of which is conclusive, are enumerated in Treasury Regulation §1.183-2(b):

1975] CASE NOTES 187

ture. Since the "holding out" analysis and the "profit motive" test were, prior to Snow, alternative grounds to deny taxpayers research deductions incurred while in the preparatory stage, one can easily infer that by expressly discarding the "holding out" criterion in the §174 context and by failing to fashion a separate test for that section, the Court has implicitly sustained the "profit motive" test for a §174 trade or business analysis. Viewed from this perspective, the "upcoming and about to reach the market" language of the Court can be construed as relating to new ventures having an expectation of future profit. Such an approach would be in accord with the general policy of the tax law—allowing a deduction only for expenses which have some relation to the generation of income. Also, in most cases, such an interpretation would promote the policy of encouraging research by taxpayers.

If the courts accept the conclusion that the §174 trade or business determination is to be based on the "profit motive" test, they might be expected to look to the Treasury Regulations promulgated under §183 of the Code to help decide in a given case whether the requisite profit motivation exists. Section 183, a relatively recent addition to the code, applies to individuals and electing small business corporations and permits the deduction of certain expenses of activities "not engaged in for profit" in the limited circumstances delineated in §183(b). The activity "not engaged in for profit" is defined as those activities which do not qualify for deductions pursuant to §162 or §212. The regulations under §183 provide nine objective standards by which a determination as to the taxpayer's bona fide profit motivation can be made. The test under those regulations is not whether there is a reasonable expectation of profit, but whether the profit intent is genuine. The factors, none of which is conclusive, are enumerated in Treasury Regulation §1.183-2(b):

47 Id. at 504.
48 Int. Rev. Code of 1954, §183(b) provides:
In the case of an activity not engaged in for profit . . . there shall be allowed—
(1) The deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).
50 Int. Rev. Code of 1954, §183(c) provides:
For purposes of this section, the term 'activity not engaged in for profit' means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.
(1) The manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of the occasional profits, if any, which are earned; (8) the financial status of the taxpayer; (9) the elements of personal pleasure or recreation.\footnote{Analytically, there is a difficulty presented by these tests under Treas. Reg. § 1.183-2(b) and the definition of an "activity not engaged in for profit" as given in § 183(c), supra, note 50. Where a taxpayer is engaged in an activity which does meet the "profit motive" test, but which does not meet the "holding out" trade or business test of § 162, the taxpayer's activity is one other than an activity with respect to which deductions are allowable under § 162. Thus, by the definition given in § 183(c), the activity is an "activity not engaged in for profit." However, an examination of § 1.183-2(a) reveals that the taxpayer's activity is one for which there is a profit motive and therefore, an activity to which § 183 would not apply. This analytical difficulty is due to the fact that the regulation deals only with the "profit motive" test for a given activity and overlooks the other § 162 trade or business test. Pragmatically, the question is probably academic because it is unlikely that an activity which does not meet the "holding out" criterion would have any gross income from which a § 183(b) deduction could be taken.}

Assuming that the courts in analyzing claimed § 174 deductions use these nine objective tests in Regulation § 1.183-2(b), the taxpayer who "putters" in his garage as a hobby activity would be precluded from using § 174 to deduct all his research and experimental expenditures; however, he would still be entitled to the limited § 183 "hobby" expense deduction. Meanwhile, those persons incurring research expenditures who meet the objective criteria listed in that regulation would be able to demonstrate their bona fide profit intent and would thereby be allowed the full § 174 deduction irrespective of whether the "holding out" test is met. Because the requisite motivation would more easily be evidenced by a paper trail as was done in Snow, this type of analysis would be more beneficial to the formal business association than it would be to the individual inventor. Nonetheless, if the courts in the aftermath of Snow decide to use the "profit motive" analysis, the § 183 regulations would be helpful in deciding whether a § 174 deduction is justified.

Faced with the basic issue of construing the language of § 174, the Supreme Court in Snow determined that the primary intent for the enactment of that section was to encourage research and experimentation by taxpayers. In an effort to effectuate that policy the Court held that the "holding out" test of § 162 used to determine whether one is carrying on a trade or business has no relevance to a § 174 analysis. In so holding, the Court allowed research expenditures
incurred in anticipation of entering a trade or business to be deductible. In this way, the tax consequences of an enterprise well established in the commercial market incurring research expenses and those of a fledging enterprise incurring similar expenditures are equalized.

In the aftermath of Snow, investment at the early stages of invention may be expected to increase because of the more favorable tax consequences. A clarification of the meaning of the term “research and experimental” expenditures in the “laboratory and experimental sense” can be expected to result from this decision as preparatory businesses try to avoid the more restrictive “holding out” tests under §162. Finally, the lower courts will need to fashion a trade or business standard for §174 because the Supreme Court declined to do it for them. It is suggested that a trade or business test does still exist under §174 and the proper criterion to be applied by the lower courts in analyzing §174 controversies would be the “profit motive” test. To assist the lower courts in analyzing whether that test has been met, it is suggested that the courts look to the objective standards enumerated in Treasury Regulation §1.183-2(b).

Larry R. Thompson