Federal Income Tax Treatment of Business and Employment Investigatory Expenses

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I. INTRODUCTION

Almost every taxpayer at one time or another investigates the possibility of entering a new business, new employment or some like endeavor. In so doing he incurs so-called "investigatory expenses"—travel expenses in search of a job, costs of newspaper advertising, employment agency fees, costs of economic surveys or reports on a prospective business acquisition and other expenditures made prior to the time at which a decision is made to undertake income-producing activity.¹

Until recently, the Internal Revenue Code's scheme to permit deductions of expenses and losses incurred in connection with income-producing activity has not been interpreted to allow the deduction of investigatory expenses. The Congressional purpose in allowing expense deductions under Section 162 or Section 212 is to ensure that a taxpayer is taxed only on net income and not on the cost of producing income.² Accordingly, courts have found it difficult to place investigatory expenses in the category of Section 162 business or Section 212 nonbusiness expenses since investigatory expenses are only remotely of benefit in the creation of goods and services which produce income, unlike, for instance, the salary costs of an established business or the upkeep costs of rental apartments which are of direct benefit in the creation of goods and services which produce income.

¹ The fact that these outlays are incurred prior to such a decision distinguishes them from other preliminary expenses which might be loosely termed "pre-operating expenses," i.e., legal fees expended in attempting to acquire a business license or costs of hiring and training personnel in preparation for eventual business activity. Pre-operating expenses are often closely linked to the acquisition of a particular asset of the prospective business or investment. They are generally capitalized. See Mandell, Deductibility of Pre-Operating Expenses: Successful and Unsuccessful Ventures, N.Y.U. 25TH INST. ON FED. TAX. 1235, 1236–47 (1967). See generally T. Fidelity & H. Kupfer, Accounting for Business Lawyers 175–95 (1971). See also text accompanying notes 27–29 infra.

² See J. Chomme, Federal Income Taxation 67 (1968); R. Goode, The Individual Income Tax 76, 99 (1964). The requirement that only net income be taxed may be a constitutional mandate. B. Bittker, Federal Income, Estate and Gift Taxation 71 (3d ed. 1964). However, a tax on gross income without the allowance of deductions might be considered an "excise" and thus constitutional. See Spreckels Sugar Refining Co. v. McClain, 192 U.S. 397 (1904); B. Bittker, supra, at 71–75.
Similarly, it is difficult to allow a loss deduction of investigatory outlays since the conventional concept of loss necessarily involves an involuntary deprivation. It is also troublesome to categorize them as nondeductible capital outlays (which might allow an addition to basis of a subsequently acquired asset and possibly a gradual depreciation recoupment) since the criterion for capitalization is long-term benefit to income-producing activity similar to the short-term benefit of an ordinary business or nonbusiness expense. Since an investigatory expense is of remote benefit to current creation of income, it is no less remotely beneficial to such production over a longer period.

In addition to these broad conceptual objections to the deduction of investigatory costs, courts are faced with the language restrictions of the specific deduction provisions. The reading the courts have given these provisions as they are applied to investigatory expenses is best exemplified by the Tax

3. However, it would not seem completely unreasonable to characterize investigatory outlays as business expenses since they appear to be an essential precursor to any subsequent earning activity conducted by the taxpayer. Int. Rev. Code of 1954, § 162 [hereinafter cited as IRC] allows a business expense deduction for "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business..."

4. See generally 5 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 28.39, at 180-82 (rev. ed. 1966) [hereinafter cited as J. MERTENS]. However, the courts have not adhered strictly to this conventional theory of the nature of loss. Although the core concept of loss may involve some notion of involuntariness, it is clear that a loss may be deducted in some cases even though incurred voluntarily. For example, the amount by which expenses exceed gross income in a given year may be deducted as a loss. However, this broader concept does not help investigating taxpayers since, as a technical matter, most courts find that "entrance" into an investigation is not compliance with the Section 165(c)(2) requirement for a loss that a transaction or trade or business actually be entered. See, e.g., Morton Frank, 20 T.C. 511 (1953); IRC, § 165(c)(1) & (2).

5. See T. FIFLIS & H. KRIPEK, supra note 1, at 75; 4A J. MERTENS, supra note 3, at § 25.08.

6. However, investigatory expenses are similar to the ordinary capital outlay in that both are preliminary and incidental to the acquisition of an asset or income-earning position. Some courts have accordingly held that they are capital expenditures. See McDonald v. Commissioner, 139 F.2d 400 (3rd Cir. 1943). However, the principle was not relied upon by the Supreme Court in McDonald v. Commissioner, 323 U.S. 57 (1944) in affirming the denial of the deduction of the campaign expenditure. See also Dwight Ward, 20 T.C. 332 (1953), aff'd, 224 F.2d 547 (9th Cir. 1965); 4A J. MERTENS, supra note 3, at § 25.08 at 33.

7. It is often argued that deduction provisions are to be strictly construed as a matter of statutory construction, since deductions are a matter of "legislative grace." See J. CHOMMIE, supra note 2, at 67.
Court opinion of Morton Frank.9 There the taxpayer, who had been in the newspaper business prior to service in the armed forces, began traveling to various cities investigating the purchase of a newspaper business upon his release. His search continued for approximately one year, six months of which he was employed by a newspaper while investigating newspaper business opportunities in his free time. Expenses were incurred for travel, communication and legal services. In several cities offers to purchase various properties were made and rejected. A newspaper was finally purchased and operated in Canton, Ohio.

The taxpayer argued for a deduction under three Code provisions. He maintained that a deduction should be allowed either as a business expense under the predecessor of Section 162, as a nonbusiness expense under the predecessor of Section 212 or as a loss resulting from an abandoned "transaction entered into for profit" under the predecessor of Section 165(c)(2). The court denied the Section 162 business expense deduction since the statutory language required that the expenditures be incurred "in carrying on a trade or business,"9 which does not permit deduction of preliminary expenditures.10 Similarly, Section 212 nonbusiness expense treatment was denied, although the language of the provision allowed deductions for ordinary and necessary expenses incurred "for the production or collection of income."11 The court held that the taxpayer failed to show an existing interest in some ongoing enterprise or investment at the time the expense was incurred.

The expenditures were not a Section 165(c)(2) loss deduction since the only transaction entered into was the purchase of the newspaper in Canton. The fruitless investigations in other cities, the court felt, were not transactions but were merely preliminary thereto. Even if the entire search were to be regarded as one transaction, there could be no loss at the time the newspaper was acquired, since such acquisition was

8. 20 T.C. 511 (1953).
9. This language appears in identical form in Int. Rev. Code of 1939, § 23(a)(1) and IRC, § 162(a).
10. The further language in the same section of the Code that travel expenses could be deducted if incurred "while away from home in the pursuit of business" did not help petitioner for two reasons. First, the Court found that the words "in pursuit of" presuppose an existing business with which the taxpayer is connected. Second, the taxpayer had not established a "home" within the meaning of the statute and thus could have no expenses "while away from home." 20 T.C. at 513–14 (1953).
11. IRC, § 212(1).
merely the continuation of the transaction. Since there was no abandonment of that transaction there could be no loss deduction.\textsuperscript{12}

II. BUSINESS OR NONBUSINESS EXPENSE DEDUCTION UNDER SECTION 162 OR SECTION 212


Although the theoretical reason for allowing expense deductions is to reduce a gross income stream down into a taxable net income, Congress, the courts, and the Internal Revenue Service have not strictly required a particular or even an existing income stream as a prerequisite to the deduction of expenses. For example, it is evident that the deductibility of an expense is not contingent on the success of the profit-making activity to which it relates. Treasury Regulation § 1.162-1(a)\textsuperscript{13} states that business expenses otherwise deductible are not rendered nondeductible by the fact that they exceed the gross income derived from the particular activity during the taxable year. The taxpayer is permitted to deduct from his entire income for the year. Furthermore, the taxpayer who has income from no other sources is relieved by the provisions for net operating loss carry-

\textsuperscript{12} The Court explicitly refused to deal with the issue of capitalization since it was not raised by the litigants. 20 T.C. at 514. It is possible that, had it been raised, the Court would have found that the investigatory expenditure could be capitalized in the business which the taxpayer ultimately acquired. This could imply any of several tax consequences. Most likely it would mean a separate ordinary or capital loss at the sale or other disposition of the business. However, it could also mean an allocation of the investigatory costs to various assets of the business which would allow gradual recoupment if some of those assets were depreciable and would be part of the basis of each type of asset. Therefore, if and when the business were sold, there would likely be an offset to both ordinary and capital gain. See Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945).

An alternative to proportional allocation of the investigatory expense among the assets would be to add all of it to the basis of good will in which case it would be an offset to capital gain or would increase capital loss. The similarity of investigatory expenses to a purchase of good will was pointed out in George Westervelt, 8 T.C. 1248 (1947) (expenses of investigating various aspects of the cattle business prior to engagement therein held to be capital expenditures).

As for the possibility of an ordinary loss deduction, see Roy Harding, 29 CCH Tax Ct. Mem. 789 (1970) (taxpayer not allowed an ordinary loss deduction for exploratory expenses on a Subchapter S passthrough; no abandonment of the land acquisition venture shown).

\textsuperscript{13} Treas. Reg. § 1.162-1(a) (1960).
converted to investment purposes, even though his attempts are unsuccessful and no rental income is derived from the property.\textsuperscript{19}

These authorities indicate that although a taxpayer's expenditures must bear some relationship to activity from which he expects to derive income, for the purpose of an expense deduction no showing of a direct link with actual income inflow is required. Thus, a deduction for investigatory expenses would not be inconsistent with the net income concept as it has been liberally construed.

Just as the remoteness of investigatory expenses from the income stream might have prevented their deduction in the past on account of the net income concept, it has also led some courts to classify them as personal expenses,\textsuperscript{20} generally nondeductible under the Code.\textsuperscript{21} One step removed from income-producing activity, investigatory expenses arguably are similar to such nondeductible items as preparatory educational expenses and commuting expenses. However, commuting expenses would seem to be more clearly personal in nature since they are a result of the taxpayer's choice of personal residence. Similarly, educational expenses presumably result in broad benefits to the taxpayer unrelated to his profit-making capability. Investigatory expenses, by contrast, do not result in, and are not aimed at, anything other than a profit-making goal.

A recent Tax Court case has rejected the ideas that investigatory expenses should be nondeductible either because they are not closely related to the income stream or because they are of a significantly personal nature. In \textit{David Primuth}\textsuperscript{22} a deduction was allowed for an employment agency fee which resulted in the taxpayer procuring a new job similar to the one held when the fee was paid. The deduction was allowed from taxable income in the year in which he received income only from the old job.

\textsuperscript{19} See William C. Horrmann, 17 T.C. 903 (1951); Mary Robinson, 2 T.C. 305 (1943). \textit{But see} Warren Leslie, Sr., 6 T.C. 489 (1946).

The courts have imposed a higher burden on the taxpayer to show conversion to profit-seeking purposes in order to get a partial loss deduction on the sale of such property. As a result, various nonbusiness expense deductions may be allowed for the property over a period, but when the taxpayer sells the property and attempts to take a loss deduction it very likely may be disallowed. \textit{See, e.g.,} William C. Horrmann, 17 T.C. 903 (1951).


\textsuperscript{21} IRC, § 262.

\textsuperscript{22} 54 T.C. 374 (1970).
overs and carrybacks\textsuperscript{14} which allow the excess business expense over income for the present year to offset income from any income-producing activities in other taxable years.

There is also authority under Section 212 that expense deductions will be allowed even though no income at all is derived from an interest or investment. The House Committee Report states that expenses are deductible under Section 212 even though "there is no likelihood that the property will be sold at a profit or will otherwise be productive of income."\textsuperscript{15} A regulation\textsuperscript{16} under Section 212 states that expenses incurred in connection with bonds or rental property held with the expectation of producing income are deductible despite the fact that no income is realized in the taxable year. This principle allows, for example, a deduction for the cost of a safety deposit box containing defaulted bonds, or for the upkeep of a condemned house held for rent, neither of which have any prospect of income production.

There is also case law which supports the idea that there need be no income inflow. A business expense deduction under Section 162 has been allowed\textsuperscript{17} where the taxpayer printed and distributed religious handbills which advertised an idiosyncratic prophetic book which had no likelihood of being sold, on the ground that the taxpayer did not engage in the activity for pleasure but had a profit-making purpose, however unreasonable. The Tax Court has allowed\textsuperscript{18} the Section 162 deduction of the business entertainment expenses of an unemployed salesman who had no sales income in the taxable year, but who was actively seeking another position where he would serve the same customers. Where a taxpayer has attempted to rent out his house after abandoning it as a personal residence, the Tax Court has allowed him to deduct the expenses of maintenance and depreciation under Section 212 on the ground that it has been

\begin{footnotesize}
\begin{enumerate}
\item[14.] IRC, § 172. Section 172(c) provides that the net operating loss, which can be applied to prior or subsequent taxable years, includes any deduction given by "this chapter," with certain exceptions, one of which is the nonbusiness expense deduction of Section 212.
\item[15.] H.R. REP. No. 2333, 77th Cong., 2d Sess. 74-75 (1942).
\item[16.] Treas. Reg. § 1.212-1(b) (1957). \textit{See generally} Lykes v. United States, 343 U.S. 118, 125 (1952); Daniel Kelly, 23 T.C. 682 (1955); Stella Tyler, 6 T.C. 135 (1946).
\item[18.] Harold Haft, 40 T.C. 2 (1963). \textit{See} Furner v. Commissioner, 393 F.2d 292 (7th Cir. 1968) (teacher who took a year off to secure a master's degree allowed a deduction for cost of courses).
\end{enumerate}
\end{footnotesize}
The taxpayer did not begin work in the new job until the subsequent tax year.\textsuperscript{23} The court also made a finding that the employment agency fee was not a personal expenditure since it had an exclusive and direct relationship to profit seeking and the potential receipt of income.\textsuperscript{24} Thus it would appear that the Tax Court does not consider either the net income concept or the nondeductibility of personal expenses to be an impasse to investigatory expense deductions.

B. Trade or Business Expense Deduction Under Section 162

In addition to the implicit rejection of a strict net income concept and a finding that the employment fee was not personal in nature, the Primuth Court, in order to allow Section 162 deduction, had to overcome barriers which in the past had been built on a narrow reading of the statutory language. To understand fully how the Court broke through these barriers to develop explicitly a novel concept of what constitutes a "trade or business" under Section 162, a thorough examination of the traditional view and its history is required.

1. The Strict View of Time of Entrance Into a Trade or Business

In order to qualify for the Section 162 deduction, a taxpayer must be pursuing a "trade or business." To meet this test he traditionally has been required at least to show that he has entered and is pursuing an ongoing activity at the time the expenses are incurred.\textsuperscript{25} The determination of the time of entrance

\textsuperscript{23} Id. at 375-77.

\textsuperscript{24} Id. at 381.

\textsuperscript{25} See 4A J. MERTENS § 25.08. IRC § 162(a) states that a deduction is allowed for "ordinary and necessary" expenses incurred "in carrying on any trade or business." There is no definitive statement of the type of activity that constitutes such an ongoing business under Section 162. It has been held that at a minimum the activity must be something more than a single transaction entered into with the expectation of profit. Stanton v. Commissioner, 399 F.2d 326 (5th Cir. 1968); Industrial Research Products, 40 T.C. 578 (1963). The Third and Sixth Circuits require that there be extensive or repeated activity over a substantial period of time. McDowell v. Ribicoff, 292 F.2d 174 (3rd Cir. 1961); Wright v. Commissioner, 31 T.C. 1264, aff'd, 274 F.2d 883 (6th Cir. 1960).

In Stanton the taxpayer had engaged in sporadic inventing in the past and sought deductions for the expenses of designing and making a model of a storm-proof boat. The court stated that he had not been active with sufficient "continuity or regularity" to justify a finding that he was engaged in a trade or business. 399 F.2d at 330. The court did not clearly define the test, and the reluctance of the court to do so is indicative of the troublesome lack of guidelines in this area.
into this continuing activity is critical for a taxpayer incurring preliminary expenses generally. All expenditures incurred prior to this time will be deemed nondeductible, despite the fact that they are of current benefit only and hence not capital in nature.26

At least where a sole proprietorship or corporation is concerned, the courts have been restrictive in the determination of when the requisite activity is begun. In Richmond Television v. United States,27 the court held that although there had been an incorporation, there could be no business expense deduction of salaries until the activities for which the enterprise had been organized actually were begun. The court emphasized that the corporate taxpayer had not yet obtained an FCC license, nor acquired facilities for broadcasting. It is not clear from the opinion whether the court would have considered the acquisition of assets or the beginning of operations as the critical point at which the taxpayer would have entered the trade or business, since all the expenses at issue were incurred before either event.28 But either test would appear to rule out the deduction

See also Deputy v. DuPont, 308 U.S. 488 (1940), where Justice Frankfurter, in a concurring opinion, originally asserted the definition of a trade or business in terms of the taxpayer holding himself out to others as being in a particular enterprise.

Although Section 162, and many other of the sections of the Code which use the trade or business term, do not specifically define it some guidelines are offered in a few of the Code sections. Some guidelines for what is not a trade or business are given in Section 183 which prevents favorable tax treatment for activities not engaged in for profit.

Sections 355 (distributions of a controlled corporation) and 346 (partial liquidation of a corporation) provide favorable tax treatment in certain circumstances if a corporation distributes the assets or proceeds from the sale of a "trade or business." The definition of the term for both provisions is set forth in Treas. Reg. § 1.355-1(c) (1955). The "trade or business" is defined as "a specific existing group of activities being carried on for the purpose of earning income or profit. . . . Such group of activities ordinarily must include the collection of income and the payment of expenses."

See generally 4A J. Mertens, supra note 4, § 25.08 at 26, where it is stated that the trade or business term is "one of the most deceptively simple phrases" used in the Tax Code.

26. Id. at 32-33.
27. 345 F.2d 901 (4th Cir. 1965).
28. In Petersburg Television Corp. v. Commissioner, 20 CCH Tax Ct. Mem. 271 (1961), the court stressed acquisition of the FCC license as determinative. See also, Cohn v. United States, 57-1 CCH U.S.T.C. ¶ 9457 (W.D. Tenn. 1967), where it was held that the taxpayer could not deduct expenses incurred prior to the actual opening day of the pilot training school.

A possible definition of entrance into business activity is found in the regulations for IRC § 248 which gives the taxpayer an election to
of investigatory expenses, since both events would likely occur at the end of any investigation and the beginning of a commitment to a particular income-producing activity.

For those who are not investigating an enterprise, i.e., employees, professionals or office-holders, it would appear that in most cases there is no entrance into the trade or business until actual work activity is begun. Even if the signing of an employment contract, the election to office or some similar occurrence would suffice to trigger trade or business entrance, it is clear that any investigatory expenditures which preceded that point in time would be nondeductible.29

2. Evolution of the Trade or Business Concept

The "trade or business" of a taxpayer for Section 162 purposes traditionally has been loosely associated with the particular job or income-earning position of the taxpayer.30 Recently the idea of what constitutes a "trade or business" has been broadened in three distinct ways. The first development, which may appropriately be labeled "expansion" of the trade or business concept, is peculiar to investigatory expense situations. The situation arises when a taxpayer incurs expenses to explore the possibility of entering an activity which the court finds is closely

amortize organizational expenses. The purpose of the definition is to determine when the 60 month amortization period begins, before which time the taxpayer must make the election. Treas. Reg. § 1.248-1(a)(3) (1956) states that the corporation begins business when it starts the business operations for which it was organized or when activities have advanced to the extent necessary to establish the nature of its business operations. An example is given which indicates that such test is met when the operating assets necessary to the enterprise are acquired.

For a discussion of the restrictive view of the courts as to when a business is entered and the manner in which that view has been applied to deny the expense deduction to pre-operating expenditures which are not capital in nature, see Mandel, supra note 1, at 1235; Waters, Sideline Ventures: Planning to Achieve Maximum Tax Benefits From Losses Incurred, 29 J. of Tax. 100 (1968).

29. See 4A J. MERTENS, supra note 4, at § 25.08.

The usual employee expense deductions are for union dues or uniforms although entertainment expenses are allowed for salesmen. Employees also have been allowed to deduct the amount of defaulted loans made to the employer as trade or business bad debts under Section 166 and thereby receive ordinary loss rather than capital loss treatment. See Weddle v. Commissioner, 325 F.2d 849 (2d Cir. 1963); Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963); Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961).

akin to the type of activity he is undertaking in his current job or position. The court "expands" the taxpayer's trade or business to allow the deduction on the basis that the activity explored will be an appendage to his existing income-earning activity, and not an entirely new trade or business. "Expanding" the trade or business of a taxpayer might be exemplified by the allowance of a deduction for a dealer in domestic automobiles who explores the possibility of acquiring a franchise on foreign cars, or investigates a possible car servicing business.\(^{31}\)

The second development, which might be labelled "extension", is not peculiar to investigatory expense situations and indeed, first appeared in cases where taxpayers claimed deductions of outlays for business entertainment and educational expenses.\(^{32}\) A court, in "extending" the taxpayer's trade or business, allows the taxpayer to deduct expenses even though he has ceased gainful activity in a particular job or position, when it appears that the taxpayer will continue identical or at least closely similar activity within a reasonable time. For example, a court might "extend" a salesman's trade or business to allow the deduction of expenses for the entertainment of his clients during a short period after he has ceased gainful activity as an employed salesman.

Both of these developments have influenced the third and most recent development of the *Primuth* case and its progeny.\(^{33}\) Under these decisions, a taxpayer's trade or business is detached or disassociated from any particular job or position and the taxpayer is given what might be called a trade or business status in the field in which he is generally employed. Under this view, the expenses of investigating a job or position similar to one held currently or in the recent past can be viewed as not investigatory in nature at all, but as expenses merely incidental to his more abstract "trade or business" which subsumes the jobs

\(^{31}\) An excellent example of the Service "expanding" trade or business standing is found in a regulation associated with Section 162. Treas. Reg. 1.162-5 explains the types of educational expenses which are allowed as deductions because they prepare the taxpayer for some new activity not considered to be a new trade or business. It states that a shift from elementary to secondary school teacher, from classroom teacher in one subject to classroom teacher in another subject, or from classroom teacher to guidance counselor is not a change to a new trade or business. Hence the educational expenses which qualify one for such a shift are not nondeductible.

\(^{32}\) See text accompanying notes 40-49 infra.

\(^{33}\) See text accompanying notes 51-57 infra.
or positions investigated as well as the one currently or recently held. This trade or business status would seem then, to represent a field of activity in which the taxpayer has background and experience and where he will probably continue to earn his living in the future.\footnote{This development has been facilitated by the great liberality with which the net income concept has been viewed since the allowance of deductions for a taxpayer who has such status will sometimes not be immediately helpful in the production of income. But, as in the case of the entertainment expense deduction during inactivity or the expense of exploring a new job or position, the deductible outlay can still be viewed as proximately related to future income though sometimes only in the form of an expectation.}

a. Pre-Primuth Expansion of the Trade or Business

In J.W. York v. Commissioner,\footnote{261 F.2d 421 (4th Cir. 1958).} the taxpayer was in the business of promoting and developing shopping centers and residential areas. Intending to begin the development of industrial real estate as well, he spent money for an economic survey of the industrial potential of certain lands but thereafter abandoned the exploration. The Tax Court held that the expenditures were preparatory to entering a new venture and thus were not deductible under either Section 162 (citing Frank) or Section 212. The Fourth Circuit reversed, holding that the new venture was not a new line of business. The court felt that the venture would not have been a new pursuit, but was part of his general occupation in real estate development. This result was reached despite the fact that since the taxpayer never entered the new line of activity, there was no income resulting from the outlay at all. Latent in such a result is a rejection of a strict application of the net income concept as applied to investigatory expenses.

In Cornelius Vanderbilt, Jr.,\footnote{16 CCH Tax Ct. Mem. 1081 (1957).} the taxpayer had been a long-time author and lecturer. He incurred legal fees in negotiating with advertising agencies and television networks in an effort to become a narrator of a weekly television series. The Tax Court in a memorandum decision rejected the Commissioner’s contention that the television field was separate from the field of activity in which the taxpayer was engaged. The court found the activity of narrating travel films on television to be so closely similar to the activity of presenting lectures in person
on the subject of travel that the expenditures were an ordinary and necessary expense of being an author-lecturer. 37

However, in Joseph Sheban, 38 another memorandum decision, the taxpayer was not allowed to deduct the expense of investigating the possible conversion of a hotel into a senior citizen’s home. The court felt that such an expense was not integral to the taxpayer’s particular business of leasing and managing real estate properties. The results in these two Tax Court cases may be reconciled on the basis that the activities of author-lecturer and TV narrator on the same subjects are more closely related than the activities of leasing real estate properties and running a senior citizen’s home. Thus, the court’s willingness to expand the taxpayer’s current job or position to include concurrent activities within his corresponding trade or business seems to depend on an exceedingly close similarity of the new activities to those already being performed. 39

37. Trade or business standing has been comparably but more completely expanded in interpretations of Section 174 which allows the taxpayer a deduction of research and experimental expenditures incurred “in connection with his trade or business.” Originally the courts adopted a restrictive view similar to that first taken under Section 162. In John F. Koons, 35 T.C. 1092 (1961), a partner in an advertising agency who also spent time promoting and investigating various enterprises and who had had prior interests in promoting various totally unrelated products could not deduct the expenses of developing and promoting a “titanium suboxide rectifier” which never got into production. But in Best Universal Lock Co., 45 T.C. 1 (1965), a Section 174 deduction was allowed for development work on an isothermal air compressor. In the past the company had specialized almost exclusively in lock systems for industrial concerns. The Tax Court emphasized evidence which indicated that the taxpayer fully intended to put the new idea into production at the time the expenses were incurred.

The Service has accepted the Best approach in Rev. Rul. 71-162, 1971 INT. REV. BUL. No. 13, at 12. There the case is cited in ruling that the expenses to develop new products or processes, though unrelated to current product lines or manufacturing processes of the trade or business, are deductible if incurred “in connection with” the enterprise.

Although the language and purpose of Section 174 are different from that of Section 162 and apparently more conducive to expansion of the trade or business concept than Section 162, it is possible that the broad developments under Section 174 will have some effect on the development of the Section 162 trade or business concept.

38. 29 CCH Tax Ct. Mem. 727 (1970). See also Paul Seguin, 26 CCH Tax Ct. Mem. 950 (1967), where a taxpayer who retailed clothes, cards, cosmetics and other sundries could not deduct expenses of investigations in France of possible perfume importing and other ventures. There was a personal aspect to the trip since the taxpayer visited his sister. 39. There are other arguments a taxpayer can make concerning expenditures in connection with a field of activity totally unrelated to
b. Pre-Primuth Extension of the Trade or Business Concept

The progenitor case in extending a taxpayer's trade or business is the Harold Haft decision. There an unemployed salesman who actively sought sales positions for some time after leaving his old job was allowed an expense deduction for cultivating customers by taking them to dinner, to the theater and by giving them gifts. The court reasoned that since the taxpayer was actively seeking another sales job or position during the period, and he expected ultimately to serve the same customers, his carrying on of a trade or business should not be found to have terminated at the time he left the sales job. The court one in which he is already involved.

The deduction may be allowed if the Court can be convinced that the expenditure was made to protect or promote the taxpayer's business. In Cubbedge Snow, 31 T.C. 585 (1958), a law partnership organized a savings and loan association and agreed to guarantee its deficits for a period of three years. Prior to the advance, the law partners had a title opinion business which had declined owing to the lack of local money lenders to stimulate the purchase of real estate. The court found that advances made pursuant to the agreement were deductible as an ordinary and necessary expense of the law business. The court felt that the expenditures were made to protect or promote the taxpayer's business rather than as an investment in a new enterprise.

But the more strained this argument becomes, as in cases where the success of taxpayer's current business is not so closely dependent on the new activity, the less likely the court will allow the deduction. For example, it has been held that a lawyer may not deduct the expenses of campaigning for public office even though it is shown that such expenses increase the lawyer's business and are, in effect, for advertising. See James Arditto, 30 CCH Tax Ct. Mem. 866 (1971); William Maness, 54 T.C. 1602 (1970); Harry Moreland, 19 CCH Tax Ct. Mem. 938 (1960) (alleged that campaign increased business).

If a taxpayer has had past limited activity in a field unrelated to his current business he can argue that he is in a second trade or business. This argument was successful in James Warren, 27 CCH Tax Ct. Mem. 940 (1969), where the owner-operator of a telephone company, insurance agency and bank was permitted to deduct the expenses of a fruitless trip to Florida to investigate the purchase of some submarine cable for salvage. The court found that the taxpayer was in the submarine cable salvage business since he had engaged in several successful individual transactions of the same sort within the previous four years. The court avoided a strict scrutiny of the earlier cable operations which probably would not have passed the more rigorous ongoing operations test of a trade or business. See note 25 supra. In Nicholas Dodich, 30 CCH Tax Ct. Mem. 248 (1971), a full-time lab technician was permitted to deduct expenditures made to develop and promote various devices, such as a muzzle break for a rifle, none of which generated any income. In finding that the taxpayer was in a second trade or business, the Court stressed its initial finding that the activity was carried on with the bona fide purpose of realizing profit.

held that the taxpayer continued in the trade or business during a reasonable transition period between jobs and a deduction was allowed despite the lack of sales income during the jobless period.\textsuperscript{41} This special extension treatment seems justified in the case of salesmen, since the customers for which entertainment expenditures are made are often the same ones in both the abandoned and the subsequent position.\textsuperscript{42}

A slightly different issue arises when a taxpayer engaged in a particular job is given leave to attend school temporarily. For example, in \textit{Furner v. Commissioner},\textsuperscript{43} the Seventh Circuit reversed the Tax Court and allowed a deduction for the educational and related expenses of a teacher who resigned from teaching for a year in order to pursue graduate study. The additional education was not required by her employer in order for her to keep the job, but she herself felt it was necessary to maintain competence in her teaching. The taxpayer subsequently returned to the same teaching job without obtaining substantial advancement. The court noted that even though the taxpayer had totally discontinued her teaching activity during the period, there remained a sufficient relationship between the year of study and the taxpayer's intended future performance in the teaching position to justify the deduction. The year of study was considered a normal incident to carrying on the business of teaching.\textsuperscript{44} In \textit{Peter Corbett},\textsuperscript{45} however, the Tax

\textsuperscript{41} Although Haft subsequently did acquire a sales business and anticipated soliciting the entertained customers in connection with the new business, the court did not place reliance on this relationship with income flow. The court explicitly distinguished the facts before it from the investigatory expense situation and in fact specifically denied a deduction for the expenses of a trip to Florida which had allegedly been made for the purpose of investigating a sales business. \textit{Id.} at 6, 7. However, the disallowance may have rested on a suspected personal pleasure aspect of the trip and the taxpayer's admission that he investigated ventures other than those related to sales.

\textsuperscript{42} A broader application of the principle to taxpayers incurring other types of expenses is possibly suggested by the Court's comparison of the entertainment outlay to an unemployed worker's payment of union dues. \textit{Id.} at 6.

\textsuperscript{43} 393 F.2d 292 (7th Cir. 1968), reversing 47 T.C. 165 (1966).

\textsuperscript{44} 393 F.2d at 295. The Service has acquiesced in \textit{Furner} only to the extent that it allows the deduction of expenses of maintaining or improving skills when the taxpayer "temporarily ceases to engage actively in employment or other trade or business." Rev. Rul. 68-591, 1968-2 \textit{Cum. Bull.} 73. Ordinarily, the temporary period must be a year or less. It rejects an interpretation of \textit{Furner} that the expenses are incurred while carrying on a trade or business simply because they are incident to a trade or business which the taxpayer intends to resume.

\textsuperscript{45} 55 T.C. 884 (1971).
Court distinguished Furner and disallowed a former teacher the deduction of education expenses. The taxpayer had resigned her teaching position, allegedly because she wanted to begin study leading to a Ph.D., but also because she was required to care for a young child. Soon after the resignation she took temporary jobs not connected with teaching but kept in contact with the profession through membership in a professional society. Although the taxpayer continued to solicit offers to colleges and through placement services, the court felt that these activities had not been undertaken seriously. It stressed the child as a present hinderance to her work activities and questioned her motivation to continue teaching since the child apparently had caused her to resign in the first place. It also was significant that she had not worked as a teacher for four years.46

The Corbett Court cited the Canter case,47 which held that a nurse who quit her job for four years to get a bachelor's degree could not deduct the educational expenses because they did not relate to nursing.48

Thus the Tax Court has firmly accepted the idea of extension but apparently will use it only if the jobless period during which deductions are allowed is relatively short, and there are reasonable assurances that the taxpayer will take a job or position in the future similar to the one given up. In conceptual terms it is the taxpayer's old trade or business which is being extended. However, the court in Corbett, and to some extent in Haft and Furner, found it necessary to closely examine con-

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46. In disallowing the deduction the court cited Henry Owen, 23 T.C. 377 (1954), where a deduction was disallowed for the expense of upkeep of a law office in North Dakota. The taxpayer had been a governmental employee in Washington for 10 years since leaving North Dakota. The Owen court held that there was no surviving law business status since the taxpayer had taken an unrelated job and that the expenses were merely "preparatory" to resuming the law business.

47. Canter v. United States, 354 F.2d 352 (Ct. Cl. 1965).

48. See Kaufman v. United States, 233 F. Supp. 123 (E.D. Pa. 1964) (taxpayer who had been engaged in manufacturing could not deduct expenses to secure readmission to the bar after he had been disbarred 16 years earlier). But see Elliot v. United States, 250 F. Supp. 322 (W.D.N.Y. 1965) (taxpayer allowed to deduct the cost of harp lessons under Section 162 and depreciation on the harp under Section 167 when she maintained that they were preparatory to resuming her career as a professional harpist which had been interrupted for a period of years).

See also Paul Seguin, 26 CCH Tax Ct. Mem. 950 (1967), where the taxpayer who had not been in the perfume business for 14 years was denied a business expense deduction of investigating entry into perfume importing.
duct of the taxpayer which might indicate his motivation to procure a future job or position. This suggests that underlying the extension concept is the notion that the taxpayer's expenditures must have been intended to produce future income. It is the anomaly of the extension cases that although it is the taxpayer's past trade or business as extended which gives rise to the deduction, it is his expectation of future income which controls whether he will be allowed that deduction.\textsuperscript{49} It was only in \textit{Primuth} that the Tax Court recognized this anomaly and resolved it.

c. \textit{Primuth} and its Progeny

Although neither \textit{Haft} nor \textit{Furner} suggest that a taxpayer's trade or business could be extended to allow the deduction of investigatory expenses,\textsuperscript{50} both cases were relied on in \textit{David Primuth}\textsuperscript{51} to do so while developing a more abstract concept of a trade or business. In that case, a deduction was allowed to an executive who paid an employment agency fee in connection with his search for a new job with a different company. The court reasoned that although both \textit{Haft} and \textit{Furner} involved expenses related to the taxpayer's current or former employment, the essential principle was that an employee can temporarily retain the status of pursuing a trade or business even though he is not receiving any compensation from a particular employer. Latent in this principle was the idea that the "trade or business" of Section 162 is a more generalized concept, not requiring a specific income-producing position.\textsuperscript{52} A taxpayer's

\textsuperscript{49} In the recent opinion of Don Cornish, 29 CCH Tax Ct. Mem. 235 (1970), the court examined the motive of a former physicist to determine whether he intended a temporary sojourn to improve his skills or was pursuing educational aspirations of a personal nature. The Court said that the fact situation was more like \textit{Canter} and \textit{Owen} than \textit{Haft} or \textit{Furner} and disallowed the deduction.

\textsuperscript{50} The Court in \textit{Haft} actually denied the deduction of investigatory expenses incurred by the unemployed salesman for a trip to Florida allegedly to investigate business and employment interests. 40 T.C. at 6, 7. See note 41 supra.

\textsuperscript{51} 54 T.C. 374 (1970).

\textsuperscript{52} The deduction of investigatory expenses in general has frequently been denied in the past on a finding that they are either personal or capital expenditures. See, e.g., Leon Chooluck, 13 CCH Tax Ct. Mem. 864 (1954); George Westervelt, 8 T.C. 1248 (1947). Such findings are apparently also the basis for the broad prohibition of the deduction of many types of investigatory expenses found in Treas. Reg. 1.212-1(f) (1957). Thus the Tax Court was compelled to confront the issue of whether investigatory expenses were personal or capital before
trade or business status is a type of activity determined apparently by his training and past income-producing experience with which he will be somehow connected continuously. His status will continue despite the change of jobs or positions within that field, and despite the fact that there are periods in between which no income is generated. Once this idea is accepted it is a short step, if it is any step at all, to the simple proposition accepted in Primuth that expenditures incurred in making change to a new job or position within the field should not be viewed conceptually as "investigatory" at all, since a new trade or business is not being entered. Rather, the expenditures represent ordinary and necessary expenses incidental to the taxpayer's abstract "trade or business" which is uninterrupted by the change of jobs.

In Primuth the taxpayer actually did procure a new job as a result of the expenditure, and thus the court did not need to consider whether the expense would be deductible had the investigation been fruitless. However, a subsequent case has found the Primuth rationale appropriate to such situations.\(^5\) It allowed the deduction under Section 162. The court found that the expense had no personal overtones because it did not lead to a different employment position than the one relinquished, nor did it lead to what could be considered a personal asset or personal enjoyment. Similarly, it was not capital because no capital asset had been purchased. 54 T.C. at 279-81.

53. There were two other decisions which followed Primuth and foreshadowed the ultimate extension of the employment fee deduction rationale of that case to fees from which no job resulted. In Dale Huber, 29 CCH Tax Ct. Mem. 958 (1970) the employed taxpayer used a resume prepared by an employment agency when he interviewed with the new employer, but did most of the work to procure the new job himself. The court found that the employment agency had materially assisted the taxpayer in acquiring his job, though it is apparent that the bulk of the fee was expended for the agency's fruitless efforts and only a small part of the fee was even indirectly instrumental in procuring a job for the taxpayer. The court tenuously distinguished a pre-Primuth Ninth Circuit decision, Morris v. Commissioner, 423 F.2d 611 (9th Cir. 1970), which had disallowed a similar expenditure on a finding that it had in no way helped the taxpayer procure the new job. See Tucker, An Individual's Employment-Seeking Expenses: Analyzing the New Judicial Climate, 34 J. of Taxation 352 (1971).

In Kenneth Kenfield, 54 T.C. 1197 (1970), the taxpayer made an agency fee expenditure which produced a new job, but then did not take the proferred job when his current employer promoted him and increased his salary. The court allowed the deduction on the ground that the promotion was a result of the employment fee, but it is clear that the more substantial causative factor was merely the threat of his leaving the job which might have happened even if the taxpayer had not procured the new job through the employment fee. Thus the
In *Leonard Cremona*, the Tax Court was faced with an employed "administrator" who claimed a deduction for an employment counselling fee incurred in seeking new employment which he never obtained. The court refused to recognize a difference between an employment expenditure which because of economic conditions or otherwise did not result in a new employment position and one which did. The court found that the taxpayer had "in good faith engaged the services [of the job counseling service] . . . in order to improve his job opportunities" in the trade or business of "administrator."

The effect of extension, expansion, and the *Primuth-Cremona* principle is shown in the recent memorandum decision of Walter Hendrix. In *Hendrix*, a Section 162 deduction was allowed for expenses of exploring, on a trip to Europe, the possibility of setting up a sales business. The taxpayer, who had been an employee salesman of pharmaceuticals and over-the-counter items, intended to sell home decorative items to the same customers in a new business of his own. The idea was abandoned before any income was realized and he did not return to his former employment. The Tax Court expressly refused to follow *Frank*, and stated that *Haft* was controlling. In so doing the court read *Haft* on its broadest grounds to mean that, despite the termination of his income producing position, the taxpayer's status of "salesman" continued for tax purposes. *Hendrix* is significant in some additional respects. First, instead of selling pharmaceuticals and over-the-counter items, the taxpayer was planning, at least at the outset, to market home decor-

agency fee appears remote as a causative factor. The job search can be viewed fruitless in the sense that it did not result in what it was intended to produce, namely, a new job taken by the taxpayer.

54. 58 T.C. No. 20 (May 4, 1972) (as yet unpublished opinion).

55. As a result of *Primuth*, the Internal Revenue Service retreated from its stance that in order for an agency fee to be deductible it must be payable by the taxpayer only if the agency is successful in obtaining the job. In Rev. Rul. 71-308, 1971-2 *Cum. Bull.* 82, the Service ruled that fees paid for psychological examination and employment counseling were deductible even though not subject to such a contingency. However, this ruling is based on the premise, subsequently denied in *Cremona*, that the fee would not be deductible if a job were not procured as a result of the outlay.


57. The court found that much of the trip was for personal reasons, and thus allocated only a small amount of the expenditures to deductible business purposes. It is notable that the deduction might have alternatively been allowed as a loss once the court found that the taxpayer maintained his trade or business status. Section 165(c)(1) allows all losses incurred in the taxpayer's trade or business.
INVESTIGATORY EXPENSES

ative items. The court thus expanded the taxpayer's trade or business. Second, as in Cremona, the job investigation was fruitless, resulting in no sales income for the taxpayer, yet the deduction was allowed.

Hendrix and Cremona signal a serious erosion of the Frank case. If the rationale of these cases were to be applied to the Frank fact situation, at least some of the newspaper search expenses would be allowed, namely those incurred after Frank had taken an employment position with a newspaper. In fact, the Frank taxpayer's argument for a Section 162 deduction seems stronger than the unemployed salesman's argument in Hendrix. A taxpayer who is already in a gainful position and incurs expenses looking for another should have a better claim for a deduction than a taxpayer out of work looking for a position similar to one held in the past.\[58\]

3. **Existing Boundaries of the New Trade or Business Test for the Section 162 Deduction of Investigatory Costs**

It would appear that the rule to be synthesized from Haft, Primuth, Cremona and Hendrix is that an investigatory expense is deductible if the taxpayer's conduct and the surrounding circumstances indicate that he is actually motivated to procure a future position somewhat related to a currently occupied or recently abandoned position. It also would appear, at least from Cremona and Hendrix, that the expenditure need not result in a future position or indefinite income so long as the taxpayer is found actually to be motivated to that end. This rule has been applied only to employment agency fees in Cremona and travel expenses in Hendrix. But there would appear to be no reason to restrict the deduction to these two types of investigatory expenses since the rationale of a broadened trade or business status is just as appropriate for the deduction of the cost of economic surveys and reports, job advertisements and other incidentals to a search for employment.\[59\] In addition, the concept of such a trade or business status should be considered to in-

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58. This is essentially the argument used in Primuth to justify a deduction of the employment agency fee for a taxpayer who was actually in a gainful position at the time the expenditure was incurred.

59. See text accompanying notes 51-52 supra. Given the concept that a taxpayer has a general field of endeavor which represents his trade or business, it seems that any expenditure which helps him move from interest to interest or position to position within that field, not just an agency fee, would be incident to that "trade or business" and not an investigation of a new one.
clude taxpayers other than employees i.e., those who own their own business. Hypothetically, it should apply, for example, to allow the deduction for a sales franchisee who loses his franchise and searches for another. 60

However, there are apparently still limitations to the deduction of investigatory expenses under the newly developed trade or business test. There is a residual requirement that the taxpayer have a current or recent job or position which is fairly similar to the job or position investigated. This clearly excludes taxpayers without previous employment experience such as college graduates or servicemen, and those taxpayers who have existing employment but are investigating a completely unrelated field. The existence of this limitation is evidenced by the reaffirmance in both Primuth and Cremona 61 of the principles of Eugene Carter. 62 In Carter, the taxpayer could not de-

60. See note 59 supra. More generally, if the broadened trade or business concept represented by Primuth, Haft and Hendrix is to have impact over a wide field, McDonald v. Commissioner, 323 U.S. 57 (1944), must be more closely limited to its facts. In McDonald the Supreme Court held that campaign expenses of a judge who successfully sought re-election, because of their preliminary nature, could not be deducted under either Section 212 or Section 162. Criticism already has been leveled at the McDonald majority's reading of Section 212 in two district court cases dealing with campaign-related expenditures. See Maness v. United States, 15 A.F.T.R.2d 217 (M.D. Fla. 1965); Davenport v. Campbell, 14 A.F.T.R.2d 6004 (N.D. Tex. 1964); Comment, Taxation, Deduction of Campaign Expenses, 43 N. Can. L. Rev. 1004 (1965). Also, the McDonald Court relies to some extent on an argument based on both public policy and Congressional intent that expenditures made in politics in a democracy should not be subject to income tax deduction. 323 U.S. at 63. Since this policy is peculiar to politics, it is easy to argue that McDonald should have little precedent value outside that area.

In James B. Carey, 56 T.C. 477 (1971), the Tax Court had a chance to reassess and limit McDonald in light of Primuth. There the court was faced with campaign expenditures made in an unsuccessful attempt by a union official to be reelected. The Court acknowledged that the public policy features of the McDonald situation made that decision less broadly applicable than had been thought in the past and that the Court in McDonald had left open the possibility of the opposite result in different fact situations. Id. at 480. The Tax Court, however, found that the same public policy considerations applied as existed in McDonald as reflected in Congressional legislation dealing with unions. The petitioner was thus denied the deduction. However, in denying the deduction as it did, the court left the investigatory area open for the application of Primuth in areas other than those involving elected officials. See also Comment, Tax Court Takes a Step Back in Disallowing Union Official's Campaign Expense, 35 J. or Taxation 152 (1971).


duct search expenditures including an employment agency fee incurred while in the armed forces. The court found his trade or business to be that of an Air Force officer at the time of the expenditures and that the expenditures in no way pertained to that business but to the sought-after new employment. This approach seems undesirable and ignores the argument that a taxpayer who has been well prepared or highly trained for a given trade or business will have attained conceptually the same trade or business status as a temporarily out-of-work person in the same line of activity. Also, since the position investigated must be similar to the one recently held, under the Carter principle, a plumber could not deduct the expenses of investigating a job as a bus driver even though he might have all the job capabilities and be just as motivated to procure the new job as a person presently in the trade or business of driving buses.

4. Possible Rationales for Expanding the Boundaries of the New Trade or Business Test to Include All Investigating Taxpayers

It is possible that the courts will build on the new trade or business status concept to allow the investigatory expense deductions for two groups of taxpayers presently excluded—those who have an income-earning position but are exploring an unrelated field, and those who have no previous income-earning background at all. With respect to the first group, it would be a relatively short step from the Primuth-Cremona principle of trade or business status in a particular field, like "executive" or "administrator," to the principle of trade or business status as an "employee." Then the employed plumber investigating a bus driving job would be able to deduct investigatory expenses on the basis that they are ordinary and necessary expenses in moving from job to job in the trade or business of "employee." Although the Cremona majority expressly found that the taxpayer was in the trade or business of "administrator," three concurring judges agreed that the deductible counseling fees "related to the taxpayer's current business of being an employee." Thus a broadened test such as this seems a possible avenue for future development of the trade or business concept.

63. See also Treas. Reg. § 1.162-5 (1958) which disallows the deduction for educational expenses which a taxpayer incurs to qualify him for an entirely new business. See note 31 supra.
64. 58 T.C. No. 20 (May 4, 1972) (concurrence) (emphasis added). However, language in one of the other concurring opinions,
However, such an approach may not benefit the employed taxpayer who incurs expenses investigating an unrelated income-earning position in which he will be self-employed. To allow the deduction in such a case would amount to a holding that the taxpayer had the trade or business status of "income-earner." This would appear to be a rather strained and artificial broadening of the trade or business concept, but is perhaps not unacceptable in view of the artificiality which has prevailed in this area.

The obstacle precluding a deduction in such cases could also be overcome by a somewhat different approach which would additionally allow the deduction to taxpayers in the second group—i.e., those having no previous work experience but who succeed in acquiring an income-earning position. Such a test would involve pre-job or pre-position extension, a principle which has been accepted in at least one recent Tax Court opinion. In *Cecil R. Hundley, Jr.*, the court accepted the argument that a taxpayer who is highly skilled and prepared is already in a trade or business. The taxpayer, a baseball player, was allowed to deduct a contingent fee paid to his father for the services of coaching and training him, and for advice in getting the best possible professional baseball contract. The fee clearly was paid for services rendered prior to the taxpayer's first job as a baseball player. The court nevertheless found that the taxpayer was in the trade or business of professional baseball

that "expenses related to changing one's basic skills . . . cannot be deemed to be incurred in an employee's trade or business" would seem to deny such an approach. *Id.*


66. It should be noted that the Service has long allowed all taxpayers, whether having previous trade or business experience or not, the deduction of certain employment agency fees which are charged to the taxpayer contingent on procuring a position and which actually result in his obtaining the position. *See* Tucker, *supra* note 53, at 353. This broad allowance of an expense incurred preliminary to attainment of a business interest or employment is inconsistent with the Service's stance on investigatory expenses generally and with Treas. Reg. § 1.212-1 (1957) which denies a deduction for the expenses of employment seeking. In 1960 an ill-fated attempt to reverse the policy and disallow the agency fee ended in reinstatement of the deduction. *See generally* Fleischer, *IRS About-Face in Employment Fees Shows Shaky Basis for Taxing Similar Items, 13 J. of Taxation* 82 (1960).

The policy of allowing the agency fee deduction if the expenditure results in employment was reaffirmed in the recent Rev. Rul. 71-308, 1971-2 Cum. Bull. 82. Apparently, in view of *Primuth*, the requirement that the fees be charged contingent on the taxpayer acquiring the position has been dropped. *See* note 55 and accompanying text *supra.*
playing before the contract was signed and allowed the expense deduction and held that *Frank* and other restrictive investigatory expense cases were not in point.67

By using *Hundley* as precedent in developing the trade or business status concept beyond its present state, it is possible that a Section 162 deduction could be allowed for taxpayers with no background relevant to the new job or position obtained. The taxpayer who was successful in his investigation would be considered to be engaged in a trade or business from the time he evidenced his original commitment by incurring search expenses.68 This might be referred to as pre-activity extension. Though slightly more difficult, a similar argument could be made to support a deduction for the investigating taxpayer whose search is unsuccessful. That is, it can be argued that a commitment to finding a job or position in the particular field investigated, as manifested by the taxpayer's incurrence of a conceded investigatory expense, is sufficient to give such a taxpayer trade or business status at that time even though the search subsequently proved fruitless. However, such an argument appears somewhat artificial and rather oddly would allow a taxpayer to have trade or business status, although only for the purpose of an investigatory expense deduction, even though he has never in the past and possibly never will in the future engage in income-earning activity in the relevant field.

Despite the conceptual problems in continuing the development of the new trade or business test, it is possible that the courts will undertake such development since conceptual artificialities already have permeated recent decisions, and some sort of resolution appears necessary. The alternatives are either to tolerate inconsistency of treatment among equally profit-minded taxpayers or to find a provision more amenable to a deduction of investigatory expenses for all such taxpayers.

67. For a similar case under the Section 212 "existing interest" requirement, see Caruso v. United States, 236 F. Supp. 88 (D.N.J. 1964), where the taxpayer who paid a legal expense to have his name reinstated at the top of a civil service job eligibility list was allowed to deduct the expense since the status to be protected was an "existing interest." However, the court also extended trade or business standing to allow the deduction under Section 162 on the ground that the taxpayer had a pre-job employment interest. See text accompanying notes 85 & 86 infra.

68. But see the background discussion of the fundamental requirements of a "trade or business" in note 25 supra.
C. Nonbusiness Expense Treatment Under Section 212

At first glance the broad language of Section 212(1) appears more promising than Section 162 to justify deduction of an individual's investigatory expenses. Section 212(1) states that all ordinary and necessary expenses paid or incurred for the production or collection of income are deductible. However, an examination of the case law and legislative history of the provision would reveal that the weight of authority finds Section 162 and Section 212 to be equally restrictive.

It is widely recognized that the purpose of the provision that is now Section 212 was to avoid the type of result that was reached in Higgins v. Commissioner. In Higgins the Supreme Court held that a wealthy investor living in Paris could not deduct the expenses of maintaining and staffing an office in New York to manage, under his direction, his investments in stocks and bonds. The Court found that the "trade or business" language of the predecessor to Section 162 was not broad enough to include the taxpayer's activities. By its subsequent passage of Section 212, Congress intended to overrule Higgins and allow a deduction of the ordinary and necessary expenses of income interests other than those which would qualify as a trade or business. For example, the provision most likely would allow a full time lawyer a deduction of the expenses for upkeep of houses or apartments which are rented out for extra income.

The committee report for what is now Section 212 states that all the restrictions and limitations that apply to a deduction under Section 162 also apply under Section 212 except for the requirement that the expense be incurred in a trade or business. The courts have interpreted this statement to mean that

69. IRC § 212(1) states that

(1) for the production or collection of income.


71. 312 U.S. 212 (1941).

72. See B. Bittker, supra note 70, at 204-05.


only expenses incurred in connection with some existing inter-
est of the taxpayer are deductible under Section 212. This requirement of an existing interest has made Section 212 coex-
tensive with Section 162 in the sense that any expense prelimi-
nary to the acquisition of such nonbusiness interest will be non-
deductible. Since the expenditures made in attempting to be-
come a trustee are preliminary to acquisition of the interest, for example, they are nondeductible under Section 212. Thus it has generally been held that investigatory expenses, which are also preliminary in nature, are not deductible under the pro-
vision.

The legislative history also contains support for the contrary proposition. The committee report states that a deduction is allowable under the provision, whether or not connected with the taxpayer's trade or business, "if it is expended in the pur-
suit of income or in connection with property held for the pro-
duction of income . . . ." Thus it has been argued that Congress had a larger purpose in enacting Section 212, namely, to allow even search expenditures to be deducted, provided they genuinely are made in the pursuit of potential future income. This argument is bolstered by the fact that Section 212(2) al-

dows a deduction for the "management, conservation, or mainte-
nance of property held for the production of income." (emphasis added). It can be argued that such language indicates Congressionl intent that there be an existing property interest prerequisite to a Section 212(2) deduction; therefore the absence of comparable language in Section 212(1), which allows deduc-
tions "for the production or collection of income," means that no comparable existing interest is required.

Nevertheless, with respect to investigatory expenses, the case law leans toward a restrictive reading. In McDonald v. Commissioner a majority of the Supreme Court held that cam-

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75. See, e.g., Ellsworth Statler, 25 T.C. 1175 (1956); Henry Brawner, 36 B.T.A. 884 (1937). See also Fleischer, The Tax Treatment of Ex-

penses Incurred in Investigation for a Business or Capital Investment, 14 Tax L. Rev. 567, 580-84 (1959).


79. Fleischer, supra note 75, at 581-84; Nahstoll, supra note 74.

80. 323 U.S. 87 (1944). See also Bowers v. Lumpkin, 140 F.2d 927 (4th Cir. 1944).
Campaign expenditures made by a judge seeking to gain reelection were nondeductible under Section 212(1) on the ground that that provision did not enlarge the range of allowable deductions of business expenses, but "merely enlarged the category of incomes with reference to which expenses were deductible." The *McDonald* Court made a finding that the taxpayer was entering what constituted a trade or business under Section 162. Subsequent cases therefore have relied on *McDonald* in denying the Section 212 deduction of investigatory expenses preliminary to a trade or business on the ground that to allow the deduction would be to enlarge the range of deductions to which Section 162 is applicable. The courts also have generally interpreted the *McDonald* restriction as prohibiting the deduction of investigatory expenses under Section 212 where the interest investigated would not be a "trade or business." To a certain extent this second application of *McDonald* ignores an argument. To grant the Section 212 deduction would not enlarge the range of previously allowable deductions under that provision since the Section 212 type of interest was not covered at all under prior law. Courts arguably should be free to set wide boundaries on the range of deductions relating to this new "category of income." The denial of the investigatory expense deduction probably would occur without the *McDonald* precedent, however, given the existing interest requirement which the courts have read into Section 212(1).

In the more recent case of *Caruso v. United States*, it was held that a taxpayer whose name had been unfairly removed from the top of a civil service list could deduct under either Section 162 or Section 212 the legal expenses incurred to reinstate his name on the list. In recognizing that section 212 could apply to what the court characterized as the taxpayer's existing employment interest in remaining on the list, the court seems to imply that a status preliminary to entrance into a Section 162

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81. 323 U.S. at 62 (emphasis added). For the "liberal" view asserted by Mr. Justice Black in dissent, see id. at 62.
84. It has been argued in Fleischer, supra note 75, at 583 n. 77, that *McDonald* is of no precedent value with regard to the deduction of investigatory expenses where the interest investigated is not a trade or business since there was a specific finding in *McDonald* that the taxpayer was entering a trade or business in seeking to become a judge.
trade or business may by itself constitute a Section 212 interest. However, in *Caruso* the court did not use Section 212 independently to enlarge the range of allowable deductions since the court already had been willing to allow the deduction initially under Section 162. The future precedent value of *Caruso* for a Section 212 deduction of investigations preliminary to a Section 162 trade or business would appear to be quite limited for this reason. Though not inconceivable, it seems unlikely that a court would apply Section 212 to permit deduction of expenses preliminary to a Section 162 trade or business if the court was unwilling to find that the deduction should also be allowed under Section 162. A court which would be willing to apply Section 212 in such a situation probably would be even more likely to extend Section 162 to give the taxpayer pre-job trade or business status.

The *Caruso* court itself engaged in some Section 162 pre-job extension, in finding that the taxpayer had trade or business status as well as existing interest status in being on the top of the list. It accordingly allowed the deduction of legal fees incurred to restore the taxpayer's prime job eligibility as top name on the civil service list. This recalls the approach in *Hundley* where the taxpayer was held to be in the "business" of professional baseball player prior to signing his first contract.86 The *Caruso* court, however, expressly denied that such pre-job extension could be applied to allow the deduction of investigatory expenses.87 Thus, although courts reasoning in the *Caruso* manner may be willing to make some pre-activity extensions, they will go no further under Section 212 than they will under Section 162 in similar situations.88

III. LOSS DEDUCTION UNDER SECTION 165

At one time, only losses incurred in a trade or business were deductible. However, in 1916 Congress amended the Code to al-

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86. See text accompanying notes 65-67 supra.
87. 236 F. Supp. at 95.
88. In *Primuth* where the taxpayer was successful in arguing for a Section 162 deduction of an employment agency fee, the Tax Court did not squarely confront the *McDonald* application of Section 212 in a Section 162-type situation, as had the Caruso court. The court in *Primuth* rejected the application of Section 212 expressly in deference to *McDonald*. 54 T.C. at 381 (1970). The court also was concerned about the unequal treatment of Sections 212 and 162 deductions under the net operating loss carryover provision. See IRC, § 172(d)(4). See also note 14 supra.
low individuals to deduct losses in "transactions entered into for profit." Soon after this amendment, the Internal Revenue Service ruled that a "transaction entered into for profit" included an investigation of the possibility of entering a new business. In I.T. 1505, the Service ruled that the expenses of sending an agent abroad to investigate the possibility of organizing an export business were deductible by the taxpayer as a loss even though unrelated to the taxpayer's current activities as a salaried employee and even though the idea was abandoned before any activity which would constitute a business operation was undertaken.

The transaction for profit test as applied to allow the loss deduction of investigatory expenses was subsequently refined in the Robert Lyons Hague and Charles T. Parker cases. In Hague the Tax Court found that attorney's fees, paid for advice not to enter into a land purchase deal or patent project, were not deductible as a loss. The court found that there was no "transaction entered into for profit," since petitioner did not enter the transactions but, on the contrary, stayed out of them. In Parker, however, the court distinguished Hague and allowed the loss deduction. The court held that the taxpayer had entered and then subsequently abandoned a transaction when, in exploring the purchase of mining property, he made a 30 day test operation on the mine and rejected the investment because of low yield. The court admitted that the taxpayer had not entered permanent profit-making operations, but felt he had undertaken more than a "mere preliminary investigation."

The uncertain state of the law resulting from these cases

89. The proponents of the amendment in Congress emphasized the unfairness of allowing losses in an established business such as stock trading, while not allowing an individual engaged in infrequent stock speculation to deduct losses in identical transactions. J. Seidman, Seidman's Legislative History of Federal Income Tax Laws: 1938-1961 964-65 (1938).

The current provision, IRC § 165 (c), provides that [i]n the case of an individual, the deduction . . . shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business

90. I.T. 1505, 1-2 CUM. BULL. 112 (1922).
91. Id.
93. Charles Parker, 1 T.C. 709 (1943).
94. Id. at 711.
was finally resolved in 1957 when the IRS reversed its earlier position and ruled that investigatory expenses were not deductible under the Section 165(c)(2) transaction for profit test.\(^{95}\)

Citing the strong precedent of the then recent *Frank* opinion and the *Hague* case, the IRS propounded the broad policy that no expenses would be deductible as losses unless they were "more than investigatory."\(^{96}\) In so doing, *Hague* and *Frank* were approved and I.T. 1505 was revoked. *Parker* was distinguished by stressing that the test operations in *Parker* were more than investigatory since the taxpayer's activity was in itself a temporary investment. It is critical to the distinction that the taxpayer in *Parker* formed a joint venture, retained employees and actually kept the output from the mine. Thus, the endeavor was both an investigation of a further transaction or business and also a transaction of itself, as if the taxpayer simply had leased a mining operation for a month. The fact that this one month operation was carried on for profit, as well as to determine the feasibility of purchase, made it a transaction for profit. The fact that preliminary investigations will rarely overlap with short-term profit-taking makes Revenue Ruling 57-418 which allowed the deduction in *Parker* particularly restrictive.

This narrow treatment of preliminary expenses under Section 165(c)(2) has prevailed until recently in all but a few cases.\(^{97}\) Most courts have relied on *Frank* or the revenue ruling, and without detailed analysis have disallowed the claimed deduction of investigatory expenses.\(^{98}\) *Frank* itself, in denying the deduction under Sections 162, 212, and 165(c)(2) under the same circumstances seems to indicate a covert judicial attitude that the three provisions are coextensive as applied to investigatory expenditures.

In *Harris Seed*\(^{99}\) the strict interpretation of the loss deduc-
tion was appreciably relaxed by the Tax Court. In that case the taxpayer incurred expenses in attempting to incorporate a savings and loan association. The project was abandoned when the incorporation proposal was rejected and before the commencement of any business activity. The court held that the taxpayer's activities, though merely preparatory to final operation of the business, constituted a "transaction" in the sense of actual operation for profit as defined in *Parker*. In reaching the result, the court reasoned that if Section 165(c)(2) was to add anything to the Section 165(c)(1) trade or business test, it must contemplate activities which constitute something less than the carrying on of a trade or business. The court distinguished *Frank* in that Frank undertook no obligations in visiting various newspaper locales whereas the *Seed* taxpayer clearly had committed himself to purchase stock if the savings and loan charter were granted. In so holding, the court diminished the importance of the "transaction" aspect of Section 165(c)(2), while placing considerable emphasis on the taxpayer's profit motive as evidenced by his binding commitment to the undertaking. This seems to represent a liberalization of the *Parker* test since the *Seed* taxpayer had not entered actual profit-making activity. The court did assert, however, that a transaction for profit must be more than "the mere casual preliminary investigation of a prospective business or investment."

The *Harris Seed* decision can be criticized in at least two respects. First, the court attempted to distinguish *Frank* by stating that Frank had incurred no firm commitments. Yet at least some of his efforts would qualify as such. In several of the cities he visited he incurred expenses in making unsuccessful bids on properties which he fully intended to purchase had the

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100. Specifically, the taxpayer incurred expenses for an economic survey as well as legal and accounting expenses in preparing applications for a charter. While the applications were pending he expended additional sums for incorporation plans and a successful stock subscription. *Id.*

101. 52 T.C. at 887.

102. Most commentators agree that there are two tests in the "transaction for profit" wording. See Fleischer, supra note 75, at 585; Comment, The Transaction Test for Federal Income Tax Loss Deductions, 27 Wash. & Lee L. Rev. 158, 159 (1970). See also Theodore B. Jefferson, 50 T.C. 963, 968 (1968); 5A J. MERTENS, supra note 4, at § 28.34.

103. 52 T.C. at 885 (emphasis added). The court also cited from Eli Goodman, 30 T.C. 1178, 1192 (1958), aff'd, 267 F.2d 127 (1st Cir. 1959), where the bona fide transaction for profit was described as a transaction "which has substance and in which there is a true motive of deriving a profit."
bids been accepted. Second, the court relied on the argument that the transaction for profit test would be meaningless if interpreted to include only trade or business transactions. It is well accepted that there are certain transactions which an individual taxpayer may enter and yet not be considered in a trade or business. For instance, a taxpayer may make a small stock investment for the first time and not be considered in the business of stock trading. His loss on the sale of the stock would not be deductible but for Section 165(c)(2).104 Indeed, the primary intent of Congress in passing the transaction for profit provision was to allow the deduction of the loss on such nonbusiness speculation.105 Thus, while the court is undoubtedly correct in its assertion that Section 165(c)(2) would be meaningless if the test of transaction for profit granted no deductions in addition to those given by the trade or business loss provision, this alone in no way requires a finding that Section 165(c)(2) was intended to apply to mere preparations for operating a business.

The effect of Seed on investigatory expense deductions might be influenced by two additional aspects of the case. First, there was no real “search” in Seed. The expenses were more in the nature of initial preparation for a particular planned enterprise. If this is what is meant in the opinion by “commitment,” investigatory expenses are simply not such a commitment. But second, the court distinguished Frank by stating that no abandonment had taken place. Although this is an accurate statement, it is clear that the denial of a loss deduction in Frank was based fundamentally on the taxpayer’s failure to enter a narrowly-defined “transaction.” In distinguishing Frank on the abandonment basis, the Seed opinion may have opened the way for an alternative reading of Frank that would facilitate a more liberal transaction test. Such a reading would minimize the finding in Frank that the taxpayer entered no transaction when

105. Id. There is no explicit support in the legislative history of Section 165(c)(2) for the proposition that Congress intended a secondary purpose of allowing the deduction for expenses incurred prior to actual business operation. The only indications of a larger purpose are the statements that “transaction” is a “very broad word” and that by itself “it means anything.” 53 Cong. Rec. 13265 (1916). Thus the court may have been forced to make the rather tenuous statutory language argument of reading Section 165 (c)(1) and (c)(2) together to avoid resorting to the legislative history which is largely unfavorable to the court’s position.
each newspaper site was explored and would emphasize the as-

sertion in the opinion that

[i]f the general search for a suitable business property itself
be considered as a transaction entered into for profit, no aban-
donment of such project occurred in the taxable year so as
to enable deduction of these expenses as losses.106

Such a reading would appear to allow the deduction of all the
expenses of an abandoned unsuccessful search.

The Seed opinion does not elaborate on the broad guideline
that the taxpayer's investigations must be more than casual and
there has been no subsequent attempt to refine this potential
profit motive test. For example, in the recent memorandum
decision of Theodore R. Price,107 the court granted a loss de-
duction to a taxpayer who had incurred expenses in attempting
to organize a national bank.108 The court found that the taxpayer
had had some past experience as an employee in organizing bank-
ing institutions. But in the court's view, this sporadic activity did
not qualify the taxpayer for trade or business status as an in-
dependent promoter and thus he could not deduct the outlays
as a Section 162 expense. Similarly, he could not deduct the ex-
penses under Section 212 since there was no existing interest.
In finding that the taxpayer was entitled to a loss deduction,
however, the court insisted that, as in Parker, the taxpayer had
"engaged in activities directly relevant and material" to the
formation of a "new business."109 The court held that such
activities constituted "actual operations" within the meaning of
Parker and strained to distinguish Frank on the basis that the
taxpayer in that case incurred expenses in exploring the possible
acquisition of an "existing" business. The court felt that since
the expenses could have been capitalized if the project had been
successful, there was no reason not to allow the deduction of
these expenditures as a loss when the project was abandoned.

As in Seed, the court took an expanded view of the actual
operation concept, but did not take the opportunity to refine the
profit motive test latent in the Seed opinion. Furthermore, the
court's distinction of Frank and Parker, based on the dichot-
omy between new enterprises and existing businesses, is not
accurate as a factual matter. The taxpayer in Parker was in-

108. The expenditures were for surveying, mapping and photo-
graphing the proposed location and for completing forms for the
charter application.
109. 30 CCH Tax Ct. Mem. at 1410 (emphasis added).
investigating a mining operation which was "existing" in the sense that the apparatus for mining was already assembled, and actual operations merely had been suspended by the owner before the test run was made. Even if the distinction were factually correct, it is difficult to see a rationale for such a distinction. The distinction has no relevance to the issue of whether the taxpayer can be considered to have begun actual operational activity or whether he has profit motive. Rather, it seems a somewhat arbitrary basis on which to grant or deny a deduction since, from the point of view of investigating taxpayers, a "new" business is always being entered. The tenuous distinction of Frank would appear to be a weak attempt to avoid direct confrontation with, and erosion of that opinion.

The Internal Revenue Service recently has accepted a liberal interpretation of a "transaction," at least in one instance. It has ruled that expenses preliminary to the possible acquisition of an oil lease are deductible as a loss if the project is unsuccessful. The language of the ruling announcing this policy is somewhat ambiguous as to whether the loss is allowed under Section 165(c)(1) (trade or business losses) or under Section 165(c)(2) (transaction for profit losses). The latter characterization was probably relied on primarily since the ruling explicitly states that the taxpayer entered a transaction for profit in his attempts to acquire the lease. A prior revenue ruling was cited which had ruled that identical expenses were to be capitalized where the taxpayer subsequently acquired the lease. The Service reasoned that since no leases were acquired, there could be no capitalization with respect to these expenses and therefore there must be a deductible loss.

Although the Service has confined this liberalization to the oil and gas venture field, it is clear that it is a significant breakthrough in the Service's attitude toward the transaction

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110. Rev. Rul. 71-191, 1971 INT. REV. BULL. No. 16, at 14. The items for which the taxpayer was allowed the deduction in the ruling were fees paid for geological advice on lands available for leasing, the cost of preparation of a filed offer to lease, and the federal filing fee.

111. Engagement in a series of transactions may not constitute the type of activity which qualifies under the trade or business test for the purposes of Section 162. It is unlikely that the trade or business language in Section 165(c)(1) would be interpreted much differently. See note 25 supra.

112. Rev. Rul. 67-141, 1967-1 CUM. BULL. 153. The costs are then "recovered" through depletion. The 1967 ruling did not effect a significant change, but followed prior law. See Dorothy Cockburn, 16 T.C. 775 (1951); L.S. Munger, 14 T.C. 1236 (1950).
test. It is the first time that the Service has acknowledged that less than actual operation or investment will qualify as a “trans-
action” and the new test could easily be applied to other inves-
tigations than those involving mineral exploration.\textsuperscript{113}

Also significant in the ruling is the relationship of the loss
deduction and capitalization with respect to investigatory ex-
\begin{itemize}
\item Some of the expenses, \textit{e.g.}, a preparation cost of the
offer to lease the mineral lands, were not purely search ex-
\end{itemize}penses because they were incurred after a definite decision had
been made to pursue a particular interest. But the fees paid by
the taxpayer for advice as to land available for mineral lease
are clearly search expenses. In the ruling the Service treats
all these expenses alike by allowing the loss deduction and by
asserting that they would be capitalized if there had been a suc-
cessful acquisition. Thus it apparently recognizes that investi-
gatory expenditures may be capitalized just like any other pre-
liminary expenditure and that the determination as to whether
they are capitalized or deducted immediately as a loss depends
on whether the sought-after interest ultimately is acquired.\textsuperscript{115}

This view avoids a more comprehensive analysis of the issue
of whether search expenditures should be capitalized at all. It
might be argued first that capitalization is not the appropriate
treatment for investigatory expenses because there is not really
a “permanent improvement or betterment” as defined in Section
\textsuperscript{263.}\textsuperscript{116} Although the courts have not adhered strictly to this
characterization of the nature of the capital outlay and have
allowed capitalization recoupment where the expense abstractly
“benefits” the taxpayer over the lifetime of the asset or inter-
\end{itemize}est,\textsuperscript{117} it might still be argued that investigatory expenses fall
\begin{itemize}
\item \textsuperscript{113} The actual impact of the ruling itself on oil and gas ventures is
not as great as it may seem since some courts have been quite free in
the past in granting loss deductions for the preliminary expenses of
mining ventures, despite the lack of a well defined trade or business in
some of the cases. See Colman v. United States, 9 A.F.T.R.2d 639 (D.
Utah 1961); Leslie Duryea, 6 CCH Tax Ct. Mem. 926 (1947); Charles
Parker, 1 T.C. 709 (1943); Fleischer, \textit{supra} note 75, at 574-75.
\item \textsuperscript{114} See discussion in text accompanying notes 107-09 \textit{supra}, of
Theodore Price, 30 CCH Tax Ct. Mem. 1405-3 (1971), where the
court's allowance of the loss deduction rested in part on the idea that
the expenses apparently would have been capitalized had the venture
been successful.
\item \textsuperscript{115} 1971 INT. REV. BULL. No. 16, at 15.
\item \textsuperscript{116} IRC, § 263.
\item \textsuperscript{117} See \textit{generally} Richmond Television Corp. v. United States,
345 F.2d 901 (4th Cir. 1965); United States v. Akin, 248 F.2d 742
(10th Cir. 1957); S.M. Howard, 39 T.C. 833 (1963); Treas. Reg. § 1.263
(a)-1, -2 (1958); 4A J. MERTENS, \textit{supra} note 4, at § 25.20.
\end{itemize}
outside of this broader characterization. This result accrues because investigatory expenses are not as clearly linked to the future of the asset or interest as are, for instance, legal fees for the acquisition of land and expenditures for good will, both of which may be capitalized.118

Another objection to capitalization might be the personal aspect of the expenditures. Since Section 262 asserts that no deduction can be allowed for personal expenses,119 it can be argued that capital recoupment as well as expense deductions should be denied to personally tainted expenditures. However, the recent case of Gilmore v. United States120 seems to refute such an argument. There it was held that the cost of defending title to controlling stock in a corporation could be added to the basis of the stock despite the fact that the expenditure arose from a personal context because title had been challenged in a divorce action, and despite the fact that in a prior action121 a Section 212 deduction had been denied for that very reason. The opinion suggests that even though a personal taint bars an ordinary deduction, capitalization is not necessarily prevented.

More generally, it might be troublesome conceptually to allow capitalization of investigatory expenses relating to employment since no asset is acquired when one becomes an employee.122 The practical aspect of this problem is that when a taxpayer quits or leaves his job, it is difficult to find a "sale or exchange of a capital asset" under Section 1211 because "capital asset" is defined in Section 1221 as certain property held by the taxpayer. Likewise a "sale or other disposition of property" under Section 1001 to trigger either a capital or ordinary loss is equally difficult to find. But the Tax Court in Primuth indicated a receptiveness to some sort of loss at termination of employment by expressly stating that had the employment fee expense in that situation been capitalized, "presumably . . . the

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118. It should be noted in connection with the issue of whether an outlay is a capital expenditure or an expense that it may be neither. See Connally Realty Co., 31 B.T.A. 349, aff'd 61 F.2d 221 (5th Cir. 1936) (alteration expenditure on a building when adjacent street raised); Rev. Rul. 65-241, 1965-2 Cum. Bull. 44 (costs to cooperative of purchasing stock in a bank for cooperatives in order to get a loan from it); Note, Income Tax Accounting: Business Expense or Capital Outlay, 47 Harv. L. Rev. 669 (1934).
119. IRC, § 262.
120. 245 F. Supp. 383 (N.D. Cal. 1965).
122. This difficulty was stressed in David Primuth, 54 T.C. 374, 380 (1970).
fee would be deductible when the related employment is terminated."123

Despite these objections there appears to be ample authority for the proposition that investigatory expenditures should be permitted to be capitalized in most cases. The oil loss revenue ruling124 cited above has found recent support in the Price case.125 Earlier, in Dwight Ward,126 a case decided in the same year as Frank, the court acknowledged without discussion that expenditures for travel, research and tests in investigating the market should be added to the cost basis of stock in the enterprise. In the Primuth opinion where the taxpayer was allowed to deduct the employment fee which helped him procure a job similar to the one he had held previously, the court suggested that the expenditure could have been capitalized if the taxpayer had been changing his field of endeavor.127

IV. A WORKABLE SECTION 165(c)(2) TEST FOR THE DEDUCTION OF INVESTIGATORY COSTS FOR SUCCESSFUL AND UNSUCCESSFUL SEARCHES

A continued sympathy on the part of the courts for the investigating taxpayer would reflect not only a decision that

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123. David Primuth, 54 T.C. 374, 380 (1970). More generally, with respect to both business and employment, it has been suggested that a separate loss deduction be taken at the time of abandonment of a business on the basis that at that time the Section 165(c)(2) transaction is abandoned. See Mandell, Deductibility of Pre-Operating Expenses: Successful and Unsuccessful Ventures, N.Y.U. 25TH INST. ON FED. TAX 1235, 1241 (1967).

124. See note 110 supra. For an earlier ruling which suggests a different result on investigatory expenses see Rev. Rul. 55-442, 1955-2 Cum. Bull. 529, which held that preliminary expenses in search of a campsite were nondeductible. The Commissioner by implication excluded search expenses (expenditures for checking campsites other than the one eventually acquired) from capital treatment by listing separately the preliminary expenditures which could be capitalized (bonuses paid for signing lease, appraisal costs and legal expenses prior to acquiring the campsite).

125. See text accompanying notes 107-09 supra.

126. 20 T.C. 332 (1953).

127. David Primuth, 54 T.C. 374, 380 (1970). The court stated that "[f]urther, we do not find the instant situation analogous to the capital expense incurred by an individual in the course of changing his field of endeavor." The court rejected capitalization in the situation before it in part because of the difficulty of associating employment, which is not an asset in the traditional sense, with capitalization.

For a general discussion of investigatory cost capitalization, see Mandell, supra note 123, at 1238-39 (1967), where it is maintained that investigatory costs are "generally" capitalized and amortized if possible
INVESTIGATORY EXPENSES

Investigatory expenses are not personal, but also that such expenses should be allowed as a matter of policy and Congressional intent. It is important, however, to give careful thought to some additional problems of consistency. As a general rule, it seems clear that consistency in denying the deduction to all taxpayers or in granting it to all taxpayers is most desirable as a more fundamental policy of tax law unless there is some compelling reason for distinguishing between taxpayers. This policy is generally desirable since tax law is an area where public opinion is often most sensitive to inconsistencies and inequities.

There would appear to be no overwhelming reason to distinguish between investigating taxpayers as the courts have done under Section 162. Under the Section 162 test the courts, at least for the present, will deny the deduction to taxpayers who have no previous income-earning positions similar to the one investigated, and yet will allow the deduction to the taxpayer with the required background. Assuming that they are equally profit-motivated, the only compelling reason for denying the deduction to one and not the other might be the problem of proof but this has yet to be articulated by any court. The argument would be that such past experience strongly indicates legitimate profit motive. However, it is likely that a taxpayer's educational preparation and other experiences might indicate such motive just as strongly. In addition, it should not be too strenuous a task for the courts to inquire into other circumstances in a particular case probative of motive since such inquiries are often pursued by the courts in other areas of tax law.

If the deduction of investigatory expenses is found desirable for all profit-motivated taxpayers, it is still necessary to find a Code provision which by its terms does not distinguish among such taxpayers. It seems likely that Section 162 cannot be used since the language requiring that all expenses must be incurred because of their similarity to purchases of good will. See also 4A J. MERRINS, supra note 4, § 25.08 at 33 for the statement that it is "indisputable" that expenses incurred in deciding whether to establish a business are capital, but Frank, among other cases, is cited as authority. In Frank the tax court expressly refused to deal with the issue. See note 12 and accompanying text supra.


129. See text accompanying note 136 infra. A discussion of a proposed comprehensive profit motive test is in the text accompanying notes 133-38 infra.
in a “trade or business” may prevent the deduction for taxpayers whose trade or business is unrelated to the field investigated, or who have never been in what could be considered a trade or business. Section 212 is correspondingly narrow since the existing interest requirement, at least with respect to investigatory expenses, has become the basis for the same limitations as those developed under Section 162. However, a liberally construed Section 165(c)(2) would cover all investigating taxpayers if they have a substantial profit motive since the “transaction for profit” language does not allow for any discrimination between taxpayers.\textsuperscript{130}

In addition to providing consistency of treatment, the transaction for profit test also affords some flexibility unavailable with the Section 162 test. Under the latter provision, once the taxpayer has established trade or business status, his deduction will be allowed without much further analysis of legitimate profit motive. Under the transaction for profit test, however, once the transaction aspect is minimized, the profit motive part of the test controls. This not only relieves taxpayers who have a legitimate profit motive with no previous work experience or trade or business status, but it also would prevent a taxpayer without legitimate motive from receiving the investigatory deduction even though he might otherwise achieve trade or business status. To develop such a salutary test would obviously require a rejection of the developed trade or business status concept, at least as applied to investigatory expenses. Then each taxpayer would be scrutinized similarly for a legitimate profit motive.\textsuperscript{131}

If capitalization is found to be suitable for investigatory expenses, a loss would be allowed for an unsuccessful search and capitalization would result if an interest in fact were acquired. In the case of a protracted search there are two theories which might be used, one of which would allow a loss deduction for some expenses of a successful searcher. Under the “multiple

\textsuperscript{130} See 4A J. Mertens, supra note 4, § 25.99, at 363 n. 21. Mertens suggests that a loss deduction for the expenses of employment seeking should be allowed in the year in which the possibility of securing new employment is abandoned.

\textsuperscript{131} An expenditure is deductible generally under Section 165(c)(2) if the taxpayer meets the other aspects of the test and has, as the \textit{principal} motive, the purpose of deriving profit. The expectation of profit need not be reasonable as long as it is in good faith. See Theodore B. Jefferson, 50 T.C. 963 (1968); 5 J. Mertens, supra note 4, § 28.34.
transaction" theory each separate search in a different locale or into a different interest would be considered a transaction within the meaning of Section 165(c)(2) and considered abandoned when the taxpayer quit exploring that particular locale or interest. This theory obviously would still allow the deduction of all expenses for the unsuccessful searcher. The successful searcher could take a loss deduction for all the expenses of each of the transactions investigated prior to the one ultimately entered. Since they would result in an acquisition, investigations into the chosen enterprise would be capitalized. Under the other theory, the entire search would be considered one transaction so long as it related to a single field of endeavor or investment. Under this view, the taxpayer who is unsuccessful could take a loss deduction when the search was abandoned and the successful searcher could capitalize all the expenditures since no abandonment of the transaction would have occurred when the interest was acquired.132

A liberalized test under Section 165 for a loss deduction using either of the "transaction" theories combined with capitalization in appropriate circumstances would appear to fulfill the need for consistency without disturbing the traditional current balance between deduction and capitalization. It also sensibly reflects a largely unarticulated general policy which seems to underlie opinions such as Primuth that taxpayers who have a legitimate profit motive and incur expenses in seeking to gain a profit-making position should not be denied a deduction from ordinary income.

V. FACTORS TO CONSIDER IN A PROFIT MOTIVE TEST

With respect to investigatory expenses, both the trade or business test and the transaction for profit test are changing to de-emphasize the presence of an ongoing operational activity or

132. For a suggestion that two such possibilities exist, see Morton Frank, 20 T.C. 511, 514 (1953). A similar analysis is made in Fleischer, The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment, 14 Tax L. Rev. 567, 597-98 (1959). See Champlain Coach Lines, Inc. v. Commissioner, 138 F.2d 904 (2d Cir. 1943), where two attempts in consecutive years to procure an intrastate bus operation permit were treated as separate transactions. The Commissioner had argued that all expenses should be capitalized, but the court allowed the expenses of the first attempt to be deducted and held that only those connected with the second permit acquisition attempt, which was successful, were to be capitalized.
interest and to examine more closely the individual's profit motive. Although there are restrictions in the statutory language of Section 162 which confine deductions under that section to those taxpayers asserting trade or business status, it is apparent that the test is developing to give more weight to profit motive. To the extent that Section 212 affords a taxpayer treatment parallel to Section 162 in many respects, and because of the close relation of the provisions, profit motive will become more important to Section 212 treatment as well.\textsuperscript{133} Section 165(c)(2), which appears to be the best approach to deductibility if reform continues, would embody almost exclusively an express profit motive test if the transaction aspect of its test is loosened appreciably. Given these developments, it is important that guidelines be established to assure a consistent and accurate evaluation of a taxpayer's motive for, and expectation of, future profit when investigations are made.\textsuperscript{134}

An investigatory expense test which looks wholly at profit motive obviously requires an objective examination of the circumstances of the taxpayer's efforts in each case. A purely subjective test of profit motive is unrealistic since it is clear that a taxpayer's declarations of subjective intent will be self-serving, and do not really permit any further analysis. Such a test has been rejected in other areas of tax law.\textsuperscript{135}

The first relevant factor in an objective test should be the previous experience of the taxpayer. If he has qualifications,\textsuperscript{136}
training or business experience in the field in which he is incurring search expenses, it should reflect favorably on his asserted motive. A second factor is the character of the expense, that is, whether it could be personal. For instance, expenses of a survey or an economic report should be probative of honest profit motive because such expenses could not possibly be incurred for personal reasons unless they are preliminary to the acquisition of an asset not of a profit-making nature, such as a personal residence. On the other hand, expenses for travel to Europe to investigate a business asset should be subject to closer scrutiny since the trip could be partially or entirely for personal enjoyment.

Another factor which might be given weight is actual profit derived. If the taxpayer in fact has profited from the activity, this, although not conclusive, should strongly indicate some income-earning effort and motive. On the other hand, if the taxpayer has profited only sporadically or not at all from occasional activities in the past, it might indicate a lack of motive although it is at least arguable that lack of success does not accurately measure the motive or effort which may have been put into the previous ventures. Also important is the amount of time and money invested in the search by the taxpayer. For instance, if he travels to Europe and spends only several days out of a month visiting prospective business contacts, his motive should be suspected. However, if he spends all his time visiting such contacts and also spends substantial sums on economic surveys or advice, his motive probably is one of honest profit-seeking.

A court's accurate judgment under all circumstances would be served by requiring allocation and record keeping similar to that required under the travel and entertainment business deduction provision. A recent memorandum decision applied such standards to business and nondeductible personal expenses incurred on a trip to Europe. The taxpayer's trade or business status was extended beyond the period of his prior employment and resulted in an allowable deduction of that portion of his investigatory expenditures not attributed to personal pur-

136. See IRC, § 274(c), (d); Treas. Reg. § 1.274-4 (1963); Treas. Reg. § 1.274-5 (1962). These provisions require that an allocation be made between business and personal expenses, with certain exceptions, for travel outside the United States. More generally, a taxpayer attempting to deduct travel, entertainment or gift expenses must keep adequate records of amount, time, place and business relationship.

suits. The Tax Court invoked the record keeping standards of Section 274 and held that the deduction of some of the alleged investigatory expenses must be denied because the taxpayer had not adequately documented their business purpose. With such a tool available to coerce taxpayers to provide documentary substantiation for alleged investigations, a court should have no greater burden with investigatory expenses than is already inherent in determining the allowances of business entertainment expenses. In fact, in the latter area of tax law, decisions may be even more difficult because it is often an extremely narrow line separating expenses which are business motivated and those which are personally motivated.

A taxpayer who has outside income would have greater difficulty in establishing motive. For example, a taxpayer who investigates farming, having no other source of income than that expected from the venture, should have less difficulty in establishing profit motive than a full-time corporate executive who investigates a farm. In the latter case, there is a possibility that the taxpayer will be investigating an “activity not engaged in for profit” subject to the restrictions of Section 183 of the code.\(^\text{138}\)

\(^{138}\) IRC, § 183(a), (b), (c). Because of the wording of Section 183(c), that “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” (emphasis added), it might appear that Section 183 picks up all expenses which do not qualify for Section 162 or 212 treatment. However, the legislative intent and the service’s interpretation of the statute reflect a special meaning in the word “activity” which precludes investigatory expenses. That is, “activity” is an ongoing operational component similar to the operational component of the Section 162 trade or business test. See Oshins, Proposed Regulations Provide New Rules for the Hobby Loss Game, 35 J. OF TAXATION 214, at 216-17 (1971).

Despite the fact that Section 183 apparently does not apply to investigatory expenses, a profit motive test for investigatory expenses may find relevant factors in the judicially and legislatively developed tests under the provision. In this respect see Proposed Treas. Reg. § 1.183-2 P.H. Federal Taxes ¶ 65,371 (1972). There the determination as to whether the taxpayer falls under the provision, such that his expenses from the activity can generally only be deducted up to the amount of his income from the activity, depends on various factors. Among the factors listed are: the taxpayer’s success at such pursued activities in the past, the time and effort expended by the taxpayer, the expertise and background of the taxpayer, or the fact that he has consulted with an expert if it is a specialized pursuit. See generally Oshins, supra; Sharpe, New “Hobby Loss” Rule is Tougher But “Engaged in For Profit” Dilemma Remains, 32 J. Of TAXATION 289 (1970).