29 T.C. 520 (1957)

Expenses incurred to investigate the potential of a new trade or business are considered start-up costs and are not deductible as ordinary and necessary business expenses.

Summary

J.W. York, a real estate developer, sought to deduct the cost of a survey conducted by the Urban Land Institute (ULI) to assess the industrial development potential of a specific area. The Commissioner of Internal Revenue disallowed the deduction, arguing that the survey was a pre-operational expense related to a new business venture for York. The Tax Court agreed, distinguishing York's existing business of residential and shopping center development from the proposed industrial development. The Court held that the survey was an investigation into a potential new trade or business, making the expense a non-deductible start-up cost under the Internal Revenue Code of 1939.

Facts

J.W. York was an officer and director of Cameron Village, Inc., which developed shopping centers and residential real estate. He also participated in real estate development individually. McGinnis approached York to manage Raleigh Development Center (RDC), a corporation that leased land for industrial development. York, lacking experience in industrial development, suggested a ULI survey to assess the industrial potential of the area. York contracted with ULI for the survey, paying $10,000 (later reimbursed by McGinnis). York's existing business involved residential and shopping center development; he had no prior experience with industrial property. Based on the survey's positive findings, York invested in RDC. York claimed the $5,000 portion of the ULI survey paid in 1952 as a business expense deduction on his tax return. The IRS disallowed the deduction, leading to this Tax Court case.

Procedural History

The IRS disallowed York's deduction for the ULI survey expenses. York filed a petition in the United States Tax Court to challenge the IRS's determination. The Tax Court heard the case and issued a decision in favor of the Commissioner, holding that the expenses were not deductible as ordinary and necessary business expenses.

Issue(s)

1. Whether the $5,000 paid by the petitioner in 1952 for the ULI survey and report is deductible as an ordinary and necessary business expense under section 23 (a) (1) (A) of the 1939 Code.

2. Whether the $5,000 paid by the petitioner in 1952 for the ULI survey and report is deductible as an expense for the production of income under section 23 (a) (2) of the 1939 Code.

3. Whether the $5,000 paid by the petitioner in 1952 for the ULI survey and report is deductible as a loss under section 23 (e) of the 1939 Code.

Holding

1. No, because the ULI survey was for the purpose of determining whether York should enter a new business, making the expense a non-deductible start-up cost.

2. No, because the survey did not directly lead to income production.

3. No, because the survey was not a transaction entered into for profit.

Court's Reasoning

The court first determined the nature of York's existing business. The court concluded that York's established trade or business was limited to promoting and developing residential and shopping center properties, distinct from industrial development. When approached by McGinnis about RDC, York had no prior industrial development experience. The court reasoned that the ULI survey's purpose was to overcome York's lack of knowledge in this different field, representing an investigation into a potential new trade or business. The court cited previous cases like *George C. Westervelt*, *Morton Frank*, and *Frank B. Polachek* to support its position that pre-operational expenses are not deductible.

The court also rejected deduction under Section 23(a)(2), because the survey could not directly lead to income production. Further, the court denied deduction under Section 23(e), as no transaction for profit was entered into until after the survey. As the court noted, "At the time of the survey the negotiations between petitioner and McGinnis "were in a strictly talking stage."

The court emphasized the distinction between exploring an existing business and entering a new one, stating that, "Expenditures made in investigating a potential new trade or business and preparatory to entering therein are not deductible…"

Practical Implications

This case sets a precedent for distinguishing between deductible business expenses and non-deductible start-up costs. Attorneys should advise clients that expenses incurred while investigating the feasibility of entering a new business are not deductible as ordinary business expenses. These are considered capital expenditures. For tax planning, businesses should carefully document the nature and purpose of pre-operational expenses to determine their deductibility. The distinction hinges on whether the expenditure is related to an existing business or the investigation of a new one. It’s important to determine whether a taxpayer is in the business of the activity for which the expense was incurred. Later cases have generally followed the principle established here, requiring a clear nexus between the expense and an existing, established business to allow a deduction. Failure to do so will result in the expense being classified as a capital expenditure and not deductible.

The ruling has implications for real estate developers, entrepreneurs, and any business considering expansion into a new line of business or market. This case continues to influence the interpretation of what constitutes a “trade or business” for tax purposes and what expenses are considered start-up costs versus ordinary business expenses.

