Snow v. Commissioner, 58 T. C. 585 (1972)

Expenditures for research and experimentation must be connected to an existing trade or business to be deductible under Section 174 of the Internal Revenue Code.

Summary

In Snow v. Commissioner, Edwin Snow invested in a limited partnership, Burns Investment Co. , aimed at developing a trash-burning device. Snow claimed a deduction for his share of the partnership's research and experimental expenses under Section 174 of the Internal Revenue Code. The Tax Court held that these expenses were not deductible because they were not incurred in connection with an existing trade or business. The court emphasized that the partnership's activities in 1966 were merely preparatory to a potential future business, not indicative of an ongoing trade or business. This ruling underscores the necessity of a connection between research expenditures and an existing business to qualify for deductions under Section 174.

Facts

Edwin Snow, an executive at Proctor & Gamble, invested in Burns Investment Co. , a limited partnership formed to develop a trash-burning device invented by David Trott. Snow contributed $10,000 and participated in advisory meetings about the device's development and marketing. In 1966, Burns Investment Co. incurred $36,780. 44 in research and experimental expenses, which it claimed as a deduction on its partnership return. Snow claimed his pro rata share of this loss on his personal tax return. The device was not ready for sale or licensing in 1966, and Burns had no income during that year.

Procedural History

The Commissioner of Internal Revenue disallowed the deduction claimed by Snow, leading to a deficiency determination. Snow and his wife petitioned the U. S. Tax Court for a redetermination of the deficiency. The Tax Court held in favor of the Commissioner, concluding that the research and experimental expenditures were not deductible under Section 174 because they were not connected to an existing trade or business.

Issue(s)

1. Whether the research and experimental expenditures incurred by Burns Investment Co. in 1966 were paid or incurred in connection with a trade or business of the partnership or Snow, thus qualifying for a deduction under Section 174 of the Internal Revenue Code.

Holding

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1. No, because the expenditures were not connected to an existing trade or business. The court found that Burns Investment Co. was not engaged in a trade or business in 1966, and the expenditures were preparatory to a business that did not yet exist.

Court’s Reasoning

The court applied the requirement from Section 174 that research or experimental expenditures must be incurred in connection with a taxpayer’s trade or business to be deductible. It cited John F. Koons, 35 T. C. 1092 (1961), which held that such expenditures must relate to the development or improvement of existing products or services or to new products or services in connection with a going trade or business. The court determined that Burns Investment Co. was not holding itself out as engaged in the selling of goods or services in 1966, and its activities were merely preliminary to a potential future business. The court distinguished this case from Cleveland v. Commissioner, where the taxpayer was found to be engaged in a joint venture with an inventor, and Best Universal Lock Co. , where a corporation was already in a going business when it undertook research on a new product. The court noted that Snow’s involvement in other partnerships did not change the fact that Burns was not engaged in a trade or business in 1966.

Practical Implications

This decision clarifies that research and experimental expenditures under Section 174 are only deductible if they are connected to an existing trade or business. Taxpayers must demonstrate that their research activities are part of an ongoing business, not merely preparatory to a future business. This ruling affects how tax practitioners advise clients on structuring research and development ventures and claiming deductions. It also impacts businesses considering investing in new product development, requiring them to establish an existing trade or business before incurring such expenses. Subsequent cases, such as Richmond Television Corp. v. United States, have applied this principle, further solidifying the requirement of an existing trade or business for Section 174 deductions.

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