Todd v. Commissioner, 77 T. C. 1222 (1981)

Abandonment losses are not attributable to a trade or business under section 172(d)(4) if the business operations never commence.

Summary

In Todd v. Commissioner, the Tax Court ruled that a physician's abandonment loss from a planned apartment building project was not attributable to a trade or business under section 172(d)(4) of the Internal Revenue Code. Malcolm Todd, a physician, purchased land in 1964 to build a rental apartment but never started construction due to zoning changes and other issues, abandoning the project in 1975. The court held that since no business operations had begun, the loss could not be considered a business loss for net operating loss carryback purposes, impacting how pre-operational business losses are treated for tax purposes.

Facts

Malcolm C. Todd, a practicing physician, purchased a parcel of land in Long Beach, California in 1964 with the intention of constructing a 16-story rental apartment building. From 1964 to 1975, Todd actively pursued this venture, hiring professionals and incurring significant expenses. However, high interest rates and issues with the California Coastal Commission delayed the project. In 1975, a zoning change by the city of Long Beach made the project unfeasible, leading Todd to abandon his plans. He claimed an abandonment loss of $159,783. 91 on his 1975 tax return, which he attempted to carry back to 1972 as a net operating loss.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in Todd's 1972 income tax, disallowing the net operating loss carryback from 1975. Todd filed a petition with the Tax Court challenging this determination. The Tax Court heard the case and issued its opinion in 1981.

Issue(s)

1. Whether the abandonment loss incurred by Todd in 1975 was attributable to a trade or business within the meaning of section 172(d)(4) of the Internal Revenue Code.

Holding

1. No, because the court determined that Todd was not engaged in a trade or business at the time of the abandonment, as no actual business operations had commenced.

Court's Reasoning

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The court applied the legal rule that losses must be attributable to a trade or business to qualify for net operating loss carrybacks under section 172(d)(4). It distinguished between pre-operational expenses and losses from an active trade or business, citing cases like Polachek and Goodwin, where similar losses were denied because the businesses had not yet started operations. The court emphasized that Todd's venture never progressed beyond the planning stage, and no rental operations ever began. The court also considered the policy behind the net operating loss provisions, which aims to allow businesses to average income over time, concluding that this policy did not support treating Todd's loss as a business loss since no business ever materialized. The court quoted from Polachek, stating, "he merely had plans for a potential business" which never materialized, highlighting the key distinction between planning and operating a business.

Practical Implications

This decision clarifies that for tax purposes, losses from abandoned business ventures are not deductible as business losses under section 172(d)(4) unless actual business operations have commenced. This impacts how taxpayers and their attorneys should approach claims for net operating loss carrybacks, particularly for pre-operational business ventures. It underscores the importance of distinguishing between start-up expenses and losses from an operating business. Practitioners must advise clients that significant planning and investment do not suffice to establish a trade or business for tax purposes; actual business operations must begin. This ruling has influenced subsequent cases dealing with similar issues, reinforcing the principle that a business must be operational to claim losses as business losses for tax purposes.

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