Hoopengarner v. Commissioner, 80 T. C. 538 (1983)

Lease payments made before the start of a rental business are deductible under Section 212(2) if they relate to property held for future income production.

Summary

Hoopengarner acquired a 52. 5-year leasehold interest in 1976, intending to construct and operate an office building. He made rental payments that year, but construction was not completed until 1977, and no income was generated in 1976. The Tax Court held that these payments were not deductible under Section 162 as business expenses because the rental business had not yet commenced. However, they were deductible under Section 212(2) as expenses for managing property held for future income production, except for the portion of the payment attributable to the period before Hoopengarner acquired the lease.

Facts

In April 1976, Herschel H. Hoopengarner acquired a leasehold interest in undeveloped land in Irvine, California, from Troy Associates, Ltd. The lease, originally for 55 years, required the construction and operation of an office building. Hoopengarner paid $9,270. 56 into an escrow account for rent from October 15, 1975, to October 31, 1976, and $8,974. 10 on December 1, 1976, for the period from November 1, 1976, to October 31, 1977. Construction began in February 1977 and was completed by September 1977. Hoopengarner leased the building to Penn Mutual Life Insurance Co. in December 1976, but they did not move in until November 1977. No income was generated from the property in 1976.

Procedural History

The Commissioner of Internal Revenue issued a statutory notice of deficiency in July 1979, disallowing Hoopengarner's claimed deduction for the 1976 lease payments. Hoopengarner petitioned the United States Tax Court for a redetermination of the deficiency. The Tax Court held that the payments were not deductible under Section 162 but were partially deductible under Section 212(2).

Issue(s)

1. Whether the 1976 lease payments are deductible under Section 162(a) as ordinary and necessary business expenses.
2. Whether the 1976 lease payments are deductible under Section 212(2) as expenses for managing property held for the production of income.
3. Whether the portion of the 1976 lease payments attributable to the period before Hoopengarner acquired the leasehold is currently deductible.

Holding

1. No, because the payments were not made while carrying on a trade or business; they were pre-opening expenses.
2. Yes, because the lease was held for the production of future income, and the payments were ordinary and necessary expenses for managing that property.
3. No, because the accrued rent attributable to the period before Hoopengarner acquired the leasehold constitutes part of the lease acquisition cost and is not currently deductible.

Court's Reasoning

The court applied Section 162(a) and found that Hoopengarner was not carrying on a trade or business in 1976 when the payments were made, as the office building was still under construction and no income was generated. The court cited cases like *Richmond Television Corp. v. United States* and *Bennett Paper Corp. v. Commissioner* to support the non-deductibility of pre-opening expenses under Section 162. However, under Section 212(2), the court found that the lease was held for the production of future income, and the payments were ordinary and necessary for managing that property. The court emphasized that Section 212 does not require the taxpayer to be in a trade or business, referencing *United States v. Gilmore*. The court also rejected the Commissioner's argument that the pre-opening expense doctrine should apply to Section 212 deductions, as it pertains to trade or business activities. The court addressed the dissent's concerns by distinguishing the lease payments from capital expenditures and affirming the applicability of Section 212(2) to the facts of the case.

Practical Implications

This decision clarifies that lease payments made before a rental business begins operations can be deductible under Section 212(2) if they relate to property held for future income production. This ruling impacts how taxpayers and tax professionals should analyze similar pre-operational expenses, emphasizing the need to distinguish between Section 162 and Section 212 deductions. It also underscores the importance of the taxpayer's intent to hold property for income production. Taxpayers engaging in property development should consider structuring their investments to take advantage of Section 212(2) deductions during the pre-operational phase. Subsequent cases like *Zaninovich v. Commissioner* have further refined the treatment of lease payments, particularly regarding the timing of deductions. This decision also highlights the ongoing tension between the Tax Court's majority and dissenting opinions regarding the applicability of the pre-opening expense doctrine to Section 212 deductions.

