Hardy v. Commissioner, 95 T. C. 35 (1990)

Pre-opening expenses incurred in the attempt to start a new business are not currently deductible under either section 162 or section 212 of the Internal Revenue Code.

Summary

In Hardy v. Commissioner, Arthur H. Hardy attempted to deduct $8,750 in loan fees incurred in an unsuccessful attempt to secure a loan for purchasing commercial properties. The Tax Court ruled that these fees were pre-opening expenses and thus not deductible under sections 162 or 212. The decision clarified that the pre-opening expense doctrine applies to both sections, overruling prior Tax Court cases that had allowed deductions under section 212. The court's rationale emphasized the need for temporal matching of income and expenses and the legislative history indicating parity between sections 162 and 212. This ruling has significant implications for how taxpayers can handle start-up costs and affects the interpretation of section 195 regarding the amortization of start-up expenditures.

Facts

Arthur H. Hardy was a full-time employee of the Utah Department of Education and part-time manager of 45 rental homes owned by Dalton Realty. In early 1982, Hardy sought a multimillion-dollar loan to purchase hotel, motel, and resort properties. He engaged loan broker Charles Tisdale, who represented Bancor, Inc. , to facilitate this loan. Hardy paid $8,750 in loan fees, expecting to split the loan proceeds with Antone Pryor, who had the necessary net worth. Despite these efforts, the loan never materialized, and Tisdale was later discovered to be serving time in prison. Hardy claimed these fees as a deduction on his 1982 tax return, which was denied by the IRS.

Procedural History

The IRS issued a statutory notice of deficiency in January 1986, determining a deficiency in Hardy's 1982 income tax liability. After concessions, the remaining issue was the deductibility of the $8,750 loan fees. The Tax Court heard the case and issued its opinion in 1990, reversing prior decisions and denying the deduction.

Issue(s)

1. Whether the $8,750 loan fees incurred by Hardy are deductible under section 162 of the Internal Revenue Code as ordinary and necessary expenses of carrying on a trade or business?
2. Whether the same fees are deductible under section 212 as expenses paid for the production or collection of income?

Holding

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1. No, because the fees were pre-opening expenses related to a new business that was not yet functioning, and thus not deductible under section 162.
2. No, because the pre-opening expense doctrine applies to section 212 as well, reversing prior Tax Court decisions that had allowed such deductions.

Court’s Reasoning

The court applied the pre-opening expense doctrine, established in cases like Richmond Television Corp. v. United States, which prohibits the current deduction of start-up expenses under section 162. The court extended this doctrine to section 212, citing the need for parity between the two sections as indicated by legislative history. The court noted that the pre-opening expenses were capital in nature, intended for the acquisition of a new business, and thus should not be currently deductible. The decision was influenced by several Courts of Appeals that had rejected prior Tax Court rulings allowing section 212 deductions for pre-opening expenses. The court also considered the implications of section 195, which allows for the amortization of start-up costs, indicating Congress’s intent to treat pre-opening expenses as capital expenditures.

Practical Implications

This decision clarifies that pre-opening expenses cannot be currently deducted under either section 162 or section 212, affecting how taxpayers approach start-up costs. Tax practitioners must advise clients to capitalize such expenses and consider the amortization options under section 195. The ruling impacts how businesses plan their initial expenditures and may lead to more conservative financial planning in the start-up phase. Subsequent cases have followed this precedent, reinforcing the application of the pre-opening expense doctrine across both sections of the tax code. This decision also influences the interpretation and application of section 195, emphasizing the importance of understanding legislative intent and the temporal matching of income and expenses in tax law.

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