Washington and Lee Law Review

Volume 27 | Issue 1 Article 13

Spring 3-1-1970

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diction.[48] Certainly, if federal courts consider the claims between the original defendant and the third-party defendant to be ancillary to the main suit,[49] then it is only rational that *all* third-party claims should be considered ancillary.[50] As one court declared, "to hold otherwise would deny the practical effect of Rule 14 to many cases. The object of the Rule is to avoid circuity of action and multiple suits, to adjust in a single suit the several phases of the same controversy."[51] By abandoning the independent jurisdictional requirement for a plaintiff's third-party claim, much of the cost, delay and burden of additional and unnecessary litigation in state courts would be eliminated.

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THE TRANSACTION TEST FOR FEDERAL INCOME TAX LOSS DEDUCTIONS

When an individual taxpayer decides to invest money in the investigation and organization of a business, he incurs two financial risks. Should the venture fail, he will lose his investment. Moreover, if the taxpayer does not meet the statutory requirements of section 165 of the Internal Revenue Code,[1] he will not be able to deduct this loss on his federal income tax return. Section 165, the general loss section, allows a deduction for any loss sustained during the taxable year which is not compensated by insurance or otherwise. In the case of an investment by an individual, subsection (c) limits the deduction to losses

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[48]For discussion of arguments in favor of applying the doctrine of ancillary jurisdiction to all third-party claims see text accompanying notes 13-16 *supra*.

[49]Cases cited notes 14 and 15 *supra*.

[50]Holtzoff, *Entry of Additional Parties in a Civil Action*, 31 F.R.D. 101, 110 (1963).

[51]Sklar v. Hayes, 1 F.R.D. 594, 596 (E.D. Pa. 1941).

[1]INT. REV. CODE of 1954, § 165 provides in part:

(a) General Rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . . .

(c) Liimitation on Losses to Individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

from several sources among which are: losses incurred in a trade or business, and those incurred in any transaction entered into for profit, though not connected with a trade or business.[2] Thus in the case of any loss not incurred in connection with his trade or business, a taxpayer must look to the "transaction entered into for profit" provision as the only alternative means of receiving income tax relief for such loss.

The "transaction entered into for profit" test, codified as subsection (c) (2), requires the taxpayer to meet two criteria before the deduction will be allowed. First, he must have entered into the transaction primarily to make a profit. Second, he must actually have entered into a *transaction*. The requirement of a profit motive has been explained by cases which, while permitting bona fide losses to be deducted, tend to protect the Treasury from taxpayers who enter into ventures, fully expecting failure, with the intention of deducting the losses incurred against ordinary income.[3] It is the second test, that of entering into an actual transaction, which is not so clearly defined.

In *Harris W. Seed,*[4] the taxpayer invested $1,566.82 in a joint venture to organize a savings and loan association. The co-incorporators contributed their money to an "organization fund" to cover the cost of a requisite economic study of the community, as well as legal, accounting, and other fees in connection with the application for incorporation. The incorporation plans were then completed, and tentative sales of stock were executed. Seed subscribed to 4,500 shares at a total value of $63,000. Over 14,000 additional shares were subscribed to by the general public. The only item remaining before actual commencement of business was the approval of the application for incorporation. When approval was denied for the second time in July, 1964, the promoters were forced to abandon the project.

On his federal income tax return for 1964, Seed deducted his entire investment as a loss incurred in a transaction entered into for profit.

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[2]INT. REV. CODE of 1954 § 165(c)(3), providing for casualty losses is not within the scope of this comment.

[3]A taxpayer's investment must be "primarily" for profit, and "primarily" shall have its ordinary meaning of "first," or "principally." Theodore B. Jefferson, 50 T.C. 963, 968 (1968).

In Eli D. Goodstein, 30 T.C. 1178 (1958), *aff'd,* 267 F.2d 127 (1st Cir. 1959), the taxpayer was denied a deduction because it was found that he had entered the transaction for tax-saving purposes. "In other words, there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been 'without economic substance' or a 'sham'." Knetsch v. United States, 348 F.2d 932, 938 (Ct. Cl. 1965), *cert. denied,* 383 U.S. 957 (1966).

[4]52 T.C. No. 93 (Aug. 28, 1969). At this writing this opinion has not been paginated in an official reporter.

The Internal Revenue Service (IRS) disallowed the deduction on the ground that Seed had not entered into any transaction before the project was abandoned. In reviewing the determination of the IRS, the Tax Court ruled that Seed's activities did indeed constitute a transaction, thereby approving the deduction.

In order to reach this result, the Tax Court was faced with the task of ascertaining the statutory meaning of "transaction." As is frequently the case in statutory interpretation where the definition of a term or phrase is determinative, the court searched the legislative history;[5] with respect to the term "transaction," however, the court found little guidance. Section 165(c)(2) first appeared as section 5(a)(Fifth) of the Revenue Act of 1916,[6] and therefore the inquiry began with the committee reports regarding that act.[7] These revealed that more emphasis was placed upon the necessity of a profit motive than upon the definition of transaction. Indeed, the only comments involving this important term were that " '[t]ransaction' is a very broad word," and "by itself means anything."[8] The court ended its investigation of the legislative history at this point, failing to note a rather material difference between the 1916 provision and the current one. The former allowed a deduction of losses on a transaction only to the extent of any profits realized on that same transaction.[9] Were this provision still in force, Seed would certainly have been denied his deduction. The Revenue Act of 1918[10] amended the provision to allow the loss to be deducted in full without the requirement of antecedent profits. Although this change does not in itself aid in the search for a definition, it indicates that Congress apparently did not intend to require that the taxpayer go so far as actually to engage in operations in order to qualify for the deduction. The acts of 1924[11] and 1934[12] contained changes immaterial to this discussion, and the language of section 23(e)(2) of the 1934 act is identical to the current section 165(c)(2).[13]

In order to fill the void left by Congress, the Treasury has twice issued rulings which attempt to define the term "transaction."[14] The

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[5]*Id.*

[6]Ch. 463, § 5(a) (Fifth), 39 Stat. 756.

[7]J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1861, at 963 (1938).

[8]*Id.* at 966.

[9]Ch. 463, § 5(a) (Fifth), 39 Stat. 756.

[10]Ch. 18, § 214(a)(5), 40 Stat. 1057, 1067.

[11]Revenue Act of 1924 ch. 234, § 214(a)(5), 43 Stat. 253, 270.

[12]Revenue Act of 1934 ch. 277, § 23(e)(2), 48 Stat. 680, 689.

[13]INT. REV. CODE of 1954, § 165(c)(2).

[14]*See* Rev. Rul. 57-418, 1957-2 CUM. BULL. 143;I.T. 1505, I-2 CUM. BULL. 112 (1922).

more recent attempt, Revenue Ruling 57-418,[15] states that a loss will be "deductible [under subsection (c)(2)] only where the activities are more than investigatory and the taxpayer has actually entered into a transaction for profit and the project is later abandoned."[15] It appears that the Treasury is defining transaction as an activity which is more than an investigation. This ambiguous definition is helpful only when analyzed in connection with the three cases that the Ruling attempted to distinguish,[16] and with I.T. 1505,[17] which it simultaneously revoked.

In 1922 the IRS published I.T. 1505, which ruled that the expenses of an agent who traveled to Europe to investigate the possibility of opening an export business were deductible after the project was abandoned. *Robert L. Hague*[18] and *Morton Frank*,[19] two of the three cases embodied in Rev. Rul. 57-418, seem to conflict with this view. In *Hague,* the taxpayer was denied a deduction for legal fees paid for the advice *not* to enter certain business ventures. To taxpayer's contention that these fees were losses incurred in a transaction entered into for profit, the Board of Tax Appeals replied, "The simple answer to this contention is that petitioner did not enter into these transactions but, on the contrary, stayed out of them."[20] Thus merely inquiring into the advisability of a business venture does not constitute a transaction under subsection (c)(2).

The second case in conflict with I.T. 1505 was *Morton Frank,* in which taxpayers made several unsuccessful trips to various cities in an attempt to purchase a radio station or a newspaper company. Taxpayers tried to deduct travel expenses and legal fees incurred on the trips, but the Commissioner refused to concede that they had entered into any transaction. The Tax Court upheld the Commissioner:

> It cannot be said that petitioners entered into a transaction every time they visited a new city and examined a new business property. . . . Rather, they refused to enter into such transactions after the preliminary investigation.[21]

As in *Hague,* the court felt that petitioner Frank had not gone beyond the investigatory stage.

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[15] 1957-2 CUM. BULL. 143, 144.

[16] Morton Frank, 20 T.C. 511 (1953); Charles T. Parker, 1 T.C. 709 (1943); Robert L. Hague, 24 B.T.A. 288 (1931).

[17] I-2 CUM. BULL. 112 (1922).

[18] 24 B.T.A. 288 (1931).

[19] 20 T.C. 511 (1953).

[20] 24 B.T.A. at 290.

[21] 20 T.C. at 514. *See also* Joseph W. Brown, 40 T.C. 861 (1963) (loss deduction disallowed for expenses relating to the inspection of timber land which taxpayer decided not to purchase).

A different result was reached, however, in *Charles T. Parker*,[22] the third case embodied in Rev. Rul. 57-418. Parker, a contractor, invested in a joint venture to operate a placer gold mine. The investors first inquired of another contractor as to the advisability of the project, and upon his advice, made a thirty-day test run. When the recovery proved to be lower than expected, the project was abandoned. The court sustained petitioner's deduction of all his expenses as a loss incurred in a transaction for profit[23] and justified its decision in the following language:

> Although the transaction was to test the advisability of a more extensive operation, it was nevertheless a transaction entered into for profit.
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> . . . .
>
> [T]he fact that they [the test operations] did not result in a permanent undertaking does not take the transaction outside the statutory provision.[24]

The *Parker* court seems to have been impressed by the fact that the petitioner had actually engaged in "usual operations" for thirty days before abandoning the project.[25] In light of *Seed* this presents an interesting situation. The petitioner in *Seed* validly argued that he had gone beyond a mere preliminary investigation; it could not be said, however, that he actually entered into "usual operations" of a savings and loan association. *Seed* seems to represent the middle ground between "usual operations" and "preliminary investigation."

Two material facts of *Seed* distinguish *Seed* from *Hague* and *Frank* on the one hand, and from *Parker* on the other. Clearly, the taxpayer Seed did substantial work beyond the preliminary investigation stage discussed in *Hague* and *Frank*. He prepared applications for incorporation and procured tentative commitments from outsiders. In fact, all actions necessary for the commencement of the prospective business had been completed. Unlike *Parker*, however, and through no fault of his own, the taxpayer was never able to begin "usual operations." In *Seed*, the Tax Court considered these "middle ground" activities as constituting a transaction.

In a case similiar to *Seed*, *Finch v. United States*,[26] the petitioner made all the necessary arrangements prior to the purchase of land on which he planned to erect a Holiday Inn Motel. He obtained a fran-

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[22]1 T.C. 709 (1943).

[23]*Id.* at 711.

[24]*Id.* at 710-11.

[25]*Id.* at 710.

[26]18 A.F.T.R.2d 5259 (D. Minn. 1966). This case is not reported in a West reporter.

chise from Holiday Inns of America, Inc. and arranged for a mortgage on the realty. When the land became unavailable, the petitioner abandoned his plan, losing his investment in travel expenses to the site, and legal fees for corporate and tax consultations. The district court sustained his claimed deduction in excess of $3,500.[27] *Finch* is a valuable aid to the taxpayer for it requires less activity than did *Parker*.

Neither *Finch* nor *Seed* considered the question of whether the loss involved was ordinary or capital. Both Finch and Seed clearly exceeded the maximum statutory capital loss deduction of $1,000.[28] In both cases, however, a deduction exceeding this amount was permitted. It is questionable whether this result is correct. If the businesses had succeeded, the organization costs would have been capitalized,[29] and any losses of the investments would seemingly have been capital loss subject to the $1000 deduction limitation. There are two possible explanations for the courts' failure to consider this point.

The courts may have assumed that the investment was not a capital one. Although the expenditures would have been capital in nature had the businesses come into existence,[30] in *Seed* and *Finch* the money was spent in *contemplation* of a capital investment. The investments never became capital ones because the corporations never became realities. The argument that an investment is not capital until a corporation comes into existence was used successfully in *Champlain Coach Lines v. Commissioner*.[31] A second explanation might be that the losses, although involving capital items, do not come within the statutory definition of capital losses. Subsections (2) and (4) of Section 1222[32] define such losses as those resulting from the "sale or exchange of a capital

[27]For the significance of $3,500 see text accompanying notes 29-34 *infra*.

[28]INT. REV. CODE of 1954, § 1211(b) limits deductions of capital losses to $1,000.

[29]Items which must be capitalized are illustrated by the following cases: Nachman v. Commissioner, 191 F.2d 934 (5th Cir. 1951) (cost of acquiring a liquor license); Radio Station WBIR, Inc., 31 T.C. 803 (1959) (cost of acquiring a television license); Dwight A. Ward, 20 T.C. 332 (1953) (expenses involved in research, engineering, and travel preliminary to the organization of a corporation).

[30]Dwight A. Ward, 20 T.C. 332, 343-44 (1953). INT. REV. CODE of 1954, § 248 gives an election to amortize certain organizational costs.

[31]138 F.2d 904 (2d Cir., 1943). In order to extend operations to new territory, corporate-taxpayer Champlain planned to create a wholly owned subsidiary corporation. Champlain then bought 210 shares of the subsidiary's stock for $21,000. When the New York Public Service Commission denied the subsidiary the right to operate, Champlain claimed a deduction of the full amount of its investment. The court agreed that since the Public Service Commission had refused to allow the subsidiary to issue stock (and thus to exist as a corporation), Champlain had not made a capital investment. *See also* Rev. Rul. 56-529, 1956-2 CUM. BULL. 170.

[32]INT. REV. CODE of 1954, § 1222(a)(4).