In the

Supreme Court of the United States

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EDWIN A. SNOW and HELEN B. SNOW,

Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

Docket No. 73-641

Pages 1 thru 44

Washington, D. C.

April 16, 1974

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IN THE SUPREME COURT OF THE UNITED STATES

EDWIN A. SNOW and HELEN B. SNOW, Petitioners	:	
v.	:	No. 73-641
COMMISSIONER OF INTERNAL REVENUE, Respondent	:	

Washington, D. C.

Tuesday, April 16, 1974

The above-entitled matter came on for argument at 11:11 a.m.

BEFORE:

WARREN E. BURGER, Chief Justice of the United States
WILLIAM O. DOUGLAS, Associate Justice
WILLIAM J. BRENNAN, JR., Associate Justice
BYRON R. WHITE, Associate Justice
THURGOOD MARSHALL, Associate Justice
HARRY A. BLACKMUN, Associate Justice
LEWIS F. POWELL, JR., Associate Justice
WILLIAM H. REHNQUIST, Associate Justice

APPEARANCES:

BURGESS L. DOAN, ESQ., 522 Dixie Terminal Building, Cincinnati, Ohio 45202, for the Petitioners.

STUART A. SMITH, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C. 20530, for the Respondent.

I N D E X

P R O C E E D I N G S

MR. CHIEF JUSTICE BURGER: We will hear argument next in No. 73-641, Snow against Commissioner of Internal Revenue.

Mr. Doan, you may proceed whenever you are ready.

ORAL ARGUMENT OF BURGESS L. DOAN

ON BEHALF OF THE PETITIONERS

MR. DOAN: Mr. Chief Justice, and may it please the Court: This case involves a deficiency in the Federal income tax for the taxable year 1966. The issue is whether the petitioner is entitled to a deduction for his distributive share of a net operating loss resulting from research and experimental expenditures incurred and paid by Burns, a partnership, during the taxable year 1966.

Petitioner contends he is entitled to deduct his distributive share of the net operating loss of Burns since the expenses giving rise to this loss were incurred and paid during the taxable year 1966 as research and experimental expenses. These expenses are covered by section 174 of the Internal Revenue Code of 1954.

The Commissioner of Internal Revenue has disallowed these expenses upon audit of the partnership return on the grounds that neither Burns Investment Company nor the petitioner Snow was engaged in a trade or business.

The United States Tax Court sustained the

Commissioner, and the Court of Appeals of the Sixth Circuit sustained the Tax Court decision, holding that the expenditures sought to be deducted by Burns Investment Company in 1966 were preoperating expenses and not deductible under section 174.

The facts of the case are fairly simple. In 1963 Mr. Trott, who was the inventor of a trash-burning device and who was also the managing partner of Burns Investment Company, resigned from his position with the Proctor & Gamble Company and purchased an interest in a small, closely held corporation doing business as Crossbow. In addition to his activity in Crossbow, Mr. Trott carried on research and development work on three different items: Number one, a telephone-answering device; number two, a tape recorder; and number three, the item at issue, a trash burner or a leaf burner.

Upon audit of the partnership return, the Internal Revenue Service held that Mr. Trott, the general partner, was engaged in the business of an inventor by virtue of his activities in these various projects.

The partnerships, which were three, which were formed to carry on these various ventures, were doing business as Echo Development Company -- and that partnership was formed in March of 1965. The second partnership doing business as Courier Enterprises was formed to carry on the development of a tape recorder, and that partnership was also formed in March of 1965. The partnership Burns Investment Company, which

was formed to carry on the development of the trash-burner, was formed in 1966. All three partnerships were formed for the same purpose, and that was the development, securing patents on, and finally either producing or licensing another manufacturer to produce these various items.

During 1966 Echo and Courier -- 1966 is the year at issue, and during 1966 Echo and Courier had completed products, that is, the tape recorder and the telephone-answering device which was then held available for sale or licensing. Patents had been applied for in the case of the telephone-answering device as of August 16, 1966. Patents had been applied for in the case of the tape recorder as of November 22, 1967. Patent for the trash burner was applied for as of June 10, 1968, and in each instance patents were granted. In the case of the trash-burner, foreign patents have been granted in at least 14 foreign countries.

The Internal Revenue Service held that Burns Investment Company was not engaged in a trade or business during the taxable year 1966. The Internal Revenue Service did not see fit to disturb the status of Echo or Courier, the two remaining partnerships.

Mr. Trott, the inventor and the managing partner, testified that he worked on the development of the trash-burner during the year 1964 and 1965, and during that time he devoted one-third of his time to that venture. On December 10,

1965, the development of the trash-burner had advanced to the stage that Mr. Trott had received an opinion from patent counsel stating that features of the trash burner were then patentable in his opinion. However, he advised against filing an application for patent in December of 1965, suggesting that the filing be held up until a prototype had been built.

QUESTION: What year was the prototype built? When did the work start on the prototype?

MR. DOAN: Many prototypes had been built prior to that time. The prototype to which we allude as existing in 1965 was a rather crude prototype model that admittedly did have some flaws in it. It did not work well.

The second letter which was received from patent counsel in February of 1966 pointed out that the prototype that was then in existence needed further modification, again in the opinion of patent counsel.

After receiving the letter from patent counsel advising of that fact in 1966, Mr. Trott proceeded to form the partnership Burns Investment Company to raise capital to further develop the trash burner. After forming the partnership, articles of partnership were drawn up and filed with the Hamilton County Recorder's office. The partners paid in their capital contributions to the extent of $40,000. The partnership proceeded to secure its Federal employer

identification number. It proceeded to establish its bank accounts. It set up its books and records. It filed its Federal income tax return.

QUESTION: You sort of skipped over a point. Where was its office?

MR. DOAN: Your Honor, the office of Burns Investment Company was in the facilities of the closely held corporation Crossbow.

QUESTION: Did it have a name on the door?

MR. DOAN: No, your Honor, it did not.

QUESTION: It didn't have a name on the door, didn't have a telephone. Where was the "business"?

MR. DOAN: The business --

QUESTION: Of that partnership, just the one, where was that business?

MR. DOAN: That business was located within the same building as Crossbow. It did not have a name on the door, and it did not have a telephone.

QUESTION: And the difference between that and Crossbow was what?

MR. DOAN: One was a partnership --

QUESTION: How many employees did this one have?

MR. DOAN: It did not have any employees directly.

QUESTION: How do you have a business without employees?

MR. DOAN: Mr. Trott --

QUESTION: Don't you have to show you have a partnership business in order to qualify?

MR. DOAN: Yes, your Honor, we have to show we have a partnership business.

QUESTION: I'm waiting for you to show me the business. The man is doing experimenting; he is making models and everything, but where's his business?

MR. DOAN: Your Honor, we submit his business is the research and experimental activity carried on in perfecting the trash burner. The partnership, Burns Investment Company, did enter into contractual relationship with Crossbow and with other suppliers obligating itself for goods and services. It conducted regular partnership meetings regarding the development work, regarding tests and experiments that were carried on, regarding the design of the trash burner, regarding the various marketing methods on how the trash burner could best be brought to the commercial market.

The partnership, Burns, did not have a trash burner that was then available for sale to the market in 1966.

Section 174 of the Internal Revenue Code provides that a taxpayer may deduct research and experimental expenditures paid or incurred by him during the taxable year in connection with his trade or business. There is no dispute as to these expenses involved in this case being research and

experimental expenses within the meaning of section 174.

QUESTION: I take it there is no dispute about the integrity of these expenses.

MR. DOAN: No, your Honor, there is not.

QUESTION: And I take it you also concede that were you relegated to 162 your case would not be a good one.

MR. DOAN: We admit that, your Honor.

The term "trade or business" is nowhere defined in section 174 or in the Commissioner's regulations under section 174.

The respondent contends in this case that the term "trade or business" has the same meaning in section 174 as it has in other sections of the Internal Revenue Code. However, the case law relied upon in support of this proposition in every instance goes back to a section 162 standard. Section 162 allows expenses incurred in carrying on a trade or business. Section 162 has other standards as well, specifically section 162 provides that a taxpayer may deduct ordinary and necessary expenses incurred in carrying on a trade or business, while section 174 has a different standard. Section 174 says that a taxpayer may deduct research and experimental expenditures incurred or paid during the taxable year in connection with a trade or business.

QUESTION: So that you are still thrown into a trade or business category. You have to satisfy that, I take

it.

MR. DOAN: Yes, your Honor. We have to satisfy the standard "trade or business."

QUESTION: How many times has this Court concerned itself with 174?

MR. DOAN: Never, your Honor, to my knowledge.

QUESTION: This is the first time.

MR. DOAN: Yes, your Honor.

The basis of the respondent's contention in this case goes back to an early decision written by this Court where the theory was advanced that before a taxpayer could be said to be carrying on a trade or business, he must be holding himself out as offering for sale goods or services.

We submit that that standard was not intended to apply to section 174 which was not written until 1954. We believe that this is borne out by the legislative history found in the committee reports in connection with the development of section 174. We believe that section 174 was intended to be a liberalizing provision to allow these expenditures which otherwise would have to be capitalized to be deductible in the year incurred. The legislative history of 174 indicates a broad purpose, to provide an economic incentive especially for small and growing businesses to engage in research for new products and new inventions.

The measure was initially introduced in the Congress

in 1951, and the purpose for its introduction was to clarify the existing confusion in respect to tax treatment of such expenditures and to prevent tax discrimination between large existing well-established businesses and their small, beginning counterparts.

QUESTION: Mr. Doan, if this had been done by IBM or 3M, do you think the Service would have allowed the deduction?

MR. DOAN: Yes, your Honor. The best illustration of that is Best Universal Lock Company case decided in 1966 by the Tax Court. Best Universal Lock Company involved a corporation, a successful large corporation, based in the State of Indiana which had historically been in the business of manufacturing locks. During the 1960's Best Lock Company decided to develop a new line of business, and as a result it commenced a research program on isothermal air compressors which was admittedly a completely unrelated line of business. The Commissioner of Internal Revenue disallowed it saying that research and development expenses claimed in this connection were not deductible. However, the Tax Court reversed or did not hold for the Commissioner of Internal Revenue in the case and said that these businesses were sufficiently -- these expenditures were sufficiently connected with an ongoing business and therefore deductible. The Commissioner of Internal Revenue has acquiesced in that

decision and in 1973 the Commissioner has issued a revenue ruling directing the employees at the audit level and on up through the ranks of the Internal Revenue Service that this decision will be followed.

QUESTION: Is the difference between that case and yours is that they were at least in an ongoing business of some other sort?

MR. DOAN: Yes, your Honor, and there lies the discrimination against my client.

The remarks of Mr. Reed who was then chairman of the House Committee on Ways and Means, in the hearings on H.R. 8300, the bill which embodied what was to become the Revenue Code of 1954, I believe makes this point very clear. He stated, and I quote, "Present law contains no statutory provision dealing with the deduction of these expenses. The result has been confusion and uncertainty. Very often under present law, small businesses which are developing new products and do not have established research departments are not allowed to deduct their expenses despite the fact that the large, well-established competitors can obtain the deduction. This provision will greatly stimulate the search for new products and new inventions upon which the future economic and military strength of a nation depends. It will be particularly valuable to small and growing businesses."

Throughout the committee reports, the term pops up "small and growing businesses." The Under Secretary of the Treasury when he appeared before that Ways and Means Committee testifying as to the present treatment of these expenses used the same analogy except that he used the term that this will help "small pioneering businesses."

QUESTION: Mr. Doan, if you lose the case, does Mr. Snow ever get any tax benefit for it? Is he allowed in some way to amortize?

MR. DOAN: Your Honor, if a taxpayer cannot utilize section 174 and the expenses are held to be in the category of preoperating expenses or investigatory type expenses, there is no provision for any relief for tax purposes except when the venture may be abandoned or when it might be sold, that is the venture itself, not an item within the venture. There is no provision for these expenditures being capitalized and amortized over the useful life because it is and has been the position of the Treasury that you cannot determine a useful life and therefore they are not subject to depreciation or amortization.

QUESTION: I suppose from the standpoint of the small pioneering, I think you called it, business, that kind of deferred tax benefit isn't very useful.

MR. DOAN: No, your Honor, it is not, especially if this is a genuine and bona fide business venture where the

people are in there trying, they put it together, and it does become an ongoing business. It grows up and it becomes a Polaroid, a Xerox, an IBM. That capital contribution would be locked in for any period of time.

QUESTION: If it becomes one of those three, they don't need that very much, do they?

MR. DOAN: No, your Honor. Hopefully it will.

We believe, however, the clear congressional intent is that a small business like Burns whose entire energies are devoted to a product development effort would seem to be precisely the kind of taxpayer Congress sought to bring within the reach of section 174. The decision by the Sixth Circuit in Snow, however, makes that section unavailable to Burns while preserving it to large and well-established competitors. The byproduct of that decision in my opinion will foster monopoly, it will stifle research and development activity, it will continue the discrimination against small businesses that section 174 was designed to eliminate.

QUESTION: I take it there wouldn't have been any problem here if there had been a patent iss, a patent had issued and had been available for licensing.

MR. DOAN: The decisions are not clear, your Honor. The test that respondent has suggested would require holding a product or service for sale.

QUESTION: Or a patent for licensing.

MR. DOAN: Yes, your Honor.

QUESTION: The expenditures after that time, that would be deductible then.

MR. DOAN: Yes, your Honor.

QUESTION: Not prior.

MR. DOAN: Not prior to that time.

QUESTION: Is it conceivable that 174 would have given some tax relief to small businesses by relieving them of the requirement for a business deduction that it be ordinary and necessary without necessarily going as far as you are asking us to go here?

MR. DOAN: That is the contention of the respondent, your Honor. However, we feel that that is a section 162 standard, but that's only part of it. Section 162 says ordinary and necessary in carrying on a trade or business. There are three elements involved in section 162, the total standard.

Now, in section 174 Congress did not choose to include any of those. Respondent suggests that it was for the purpose of eliminating the two you mentioned, your Honor, ordinary and necessary. However, I contend that the carrying on standard was also eliminated.

QUESTION: Because 174 is in connection with rather than --

MR. DOAN: Yes, your Honor.

We, of course, rely heavily on Cleveland v. Commissioner, which was decided by the Fourth Circuit. The respondent, on the other hand, relies on a later Fourth Circuit decision, Richmond Television.

Cleveland v. Commissioner was a section 174 case, a section 174 issue. Richmond Television was a section 162 case, a 162 issue. In the case of Cleveland v. Commissioner, that court found that the expenses involved in a case involving an attorney who financed an individual who was in a trade or business -- who was involved in activities in working on a formula patented product which he had hoped to obtain a patent on. He had advanced funds to this inventor over a long period of time. There were no sales of this substance or this item. There was no patent as far as I can tell as of the year at issue in the Cleveland case. There is no evidence in the record that the patent was actively held for sale. However, the Court of Appeals held in that case that the expenses involved and incurred by a joint venture between Cleveland and the inventor in that case, who was Kerla, were deductible under section 174.

In the Richmond Television case we have a situation involving expenditures by a corporation before it obtained a license to start operating a television station. The expenses involved there were section 162 expenses and involved the training of employees and getting organized and

geared up,commonly known as start-up expenses.

We feel that the Fourth Circuit has crossed the fine line of distinction between section 174 and section 162, and we respectfully submit to this Court that a new standard should be fashioned within section 174 to take care of 174 cases and leave the section 162 standard that has already been fashioned intact as it exists today.

Thank you, your Honor.

QUESTION: This doesn't have anything to do with this case; I'm just curious. These trash burners are for private --

MR. DOAN: Yes, your Honor.

QUESTION: Is there still some place you can burn trash in the United States?

MR. DOAN: Yes, your Honor. I'm glad you asked that question.

QUESTION: No place I know of.

MR. DOAN: One of the problems -- and this is not in the record.

QUESTION: It has nothing to do with the case.

MR. DOAN: One of the problems Burns Investment Company ran into in 1966 was a pollution standard problem.

QUESTION: That's what we are worried about.

MR. DOAN: Now, the device has been perfected at this point in time and it does meet pollution standards. I

thought I would get in the commercial.

Thank you.

QUESTION: Various municipalities have ordinances specifying requirements for trash burning, isn't that right?

MR. DOAN: Yes, your Honor.

QUESTION: I have a trash burner but it doesn't satisfy the requirements of the county regulations out West so I can't use it.

MR. DOAN: I am informed that the trash burner in this case does now satisfy all of the ordinances that we know about to date.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Doan.

Mr. Smith.

ORAL ARGUMENT OF STUART A. SMITH

ON BEHALF OF THE RESPONDENT

MR. SMITH: Mr. Chief Justice, and may it please the Court: I think I would like to refer to the text of the statute which is set forth in Appendix A of our brief. This statute provides that a taxpayer may treat research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business as expenses which are not chargeable to capital account.

Subsection (b) provides for an election to amortize such expenses over a period of time not less than 60 months.

Now, this case focuses upon statutory requirement which exists in both subsection (a) and subsection (b) that the expenditures be incurred in connection with the taxpayer's trade or business.

QUESTION: Is your view of that that the trade or business must already be an ongoing business?

MR. SMITH: Yes. In our view the term "trade or business" has had a long and honored history under the Taxing Act as recognized by this Court that the tax law has long drawn a distinction between investment activities or income-producing activities and that trade or business connotes something more than that, more than the hope of a profit, it connotes a holding oneself out as available for selling goods or services.

Now, this case involves only 1966, and the courts below I think properly confined their attention to the events of that year. Now, in that year you had a situation where Trott, the purported inventor, had this idea for a product. He needed some financing. He asked several of his friends to give him some money,and ultimately a limited partnership venture was formed, the petitioner here contributing $10,000, I think, for a 4 percent limited partnership interest.

Now, the important thing in our view is what exactly happened in 1966, and I think the findings of fact of the Tax Court are not disputed in this regard that what happened

simply was that a very crude prototype model was developed; patent counsel examined it, looked at it and said simply that it wasn't reduced to practice, that it didn't work properly and that additional work would have to be done on it. Ultimately the partnership spent the rest of its $40,000 initial capital I think in the next year, 1967, and then ultimately as both courts below alluded to, more work had to be done on it and the device radically changed before the ultimate patent was applied for in 1969 and received in 1970. The device became a very different device.

Now, in our view --

QUESTION: Has the Service -- I assume this is outside the record -- has the Service ever recognized that this particular taxpayer has now qualified under 174 in subsequent taxable years?

MR. SMITH: That, Mr. Justice Blackmun, is outside the record. What can be pieced together essentially is that the partnership went out of existence in 1968 or 1969. A corporation was formed called the Burns Investment Corporation. That's in the Tax Court findings of fact. Whether that corporation, whether the shareholders of that corporation are the same as the limited partners here is unclear from the record. I would just assume, speculate, that probably is the case that the partners contributed the partnership assets to the corporation in a tax exchange. I think that is

probably what happened.

QUESTION: Perhaps the other partnerships, too, went into it.

MR. SMITH: Perhaps Echo and Courier also went the same way.

QUESTION: If it had to be an ongoing business created.

MR. SMITH: Yes. Essentially -- Mr. Doan pointed out that the Service did not disturb petitioners' claimed deductions for 174 treatment for the other partnerships in the year 1965. That is probably the case, although I think it's quite irrelevant. It was simply an oversight or, you know, the Service has to set priorities for its audit work.

QUESTION: Mr. Smith, you state that the Government's position is that there must be an ongoing trade or business. Let's assume for the moment that Burns did have an ongoing business in the manufacture and sale of some other product and that at the same time this inventor commenced work on the incinerator. Would that partnership have been entitled under your position here today to deduct the expenses of that work?

MR. SMITH: I think it probably would, Mr. Justice Powell. I think that that flows from the Service's acquiescence in the Best Lock Company case. There was a case where the company was clearly in the business of manufacturing

locks. The Tax Court's findings -- the Internal Revenue Service, however, disallowed claimed 174 deductions for the development of an isothermal air compressor, and the Tax Court in its opinion said simply that that disallowance ignored that corporation's long history of experimentation in its efforts to develop new products. I think once you have an ongoing trade or business, I think it's a statutory matter you have a trade or business in connection with which research or experimental expenditures would be incurred, I think they would.

QUESTION: Would it make any difference at all if the incinerator was totally dissimilar to the other product then being manufactured?

MR. SMITH: Apparently there is a case called Mayrath, decided by the Fifth Circuit, which involved the situation of a man who developed, who invented farm implements, and then he spent a lot of money on an experimental home. The Service disallowed that deduction. There was very little in the way of focusing on the question as to whether -- he was clearly an inventor, having invented and sold farm products, but the Fifth Circuit simply said that this was an experimental home in which he was living and then they were classified simply as personal expenses.

I think that the Service probably would like to reserve some leeway, so to speak, if the products are totally

unrelated, you know, to each other, because the Best Universal Lock Company case rested in part, I think, on the corporation's long history of experimentation. But I think that as a general matter the acquiescence in that case I think stands for the proposition that if you have an ongoing business, which was clearly not the case here in 1966, that research or experimental expenditures expended to develop a new product would come within 174 treatment.

QUESTION: It would be hard to be more unrelated than in the Lock case.

MR. SMITH: I suspect so. I mean, you have an isothermal air compressor --

QUESTION: Well, suppose a soap manufacturer -- actually this one was connected with Proctor & Gamble, wasn't it? They are constantly in research and development in various soap products, detergents, and all that stuff. Suppose they had taken on the development of this incinerator.

MR. SMITH: Well, I think we would have a more difficult task.

QUESTION: Wouldn't that be the Lock case?

MR. SMITH: It probably would be the Lock case. I don't think we have to worry about that here because I think under the Court's Whipple opinion and the long history of separating corporations from their employees, I think there is no suggestion here that we can attribute the

business of Proctor & Gamble to the petitioner in this case.

QUESTION: Going back to my question to your opposing counsel about 3M or IBM having done precisely this, as I take it is Mr. Justice Brennan's question, do I detect from your answer that probably they would have been given the deduction?

MR. SMITH: Probably would have been given the deduction because they are in the -- they would be deemed to be engaged in a trade or business.

I would like to address myself to another question that you asked during Mr. Doan's argument, and that is what the ultimate effect would be, what the ultimate tax benefit of these expenditures would be. I don't think that it's entirely clear that they are lost forever. I think that if the partnership had continued, I think that there certainly is an arguable case for saying that these things could have been -- the election could have been made to amortize the expenditures. In fact, the amortization aspect of the statute is exactly designed to help the kind of small pioneering business that Mr. Doan has --

QUESTION: That is figured also by being in a trade or business.

MR. SMITH: Yes, that is true, but the point is that the election to amortize -- assuming that the partnership went along for a few years and then ultimately satisfied the

test of being in a trade or business, the amortization provisions provide that the election to amortize begin with the first year in which benefits from the expenditures are derived. So, assuming that a few years went on and then the partnership ultimately held these things out for sale, I think that the partnership would have a strong case then to say, "We elect the amortization provision because we are in a trade or business."

QUESTION: And open up prior years?

MR. SMITH: I don't think you could go back in this case. It would depend simply whether the year would be open in which the benefits were first derived.

QUESTION: In any event they would be considered capital expenditures.

MR. SMITH: Yes.

QUESTION: So they are not lost.

MR. SMITH: They are not lost in that respect.

Now, this case is muddied further by the fact that apparently the whole thing went into a corporation.

QUESTION: Mr. Smith, suppose Snow had set up the Snow Soap Company, partnership, and had done the same thing.

MR. SMITH: Had done the same thing?

QUESTION: Um-hmm.

MR. SMITH: Well, it would depend very much -- see, Justice Marshall, in our view, and I think this is really

where the Fourth Circuit went awry in the Cleveland case, simply the setting up of a partnership and the execution of a partnership agreement without more --

QUESTION: Oh, no, he's got a going business --

MR. SMITH: Going soap business.

QUESTION: -- going soap business that he manufactures $2,000 worth of soap a year.

MR. SMITH: And then it began to --

QUESTION: To do what he did here, to make a trash burner.

MR. SMITH: Well, I suspect --

QUESTION: He's got a going business.

MR. SMITH: He's got a going business.

QUESTION: What else does he need besides a going business?

MR. SMITH: Under the statute, that is really the critical thing, you need --

QUESTION: That's all he needs, to set up a little thousand dollar business to qualify.

MR. SMITH: Well, you know, I wouldn't want to suggest that any kind of cosmetic -- establishment of a cosmetic business would suffice because I think when Congress --

QUESTION: Let's change it from -- since you've used cosmetic, let's change it from soap to shoes.

MR. SMITH: All right. I meant by cosmetic, I meant

simply a facade. I think what we are talking about here is a bona fide enterprise. I think when Congress inserted the term "trade or business" here, this was done against the background of a long distinction between a trade or business and investment activities. This Court in about 1940 had held in the Higgins case that the management of one's personal investment portfolio, even if it required the hiring of several people and the leasing of an office, was not a trade or business, and the expenses in connection therewith were not deductible. What Congress did in 1942 I think is significant. It enacted section 212 which did not enlarge the category of trade or business expenses; it simply created a new category of non-trade or business expenses. I think that's really the key to this case. Congress could have --

QUESTION: I think research expenditures didn't qualify either.

MR. SMITH: Research expenses did not qualify either, right, because research expenditures are somewhat different. Research expenditures prior to the enactment of the '54 Code were regarded as --

QUESTION: Certainly 174 was intended to do something for research and development expenditures which 212 and 162 wouldn't permit.

MR. SMITH: Yes, I think it was intended to do something, and I think what it was intended to do, as we

suggest in our brief, was to relieve the necessity of qualifying under the "ordinary" standard of section 162 because research and development expenditures are traditionally the kinds of things that relate to the creation of income and benefits derived in a future year. That is the traditional kind of nondeductible capital expenditure.

Taxpayers also had a problem because of the difficulty of determining if at all whether such expenditures could be depreciated because of the difficulty of tagging it to the useful life of the particular asset.

QUESTION: Do you think 174 as read means that you may deduct those expenses which absent 174 would have been chargeable to capital?

MR. SMITH: Yes. And I think that that is confirmed by the fact that --

QUESTION: Well, let's put it the other way, all expenses that under 162 would be -- all research expenses that under 162 would be chargeable to capital and not deductible.

MR. SMITH: Yes, and could not qualify for depreciation either. In fact, that was one of the things that the statute was designed to cure, because there was a regulation outstanding for 7 years between 1919 and 1926 that came out under the depreciation provisions.

QUESTION: You are saying these expenses wouldn't qualify under 162.

MR. SMITH: These expenses would not qualify under 162.

QUESTION: And they would be chargeable as capital.

MR. SMITH: They would be chargeable as capital.

QUESTION: 174 says if they are chargeable to capital under 162, they are deductible here.

MR. SMITH: No. I think --

QUESTION: That's what I asked you, and you said yes.

MR. SMITH: I'm sorry. It says that you can treat it if they are incurred in connection with a trade or business, you can treat them as expenses which are not chargeable to capital account. I think that's the key. What Congress wanted to do was to take a class of capital expenditures and relieve them of the necessity of qualifying under the "ordinary" standard.

QUESTION: Go ahead.

MR. SMITH: I'm sorry. It's a slightly unrelated thing.

QUESTION: Well, let me ask you something else. I'd like to get to a homely hypothetical that's not quite IBM or Xerox or 3M. Suppose a man has a conception of how to handle or how to raise chickens, a new way to develop an incubator. So he quits whatever he is doing, teaching in the physics department in the university or what not, buys himself a piece of land and a house and then begins to build

this new kind of cages and applied research and development and develops a bunch of sheds and barns with the incubators. Finally is satisfied that it probably will work and buys himself a couple thousand eggs. But he isn't in business, he can't afford a telephone, he can't afford any employees. His wife and his son do all this.

Now, then, he reaches a point where it's feasible. He organizes a corporation to carry it on for the future.

Under the framework of the Government's view of this case, would this year, or work done in this taxable year on the development of these incubators, sheds, all the things I have described and a lot that you can imagine filling in, deductible or not?

MR. SMITH: Well, I think as research or experimental, it's been --

QUESTION: Maybe he hasn't sold any -- he's bought eggs to turn into chickens. He hasn't sold a chicken; he hasn't advertised, hasn't done anything. He gets into business the next year.

MR. SMITH: I think in our view of the case that would be a problem, there would be a problem in deducting that. I think that curing the hypothetical in some respects might be if he had energetically sought to interest someone in purchasing or entering into a contract with him to provide the kinds of services that he ultimately hoped to

ultimately provide from his idea. I think that under the statute, I think, though, that the amortization election would be best suited.

QUESTION: If the business were a great success, he might get it when it was immaterial to him, and if it was a failure, it would be academic, would it not?

MR. SMITH: Well, no, I don't think that tax deductions are ever immaterial. I think that what would be done, I think, that instead of -- permit me to indulge in a moment of tax advice -- I think what could be done in a situation like that is to continue operating as an individual for a while, get some gross receipts, elect the amortization provisions, and be able to write off those expenses over the 60-month period which 174 --

QUESTION: The small businessman of the kind that I think Congressman Reed was talking about -- it appeasrs to be Congressman Reed's statement -- wouldn't be helped much by an amortization extended over five years.

MR. SMITH: I think if he were to remain small during some of that period, it would help.

QUESTION: Isn't it the usual history of small businesses getting started like this, that they put themselves completely in hock, as it were, to get started?

MR. SMITH: I think that's right. I think, though, that we are faced with a statute that uses the term "trade or

business" and uses it in a way that --

MR. CHIEF JUSTICE BURGER: We will resume that after lunch, Mr. Smith.

[Whereupon, at 12 noon, a luncheon recess was taken, to reconvene at 1 p.m. the same day.]

AFTERNOON SESSION

(1 p.m.)

MR. CHIEF JUSTICE BURGER: You may proceed.

RESUMED ORAL ARGUMENT OF STUART A. SMITH

ON BEHALF OF THE RESPONDENT

MR. SMITH: Mr. Chief Justice, and may it please the Court: Resuming the Government's presentation of the Snow case, I think the best way to describe how the statute works, section 174 of the Code, is to simply suggest to the Court that there are two types of capital expenditures that could occur in any particular situation. There is the capital expenditure that is incurred before one enters a trade or business, and then capital expenditures which are incurred after the commencement of the trade or business.

Now, in our view, section 174 is only designed to cover the second category of capital expenditures. It makes them subject to the option to either current deduct or to amortize over five years. Thus the insertion, in our view, of the term "trade or business" in the statute requires that the research or experimental expenditures be incurred by an ongoing business in order to come within the purview of the statute.

Petitioner's references in the legislative history to the fact that Congressmen referred to the fact that small businesses -- that the statute was designed to benefit

small businesses, I think it should be emphasized to the extent that those remarks had relevance, the important thing is that it was still a business that was designed to be benefited, that "trade or business" is a technical term under the Code, it appears in many provisions, it has been interpreted by the courts to require the holding of oneself out as engaged in selling goods or services, and if Congress wanted to simply make all research or experimental expenditures deductible without regard to the context in which they were incurred, I think it could have easily employed the standard it used in 1942 when section 212 came into the Code, that is, expenditures incurred in connection with the production -- for the production of income. The fact that it didn't do that and the fact that Congress created this special type of non-trade or business expenditures but yet nevertheless used the term "trade or business" in section 174 is to us dispositive of the matter in terms of requiring that a stricter standard be employed in this case.

And I think that the standard is important because the trade or business test provides, in our view, an objective criterion with which to measure, to separate out, so to speak, simple personal activities, that is, someone tinkering in his basement with something that he thinks some day may amount to something and spending money on that sort of thing, and someone who is seriously interested in developing a

product and carries it through to the point in which income and benefits are derived from that expenditure.

Now, I want to also point out to the Court that --

QUESTION: If I understand this "carrying it through," if I understand you, if IBM sets this up, he starts collecting the first year.

MR. SMITH: Well, the fact that IBM sets this up -- in the IBM example, Mr. Justice Marshall, I think the fact of the matter is that there is no quarrel about the fact that IBM is an ongoing trade or business and is engaged in a trade or business. It is holding itself out as engaged in the selling of goods or services. And as a result, under the case law and under the Commissioner's view of the statute --

QUESTION: He does collect right away?

MR. SMITH: The statute is available for the election to either amortize or --

QUESTION: It doesn't depend that they are actually working on this --

MR. SMITH: No. I was addressing myself, I think, to the ongoing business.

QUESTION: If IBM had set up Snow, right?

MR. SMITH: Yes.

QUESTION: It collects.

MR. SMITH: The statute would apply in that case because IBM is engaged in a trade or business and the

expenditures are incurred in connection with the trade or business.

QUESTION: And Snow went out of business in '67, IBM would still collect for '66.

MR. SMITH: That is correct.

But the point of the matter is that that simply is not involved here. What we have here is no trade or business within the tax year under scrutiny, 1966.

Now, the petitioner focuses upon the fact that there is an alleged difference in terminology between sections 162 and 174. He says that you have the phrase "incurred in carrying on a trade or business" in section 162 and you have the phrase "incurred in connection with a trade or business" in section 174. In our view this terminology is equivalent. The committee reports for section 212 use the phrases interchangeably. In fact, the Commissioner's regulations under section 162 used the phrase "in connection with" and "incurred in carrying on" interchangeably. I don't think there is any difference between those two statutory expressions. The fact of the matter is both require the existence of an ongoing trade or business.

Now, the connection between section 162 and 174 is in our view --

QUESTION: IBM couldn't deduct these research expenditures under 162, could it, if it did what Snow did

here?

MR. SMITH: That is correct, because they probably would not fit within the ordinary standard.

QUESTION: Or necessary.

MR. SMITH: Necessary is simply regarded as a -- I don't think "necessary", the term "necessary" is involved in the case. I think it's the term "ordinary." And the fact that the term "ordinary" was deleted from section 174, in our view, is the key to what this section was designed to do, make what would otherwise be capital expenditures incurred by an ongoing business currently deductible.

Now, the connection between 162 and 174 was made by what we think is the more current and correct rule of the Fourth Circuit in the Richmond Television Corporation case, because while that case involved a corporation and involved a claimed deduction for expenditures under 162, the Court nevertheless cited in a footnote not only the classic, what we regard --

QUESTION: Could I ask you this question before I forget it?

MR. SMITH: Sure.

QUESTION: Assume Snow here had rented an office and got a telephone and hired a secretary, they needed correspondence and what not, I take it you would have the same position with respect to the rent paid for the office?

MR. SMITH: I think we probably would have the same position with regard to the rent paid for the office. I think the important thing here is that within the meaning of the test, there was no holding oneself out as engaged in selling goods or services, because as a factual matter they had nothing whatever --

QUESTION: What happens to the expenses paid out for the rent of the office? They aren't just capitalized, surely?

MR. SMITH: Well --

QUESTION: Are they losses?

MR. SMITH: I suspect that they --

QUESTION: You say they're not deductible, so --

MR. SMITH: I think in the partnership context, I think they probably would have to increase the basis of each partner's partnership interest and to the extent that they might be subsequently amortized at a later date, they might be amortized -- I see your point because the point is that it deals with rental for a particular year. But I think that essentially the problem is the same problem that the Court is facing under the consideration of the Idaho Power case.

QUESTION: If they were deductible at all under 162, you would be in great trouble here, I suppose.

MR. SMITH: I think our position is that they are not because they are in connection with -- I think the issue

in Idaho Power is the same, you are talking about depreciation of construction equipment and there, while it's an annual expense, it nevertheless has to go into the basis of the asset that's ultimately created.

QUESTION: Let me add to Justice White's hypothetical another but nonrecurring item of expense. Suppose they called a professional employment agency and said, "Here is the staff we think we will need. We will need X number of executives and so many stenographers, and a shop foreman," and a whole list, and engage them on a professional basis for hire. Now, have they got into business yet, along with the office?

MR. SMITH: I think the critical thing is really holding oneself out as engaged in -- if the product had gotten to the point where they could offer it for sale and make, enter into pecuniary arrangements with people who are willing to pay for something that they had, third parties, I think then that they would be engaged in a trade or business.

QUESTION: You say they would have to be trading with somebody or actually doing business with somebody.

MR. SMITH: There would have to be an ongoing business with someone selling something --

QUESTION: Or offering --

MR. SMITH: Offering something. They may be ultimately unsuccessful.

QUESTION: And it must relate to the product which

is ultimately to be distributed, is that right?

MR. SMITH: Yes, it must relate to the product which -- I have one final point if I may just for a moment.

MR. CHIEF JUSTICE BURGER: Just briefly.

MR. SMITH: Petitioner raises the hypothetical of what might be considered the usual type of investment in a real estate venture and says, well, isn't it clear that interest is deductible during the construction period of a project. And the simple answer to that is that in section 163 Congress provided for the deduction of interest without regard to any trade or business nexus or any production of income nexus whatever. It simply is interest incurred on an indebtedness. And we think the analogy is false; we think that this case has to be viewed within the trade or business nexus of the statute.

QUESTION: Mr. Smith, I hold you for a moment. I have two quick ones.

Suppose that on December 1st, we're on a calendar year base, Mr. Snow did get into a trade or business within the services concept. Would you permit the deduction of research and development expense incurred in the preceding 10 months of that calendar year?

MR. SMITH: I think that since the system is an annual accounting system, I am not sure of the answer to this, but I think probably yes, simply because we are talking about

incurred within, during the taxable year, and if we are talking about a calendar year, I think the answer to that would be yes.

QUESTION: And secondly, I admittedly haven't gotten into the legislative history, but what brought about 174? Was this brought into the Code at the behest of the Service, or was it, as it were, imposed on the Service by some group of taxpayers who were able to persuade the Congress to put it in? Do you know?

MR. SMITH: I am not sure I know the answer to that question. I think it was simply a general dissatisfaction with the fact that such expenditures were being disallowed as capital expenditures because they did not relate to the production -- they did not derive any benefit within the taxable year. I think Congress simply eliminated the"ordinary " requirement. I don't think there is any feeling inherent -- there were private people who testified, and as Mr. Doan has pointed out, the Under Secretary of the Treasury testified also. I don't think I can give you a precise answer to that question.

QUESTION: Many times these things are imposed upon the Service.

MR. SMITH: That is true. I didn't find any suggestion of that in the legislative history.

MR. CHIEF JUSTICE BURGER: Very well, Mr. Smith.

Do you have anything further, Mr. Doan?

REBUTTAL ORAL ARGUMENT OF BURGESS L. DOAN

ON BEHALF OF THE PETITIONER

MR. DOAN: If I may, Mr. Chief Justice, I believe I have two minutes.

MR. CHIEF JUSTICE BURGER: You have four minutes now.

MR. DOAN: If I may respond to the last comment first, in 1951 Representative Camp indicated that the American Bar Association had urged section 174.

I would also like to point out that I believe the issue has really boiled down to whether or not the petitioner Snow was in a trade or business, that is, whether or not there was a trade or business in existence, not whether or not he was carrying on a trade or business. And in that regard, if I might draw from the regulations under a different Code section, and that is section 248, the regulations under that section define existence of a trade or business versus the beginning of a trade or business. I'm sorry, not trade or business, just business. And it has to do with the amortization of organization expenditures, which is the type of expenditures that is very much akin to a section 174 type of expenditure, that is, preoperating type of expenditure.

The regulations as promulgated by the Commissioner says that if the activities of the corporation have advanced to the extent necessary to establish the nature of its

business, the business operation, however, it will be deemed to have begun business.

QUESTION: What is that section again, Mr. Doan?

MR. DOAN: That is section 248, your Honor.

For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

And may it please the Court, I submit to you that Burns Investment Company had acquired everything it needed to carry on the operation contemplated by Burns Investment Company. It had entered into a contract with a separate corporation to manufacture these prototype models, and this is specifically permitted under the regulations under section 174. It had contracted for these services; it had collected the capital from the partners. Mr. Trott devoted one-third of his time to this venture, and he commenced devoting his time way back in 1964, not in 1966. This was a continuous activity through this period of time. It was not a sporadic venture that just popped up in 1966. It was a bona fide business venture. This man gave up a very good position and devoted his entire energies and efforts to the development of these products. It was certainly no plaything. And it was a continuing endeavor on his part. And this is the kind of thing that Congress chose to encourage by implementing into law section 174.

I am not sure that we are clear on one further point, and that is amortization versus deductibility of expenses under section 174. That, I submit, is a choice. If he can amortize these expenses, he can deduct these expenses under section 174. The only remedy available to my client if it is held that Burns Investment Company is not engaged in a trade or business is a capitalization of these expenditures without any depreciation available to him.

Thank you.

MR. CHIEF JUSTICE BURGER: Thank you, gentlemen. The case is submitted.

[Whereupon, at 1:19 p.m., the oral argument in the above-entitled matter was concluded.]