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THE EVOLUTION OF THE PHRASE "TRADE OR BUSINESS": FLINT V. STONE TRACY COMPANY TO COMMISSIONER V. GROETZINGER—AN ANALYSIS WITH RESPECT TO THE FULL-TIME GAMBLER AND THE INVESTOR*

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I. INTRODUCTION

The phrase "trade or business" appears a total of 1,138 times throughout the Internal Revenue Code, the Treasury Regulations and the Proposed Regulations.[1] Although it is undoubtedly one of the most commonly used terms in federal taxation,[2] it is not defined anywhere in the legislative history, the Internal Revenue Code or the Regulations.[3] Rather, the courts have been left with the task of formulating the proper definition.

The judicial development of a definition for the term "trade or business" has been slow to emerge. Although the courts were first presented with the phrase over seventy-five years ago[4] and have had several opportunities to define the term since that time, to date no precise definition has been developed.[5] Several reasons can be offered to explain why the judiciary has been unable to articulate an all encompassing definition for the phrase "trade or business."

This article analyzes the judicial development of the phrase

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1. The phrase "trade or business" appears in the Internal Revenue Code (I.R.C.) 357 times; in the Treasury Regulations 706 times; and in the Proposed Regulations 75 times. This information was compiled pursuant to a key-word computer search using the Lexis Federal Taxation data base.

2. All references to Sections, unless otherwise indicated, are made with respect to the Internal Revenue Code of 1986 and the regulations promulgated by the Secretary of the Treasury thereunder.

3. *See, e.g.,* Groetzinger v. Commissioner, 107 S. Ct. 980, 983 (1987). As the Court recognized, the term has been defined for very limited purposes not relevant to our inquiry. *See* I.R.C. §§ 355(b)(2), 502(b), 513(b) and 7701(a)(6).

4. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

5. *See infra* Section II. Historical Analysis.

"trade or business" as it appears in the Internal Revenue Code ("Code") and Treasury Regulations ("Regulations"). In order to make coverage of this expansive topic manageable, all analysis has been devoted to the term as it is used in Section 162, its predecessor provisions and other sections which have adopted the phrase in the same context.[6] For purposes of illustrating each of the standards which have evolved, this author has chosen to concentrate on two different taxpayers: the full-time gambler and the full-time investor.

To facilitate an understanding of the current state of the law, special emphasis has been placed on the Supreme Court's recent decision in *Commissioner v. Groetzinger*.[7] Accordingly, an analysis of the holdings of the Tax Court, Seventh Circuit Court of Appeals and the Supreme Court in that case have been incorporated in this article. Moreover, a critical examination of the dissent of Justices White, Rehnquist, and Scalia has also been included in the discussion. The ultimate goal of this article is to accurately illustrate and critique the analysis which is currently employed by the judiciary to determine whether a taxpayer is engaged in carrying on a trade or business for the purposes of federal taxation.

The term "trade or business" in and of itself is extremely broad and arguably not subject to precise definitional parameters. Moreover, the phrase appears in several different contexts throughout the Code and Regulations, making it even more difficult for the courts to formulate any universal guidelines or definitional boundaries. For example, in order for expenses to be deductible under Section 162, they must have been incurred in "carrying on a trade or business." In addition, as a threshold to obtaining special-use valuation for purposes of computing the gross estate of a decedent under Section 2032A, the taxpayer's property must have been used in an "active trade or business." Finally, in order for research and development expenditures to be deductible under Section 174, they must have been incurred in "connection with a

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6. Although the phrase "trade or business" is used in several sections of the Code, for purposes of this article, unless otherwise indicated, all references to the phrase refer to the context in which it is used in I.R.C. §§ 62, 162, 165 and 1402. The courts have determined that the term should be given the same meaning in each of these sections. *See, e.g., Groetzinger*, 107 S. Ct. at 988 n.6.

7. *See supra* note 3.

trade or business."

With the foregoing contextual differences in mind, it is not difficult to understand why the judiciary has struggled to develop an all-purpose definition for the term "trade or business." The struggle has been further perpetuated by the Supreme Court's failure to provide the lower courts with any sufficiently clear guidelines by which they could determine whether a taxpayer is engaged in a trade or business. The Court's opinions have been somewhat vague and have never articulated in other than very general terms what constitutes a trade or business. Accordingly, because the lower courts have interpreted the Supreme Court's decisions in many different ways, relatively divergent standards have been developed.[8] The two prominent tests which have emerged are the "goods or services" approach first pronounced by Justice Frankfurter in *Deputy v. DuPont*,[9] and the "facts and circumstances" approach expressed by Justice Reed in *Higgins v. Commissioner*.[10]

Under the "facts and circumstances" test, the court is required to undertake an analysis of all the facts and circumstances of each case. Although no one fact is decisive, focus is placed on the taxpayer's intent to earn a livelihood, and the regularity, continuity, and substantiality of his activities. Other than these broad considerations, the test consists of virtually no parameters.

The courts which have adopted the "goods or services" test, like those adopting the "facts and circumstances" test, look at all the facts and circumstances of each case. Under this approach, however, if the taxpayer is not engaged in offering goods or services to others, he will automatically be denied trade or business status. Although this standard can be just as nebulous in application as the "facts and circumstances" test, the goods or services requirement is appealing because its all or nothing character can serve to simplify the trier of fact's job.

Ironically, these two different approaches create the same result in all but two situations. In the first of these scenarios, the case of the investor, it appears that no matter how extensive his activities, the investor will never be considered as carrying on a

8. *See infra* Section II. Historical Analysis.
9. 308 U.S. 488 (1940).
10. 312 U.S. 212 (1941).

trade or business. Thus, the investor is a carve-out under either test. The second of these scenarios, the case of the full-time gambler, however, receives drastically divergent treatment depending upon which test is utilized. Since the gambler does not generally offer goods or services to others, the courts which have adopted the "goods or services" test deny him trade or business status. On the other hand, those courts which have adopted the "facts and circumstances" approach accord the gambler trade or business status.

Due to the inconsistent treatment of the gambler, a vast amount of scholarly[11] and judicial[12] discourse has been devoted to the development of a universal definition for the phrase "trade or business." Nevertheless, no complete solution to this problem has been developed. Just recently, however, the Supreme Court was presented with the case of *Commissioner v. Groetzinger*.[13] The facts of this case afforded the Court an opportunity to clean the slate of any prior misconceptions and pronounce a precise definitional standard by which the lower courts will be able to consistently resolve the trade or business issue. The Court, however, failed to sieze the opportunity. Rather, while renouncing the "goods or services" test, the Court simply concluded that the "facts and circumstances" approach must be implemented on a case by case basis to determine trade or business status. By adopting the "facts and circumstances" test, the Court removed the possibility of future inconsistent treatment with respect to the gambler. It did not, however, attempt to formulate any universal guidelines for determining trade or business status. Thus, the judi-

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11. *See, e.g.*, Saunders, *"Trade or Business," Its Meaning Under the Internal Revenue Code*, 1960 So. Calif. Tax Inst. 693; Freed, *Factors That Will Establish That a Taxpayer's Activity Constitutes a Trade or Business*, 31 Tax'n for Accts. 90 (1983); Note, *On Deducing a Deductible Loss: The Continuing Search for an Appropriate Legal Standard in Dreicer v. Commissioner and Snyder v. United States*, 15 Conn. L. Rev. 847 (1983); Callison, *Tax Aspects of Computer Software Development*, 13 Colo. Law 959 (1984); Lopez, *Defining "Trade or Business" Under the Internal Revenue Code: A Survey of the Relevant Cases*, 11 Fla. St. U.L. Rev. 949 (1984); Note, *The Trade or Business Issue: Can A Gambling Loss be Considered a Business Loss?*, 19 Suffolk U.L. Rev. 906 (1985); Haller, *The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers*, 38 Tax Law. 759 (1985); Comment, *Continuing Vitality of the "Goods or Services" Test*, 15 U. Balt. L. Rev. 108 (1985); Olson, *Toward a Neutral Definition of "Trade or Business" in the Internal Revenue Code*, 54 U. Cin. L. Rev. 1199 (1986); Boyle, *What is a Trade or Business?*, 39 Tax Law. 737 (1986).

12. *See infra* Section II. Historical Analysis.

13. *See supra* note 3.