Private Letter Ruling 8423005

Issue:

Are expenditures incurred in relocating managers, and interviewing, hiring and training a work force in connection with the establishment of new restaurants deductible under *section 162 of the Internal Revenue Code*, or capital expenditures under *section 263*, when the taxpayer has similar existing restaurants in other geographical locations which operate under the same tradename?

Facts:

Company is a wholly-owned subsidiary of Taxpayer and is included in Taxpayer's consolidated tax return. The Company operates restaurants in various cities throughout the United States under its tradename. All of the restaurants are operated within Company except for two stores which are operated within two subsidiaries of Company. These two entities Subsidiary #1 and Subsidiary #2, which are also included in the consolidated return, were formed for the purpose of satisfying local ownership requirements to obtain liquor licenses. From an operational standpoint, these stores are indistinguishable from any of the other Company's stores.

Taxpayer's tax returns for the years ended December 31, 1978, 1979 and 1980 are currently being examined by the District Director. The Examining Agents have questioned the propriety of currently deducting costs incurred with the establishment of new restaurants.

During the period in issue, Company incurred expenditures with respect to 28 stores. For each store Company established a separate account to accumulate these expenditures. The most significant items in the account were the salaries and travel expenses of the managers and the opening team and the salaries of the newly-hired employees during their training. The account also included items such as advertising, polygraph tests, and rental of a space for training and interviewing. Except for the salaries and expenses of the "opening team," no costs are included in the account after the store opens for customers. The same types of expenses for training, travel, and interviewing are incurred by established stores.

These expenditures are incurred during a period of approximately 6 weeks. Three or four permanent managers are first sent to the new location. They stay in a hotel for about a week at Company's expense and are then required to find permanent housing. Their initial task is to rent rooms in a local hotel from which to conduct job interviews for new employees. They must hire 150 to 175 people.

After the hiring process is complete the training process begins. Two weeks before opening, a 16 person training team is brought to the new location. These "trainers" are regular employees of other stores who volunteer to work in another store during the "opening" period. They generally assist with training in their home stores also. The trainers usually stay three weeks (2 weeks before and 1 week after the opening) but several may stay another week or two. Each trainer is skilled in a particular job such as bar, door, cashier, broiler, or waiter/waitress. Their task is to impart these skills upon the new employees. The training program is a standard course

given in a classroom setting. The training is identical to that received by new employees of established stores.

Each store is totally dependent on Company. Company provides accounting, financing, management, purchasing, advertising, and training services. Company decides what to sell, and when and how to sell it. The Company dictates the appropriate music, lighting, decor, and employee uniforms. This control is exercised so that the product served by Company from each location is identical.

APPLICABLE LAW:

Section 162(a) of the Code allows as a deduction "... all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In *Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 29 L. Ed. 2d 519, 91 S. Ct. 1893 (1971)*, 1971-2 C.B. 116, the Supreme Court of the United States examined this provision, and held that for an expenditure to be deductible pursuant to *section 162(a)*, the item must:

(1) be "paid or incurred during the taxable year,"

(2) be for "carrying on any trade or business,"

(3) be an "expense," (4) be a "necessary" expense, and (5) be an "ordinary" expense.

Section 263 of the Code provides, in part, that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. While *section 263*, by its terms, only denies a deduction for "any amount paid out for new buildings ..." the Supreme Court has stated in *Commissioner v. Idaho Power Company, 418 U.S. 1, 16, 41 L. Ed. 2d 535, 94 S. Ct. 2757 (1974)*, 1974-2 C.B. 85, that the "purpose of *section 263* is to reflect the basic principle that a capital expenditure may not be deducted from current income."

In Lincoln Savings and Loan Association the taxpayer was a member of the Federal Savings and Loan Insurance Corporation (FSLIC). The taxpayer was required to pay an "additional premium" to the FSLIC which was credited to the insurance corporation's secondary reserves. The Commissioner's determination that the payment constituted a capital expenditure was upheld. The Court made the following comments:

> (T)he presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.
>
> What is important and controlling, we feel, is that the *section 404(d)* payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under *section 162(a)* in the absence of other factors not established here.

The Court then closely examined the asset to which the payments related. Among the factors the Court found important in determining that a separate and distinct additional asset had been

created were the following: the payments flowed into a separate Secondary Reserve fund that had a separate status from other reserve funds; the taxpayer had a distinct and recognized property interest in the Secondary Reserve; all parties recognized the presence and the significance of the property interest in the Secondary Reserve; and the payments to the Secondary Reserve served to provide protection to the insured institution and its depositors that was more permanent than temporary in nature.

An expenditure that secures to a taxpayer the right to conduct a certain type of business (such as the cost of a franchise, license, lease or approval from a regulating agency) is a capitalized expense under *section 263*. See *Shutler v. United States, 470 F.2d 1143 (10th Cir.1972)*, cert. denied, *411 U.S. 982, 36 L. Ed. 2d 959, 93 S. Ct. 2275 (1973)* (cost of acquiring a lease is not deductible under *section 162*); *Wells-Lee v. Commissioner, 360 F.2d 665, 669 (8th Cir.1966)* (staff fees paid by doctors so as to be able to practice in a certain hospital brought about the acquisition of a capital asset, thus they are not currently deductible); *Nachman v. Commissioner, 191 F.2d 934 (5th Cir.1951)*(the payment of $7,250 to obtain a liquor license was the expenditure of capital in the acquisition of a capital asset reasonably expected to serve petitioners through future years, and accordingly was not deductible as an ordinary expense); *Sharon v. Commissioner, 66 T.C. 515 (1976)* aff'd *591 F.2d 1273 (9th Cir.1978)* (costs incurred to be admitted to practice law before various bars held to be capital expenditures).

Start-up costs must also be capitalized under *section 263 of the Code*. In *Richmond Television Corporation v. United States, 345 F.2d 901 (4th Cir.1965)*, the taxpayer incurred personnel training costs prior to the time that it was granted a license by the Federal Communications Commission (FCC) to operate a television station. The court related that the taxpayer's firm decision to enter a business and the spending of monies in preparation was not engaging in a trade or business. Until the business began to function as a going concern and perform those functions for which it was organized, the pre-operating expenses were required to be capitalized.

In *Briarcliff Candy Corporation v. Commissioner, 475 F.2d 775 (2nd Cir.1973)*, the taxpayer was engaged in the manufacture and sale of candy and confectionary products. Its sales had traditionally been made in the urban centers of the northeastern United States. In response to population shifts to the suburbs, Briarcliff Candy instituted a program for soliciting independently operated retail outlets, primarily drug stores, to include in their businesses the sale of Briarcliff candies. The taxpayer set up a franchise division within its organization to pursue this expansion. The government took the position that costs incurred in this expansion including sales, supervision and clerical salaries, travel, etc. were costs properly capitalized under *section 263 of the Internal Revenue Code*. The government further argued that the taxpayer's efforts amounted to the creation of a distribution system for its products involving the securing of valuable agency contracts.

The court in Briarcliff Candy found that no new or distinct capital asset had been created by the attempt at expansion. The costs incurred by the taxpayer, according to the court, fell within the long recognized principle that expenditures for the expansion of an existing business are not capital in nature.

Courts following Briarcliff Candy have held that a cost that merely provides a benefit in future years is not required to be capitalized if that cost does not serve to create or enhance what is essentially a separate and distinct asset. *Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir.1974).*

Courts have held that the commencement of a Master Charge or Bank Americard credit card division was the extension of the banking business rather than a new business even though the banks had not been engaged previously in the consumer credit card business. Colorado Springs National Bank v. U.S., Supra. *First Security Bank of Idaho, N.A. v. Commissioner, 592 F.2d 1050 (9th Cir.1979)*, aff'g., *63 T.C. 644 (1975). Iowa Des Moines National Bank v. Commissioner, 592 F.2d 433 (8th Cir.1979)*, aff'g., *68 T.C. 872 (1977).*

Taxpayer in its expansion elected, for the business reasons discussed above, to operate two of its stores or outlets as subsidiaries. Therefore it is also necessary to consider how the tax law is to be applied to those corporations.

The Supreme Court stated in *Moline Properties v. Commissioner, 319 U.S. 436, 438-439, 87 L. Ed. 1499, 63 S. Ct. 1132, 1943 C.B. 1011 (1943)* in relation to whether a corporation should be recognized for income tax purposes:

> The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. * * * In *Burnet v. Commonwealth Improvement Co., 287 U.S. 415, 77 L. Ed. 399, 53 S. Ct. 198*, this Court appraised the relation between a corporation and its sole stockholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages.

In *Elot H. Raffety Farms, Inc. v. United States, 511 F.2d 1234 (8th Cir.1975)*, cert. denied, *423 U.S. 834, 46 L. Ed. 2d 52, 96 S. Ct. 57 (1975)* the taxpayer, a Missouri corporation, agreed to form a partnership with two Missouri individuals to conduct cotton farming operations in Mexico. When they discovered that Mexican law prohibited farm operations by foreign nationals, the group formed a Mexican corporation to carry on the farming operations, which was called "El Sombrero." The group advanced funds for the corporation's operations, which taxpayer sought to deduct as business expenses under Code *Section 162(a)*. The District Court allowed the deduction because it concluded, that the Mexican operations were merely an extension of the taxpayer's farming operations in Missouri. *511 F.2d at 1237*. The Appeals Court reversed, however, stating (*511 F.2d at 1238-1239*):

> In the business area, once a corporate entity has been identified, it may not be disregarded in respect to taxation if it was intended to "have some real substantial business function, or if it actually engages in business." *Jackson v. Commissioner, 233 F.2d 289, 290 (2d Cir.1956)*. Here El Sombrero did have an intended purpose and did engage in business. Indeed, it was the sine qua non of the Missouri group's being permitted to farm in Mexico. Without it, not one acre of land could have been leased, not one dollar borrowed, not one field plowed, nor one seed planted. It was the business entity through which the entire enterprise functioned and in whose name its operations were performed.

In *Bennett Paper Corporation and Subsidiaries v. Commissioner, 78 T.C. 458 (1982)*, aff'd *699 F.2d 450 (8th Cir.1983)*, the taxpayer was the parent of an affiliated group of corporations filing a consolidated return for 1974, the year in issue. A new subsidiary was created in 1974 whose business purpose was to establish a marina and yacht club. Marina activities prior to 1974

had been carried on by the parent of this subsidiary. The new subsidiary did not begin its operations until 1975. Nevertheless the taxpayer deducted on its consolidated return preopening expenses incurred by the subsidiary in 1974.

The court held that these amounts were not deductible under *section 162(a) of the Code* because the taxpayer's trade or business had not commenced in the tax year in issue. Also citing *Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, (1979)* aff'd *633 F.2d 512 (7th Cir.1980)* the court considered and rejected petitioner's position that the trade or business requirement of *section 162(a)* may be satisfied by attributing the trade or business activities of one related entity to another.

RATIONALE:

The expenditures in the present situation as to the 26 outlets or stores operated within Company's corporate form can not be characterized as "start up" costs. "Start up" costs are not incurred in an established business operation when the new activities are similar to current business activities. "Start up" costs, however, may be incurred by an existing business if the new activities are distinguishable from those currently conducted by the business. This request does not concern an existing business that began a new activity unrelated to its prior business.

In Briarcliff Candy, the government argued that the expenditures of the taxpayer gave rise to a separate and distinct asset, a distribution system for its products involving the securing of agency contracts. As noted previously, the court in Briarcliff Candy rejected the notion that an asset had been created. The facts in this case are considerably less supportive of a finding that there was a separate asset created than the facts in Briarcliff Candy. No separate asset is created when the Company merely expands the identical business to a new geographical location.

However, when Taxpayer chooses to operate within new subsidiaries these entities may not be disregarded for tax purposes. Subsidiary #1 and Subsidiary #2 are separate and distinct corporations. The activities of their parent may not be imputed to them for the purpose of determining at what point they have entered into a trade or business. The expenditures on behalf of the new entities, occurring prior to the time that they are open for business, for salaries, wages, travel, and training can not be described as ordinary and necessary business expenses under *section 162(a) of the Code*. There is no deduction for these expenditures in this instance even though the new subsidiaries are a part of the affiliated group which files a consolidated return. See *Bennett Paper Corporation, Supra at p. 467*.

CONCLUSION:

The concept of "start up" expenses does not apply to the twenty six new outlets operated within Company's corporate structure. Further, these expenses have not resulted in the creation or enhancement of a separate and distinct asset.

Accordingly, amounts expended on behalf of these outlets are deductible as ordinary and necessary business expenses under *section 162(a) of the Code*.

Amounts as described above, expended on behalf of Subsidiary #1 and Subsidiary #2 prior to the time that they opened for business constitute "start up" expenses and may not be deducted as ordinary and necessary business expenses under *section 162(a) of the Code*.

A copy of this technical advice memorandum is to be given to the taxpayer. *Section 6110(j)(3) of the Code* provides that it may not be used or cited as precedent.