Private Letter Ruling 9027002

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 16, 1990

Whether section 195 of the Internal Revenue Code regarding start-up expenditures prohibits Taxpayer from currently deducting employment expenses and requires Taxpayer to capitalize those expenses. Specifically, when does a trade or business begin for purposes of section 195(b)(1)?

FACTS

Taxpayer was organized under the laws of State B on a to engage *****. Taxpayer issued b outstanding shares of common stock that are owned by C and D as joint tenants with right of survivorship. On c, Taxpayer filed an election to be an "S" corporation. Taxpayer elected the cash receipts and disbursements method of accounting in its d federal income tax return.

Taxpayer employed C to work full time for the business. C, a professional ***** for e years, is Taxpayer's key employee. According to Taxpayer, C performs all of the functions of a professional *****. He creates ideas for his ***** efforts, determines that markets exist and ascertains that there is a broad public interest by ***** in the subject matter. C works full time (35 hours per week) *****. Once a ***** is ***** it is then submitted to [*2] ***** or ***** for sale.

On behalf of Taxpayer, C has performed the following projects:

Taxpayer made no efforts to market C's works until f. Furthermore, Taxpayer was not under contract to produce works for any third parties in d or h.

Taxpayer paid C an annual salary of $g in d and h, contributed to a defined benefit pension plan for which the Internal Revenue Service issued a favorable determination letter, and incurred other miscellaneous expenses in d and h. Taxpayer filed its d and h federal income tax returns with the City E service center. Taxpayer incurred a net less of $l in d and a net loss of $j in h. Taxpayer passed through its losses to its 100 percent shareholders, C and D.

F, an Internal Revenue Service agent from the City G District of the Examination Division, audited Taxpayer for tax years d and h. F determined that either former section 280 or section 195 of the Code required Taxpayer to capitalize its d and h employment expenses pursuant to the provisions of those sections.

LAW AND ANALYSIS

The technical advice memorandum dated January 9, 1989, previously issued to the District Director in City F (PLR 8918001) concludes that former section 280 and section 195 of the Code [*3] do not apply to Taxpayer. While we agree with the memorandum's conclusion as to former section 280, we have reexamined the memorandum's conclusion as to when a trade or business begins under section 195(b)(1).

Section 195(a) of the Code provides that, except as otherwise provided in section 195, no deduction shall be allowed for start-up expenditures.

Section 195(b)(1) of the Code provides, in general, that start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins).

Section 195(c)(2)(A) of the Code provides that the determination of when an active trade or business begins shall be made in accordance with such regulations as the Secretary may prescribe.

Section 195(d)(1) of the Code provides that an election under section 195(b) shall be made not later than the time prescribed by law for filing the return for the taxable year in which the trade or business begins (including extensions thereof).

Section 162(a) of the Code provides, [*4] in part, for a deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 195 of the Code generally provides that start-up expenditures are not deductible. Taxpayers may elect, however, to amortize start-up expenditures. The amortization period must be at least 60 months and begins with the month in which the active trade or business begins, The beginning point of a trade or business under section 195 has two consequences. First, if an activity never reached the point the trade or business begins, start-up costs incurred in the activity cannot be amortized under section 193. Second, the 60-month or longer amortization period cannot commence until the trade or business begins. Expenditures incurred after this time cannot be amortized under section 195 and may be currently deductible under section 162(a).

The bill that later became section 195 of the Code was introduced as H.R. 5729, 96th Cong., 1st Sess. 181 (1979). H.R. 5729, as originally introduced, pegged when a trade or business begins to "the month the trade or business starts function as a going concern." This standard clearly was based on Richmond Television Corporation v. United States, 345 F. 2d 901 (4th Cir. 1965), [*5] vacated and remanded per curiam on other grounds, 362 U.S. 68 (1965), original holding on this issue reaff'd., 354 F.2d 410 (4th Cir. 1965), overruled on other grounds, NCNB Corporation v. United States 684 F.2d 285 (4th Cir. 1982).

Section 195 of the Code, as originally enacted in the Miscellaneous Revenue Act of 1980 (the "1980 Act") provided that the amortization period started with the month in which the business began. Other than a reference to when an acquired business began under former section 195(d), the 1980 Act was silent as to when such event actually occurred. The Senate Finance Committee Report to the 1980 Act stated that:

The month of acquisition is to be determined with regard to the economic substance of each situation. Generally, it is anticipated that the definition of when a business begins is to be made in reference to the existing provisions for amortization of organizational expenditures (Code secs. 248 and 709). Generally, if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, it will be deemed to have begun business.

S. Rep. No. 1036, 96th Cong., 2d Sess. 14 (1980).

In spite of the 1980 Act's [*6] legislative history, the Service follows the concept of carrying on a trade or business under section 162(a) of the Code to determine when a trade or business begins under section 195 because business start-up expenditures are expenses of a taxpayer, that would have been ordinary and necessary business expanses, except for the fact that the. taxpayer had not yet begun the trade or business at the time the expenses were incurred. "Ordinary and necessary" expenses incurred before the taxpayer is entitled to claim deductions under section 162(a) will qualify under section 195. After the trade or business begins, the expenses will be deductible under section 162(a). If the Service treated a trade or business as "beginning" before the time at which section 162(a) deductions become allowable, expenses incurred in the interim would not be deductible under section 162(a). Consequently, it would be necessary either to require that these expenses be capitalize or to treat them as "start-up expenditures" incurred after the trade or business begins.

Moreover, section 195(b)(1) of the Code, after its amendment by the Tax Reform Act of 1984 (the "1984 Act"), refers to an "active trade or business" while sections 248 and 709 only refer to when the "corporation begins business" or when the "partnership begins business." One can infer from the addition of the word "active" that the standard to be applied in section 195(b)(1) for when a trade or business begins should be stricter than the standard used under sections 248 and 709. Therefore, since the enactment of section 195 in the 1980 Act, the Service looks to section 162(a) for determining when a trade or business begins under section 195.

The leading case on the issue of when a trade or business begins under section 162(a) of the Code is Richmond Television, supra. In Richmond Television, the taxpayer, a corporation organized to operate a television station, applied for a broadcasting license in 1952. Prior to receipt of its broadcasting license and commencement of its broadcasting activities in 1956, the taxpayer incurred expenses in training prospective employees. The taxpayer deducted these expenses as business expenses under section 162(a) in taxable years 1952 through 1956.

In addressing the issue of the deductibility of business expenses, the court, in Richmond Television, stated that a taxpayer "has not `engaged in carrying on a trade or business' within the intendment of section 162(a) [of the Code] until such time as the business has begun to function as a going concern and performed those activities for which it was organized." The court held that the taxpayer was not "engaged in carrying on a trade or business" until the broadcasting license was issued and broadcasting commenced. Because the expenditures for training prospective employees were made before the license was issued and before broadcasting commenced, the court held that they were capital expenditures and not deductible under section 162(a) of the Code. The Tax Court also has followed the "going concern" test of Richmond Television. See e.g., Bennett Paper Corporation v. Commissioner, 78 T.C. 458 (1982), aff'd., 699 F.2d 450 (8th Cir. 1983); Goodwin v. Commissioner, 75 T.C. 424 (1980), aff'd. mem., 691 F.2d

490 (3rd Cir. 1982); Hoopengarner v. Commissioner, 80 T.C. 538 (1983), rev'd per curiam on other grounds, Hardy v. Commissioner, 93 T.C. 684, 93 T.C. No. 56 (1989).

In Rev. Rul. 81-150, 1981-1 C.B. 119, the Service follows Richmond Television and holds that a limited partnership organized in 1980 to construct an offshore drilling rig [*9] and to engage in contract drilling after its completion in July 1981 did not begin a trade or business under section 162(a) of the Code until July 1981, and that section 195 amortization did not begin until that date. The revenue ruling holds that the partnership was not carrying on a trade or business until July 1981, when completion and operation of the drilling rig took place. Therefore, the management fee could not be deducted under section 162(a). As to section 195, the revenue ruling states that to the extent the management fee was paid or incurred after July 29, 1980, it is a start-up expenditure subject to amortization under section 195 with the amortization period beginning July 1981.

Without referring to Richmond Television, Rev. Rul. 73-463, 1973-2 C.B. 34, holds that expenses incurred by a taxpayer for the advance promotion of a boys camp not then in existence, are not deductible under section 162 of the Code because the expenses were not incurred in the carrying on of an established trade or business.

The "going concern" test of Richmond Television was challenged in Blitzer v. United States, 684 F.2d 874, 231 Ct. Cl. 236 (Ct. Cl. 1982). The court in Blitzer upheld a deduction [*10] claimed for fees paid for the management of a low income housing project, prior to the completion of construction of the tenements, before any of the housing units were occupied and before any rent had been collected. The court limited "trade or business" in section 162(a) of the Code as requiring only regular, continuous conduct distinguishing the activity from nondeductible "personal" or "family expenses." 684 F.2d at 879-880. Rejecting the "going concern" test as an "inflexible temporal prerequisite" for the application of section 162(a), the court held that a taxpayer had begun business as soon as the taxpayer "had begun, ... a regular, continuous course of conduct," in this instance "to engage in, and carry on, its `trade or business' of developing, constructing, owning and operating an apartment project with a bona fide expectation of profit." 684 F.2d at 880-881.

The Court of Claims in Blitzer relied on United States v. Manor Care, Inc., 490 F. Supp. 355 (D.Md. 1980), in which the District Court ruled that recurring payments made by the taxpayer for wages, employee training, utilities, promotion and consumable supplies, and advertising were currently deductible under section 162(a) [*11] for the period from the first of its tax year to the date in the same year that the taxpayer obtained a permit to conduct its business. The District Court reasoned that the 1-year rule (providing in part that an expenditure producing a benefit that is exhausted completely within the tax year is currently deductible) applied to a new business during the first tax year in which it began operations, thereby producing no distortion of income.

The Tax Court in Goodwin, supra, expressed reservations about the correctness of the District Court's analysis in Manor Care. According to the Tax Court, the District Court failed to analyze the facts before it in view of the requirement imposed by section 162(a) of the Code that, to be deductible under section 162(a), expenses must be paid or incurred by a taxpayer in carrying on a trade or business. As stated by the Tax Court in Goodwin, the analysis of the section 162 issue in Manor Care fails to focus on the present tense of the "carrying on any trade or business" requirement under section 162, and thus is incorrect and should not be followed. See Goodwin, 75 T.C. at 433, footnote 8. Instead, the Tax Court in Goodwin relied on Richmond Television, supra, [*12] as support for its holding that the taxpayers were not entitled to a section 162 deduction for expenses paid or incurred during construction of an apartment building.

We believe that the Court of Claim's analysis in Blitzer is an incorrect statement of the law because it neglects to include the "carrying on" part of the "trade or business" requirement in its analytical equation. In other words, the Blitzer court failed to consider the meaning of the words "carrying on". As we have seen, this term or phrase, when used in conjunction with the rest of the clause, has been interpreted as requiring that business expenditures be incurred as an incident to a business that already exists in order to be deductible. If it is true that the function of the clause is to make personal or family expenses nondeductible, then section 262 of the Code, disallowing deductions for personal and family expenses, is unnecessary. Moreover, under the Blitzer court's interpretation of section 162, virtually all start-up expenses would be immediately deductible so long as they are incurred with a profit-making intent. If this is correct, then there is no need for section 195, which is a relief provision enacted [*13] only as late as 1980 to permit a 5-year amortization period for business start-up expenses. It is unlikely that Congress would enact a provision to allow amortization of expenses if those same expenses are already immediately deductible by taxpayers. Accordingly, we believe that neither Blitzer nor any of its progeny should be followed under sections 162 and 195.

Moreover, even if the Blitzer standard applied in determining when a trade or business began under section 195 of the Code prior to its amendment by the 1984 Act, the 1984 Act overruled the Blitzer decision to the extent it permitted expenses to be currently deducted. See Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98th Cong., 2d Sess. 296 (1984). This change was effective for periods beginning after June 30, 1984.

In the previously issued technical advice memorandum, we erroneously applied the Blitzer standard in determining when Taxpayer's trade or business began. Following the Richmond Television "going concern" test, we now conclude that Taxpayer was not carrying on a trade or business under section 162(a) of the Code until it started to market C's [*14] works on f. Likewise, Taxpayer did not start an active trade or business for purposes of section 195(b)(1) until it started to market C's works on f. This is true "even though [the] taxpayer has made a firm decision to enter into ... business, and over a considerable time has spent money in preparation for entering that business...." Richmond Television, 345 F.2d at 907. Therefore, because Taxpayer did not make the election under section 195(d) in its k income tax return to amortize its start-up expenses, Taxpayer must capitalize the start-up expenses it incurred in d and h in accordance with section 195(a).

CONCLUSION

The Service has reconsidered this issue and is revoking the January 9, 1989, technical advice memorandum to the extent it follows Blitzer and concludes that section 195(a) of the Code did not apply to Taxpayer because Taxpayer was actively engaged in the trade or business in its d and h taxable years. An active trade or business begins under section 195(b)(1) when the taxpayer is considered to be carrying on a trade or business under section 162(a). When a taxpayer is carrying on a trade or business under section 162(a) is determined by application of the Richmond Television [*15] "going concern" test.

Please advise Taxpayer of this revocation and of the procedure for requesting application of section 7805(b) relief under section 10 of Rev. Proc. 90-2, 1990-1 I.R.B. 38, 51.