Private Letter Ruling 9310001

ISSUES

1. Whether the activities of Taxpayer[1] in calendar years a, b, c constituted a new trade or expansion of an existing trade or business for purposes of sections 162(a) and 195 of the Internal Revenue Code?

2. If Taxpayer's activities in calendar years a, b, and c constituted a new trade or business, when did that trade or business begin for purposes of section 162(a) or 195(b)(1) of the Code?

3. If Taxpayer's active trade or business began for purposes of section 195(b)(1) of the Code in calendar years b or c, does Taxpayer's protective election under section 195 made on Taxpayer's calendar year a federal income tax return cover those years allowing Taxpayer to start amortizing start-up expenditures?

FACTS

Taxpayer has spent considerable time providing business management and consulting services through Corp A, a family owned and closely held C corporation, to various partnerships and S corporations of which he has an interest and to other noncontrolled entities. The pass-through entities own and operate motel, hotel, and restaurant franchises including Corp I franchises. Taxpayer's income is derived primarily from salary, director's fees, fiduciary fees, income from the pass-through entities, and other investment properties. In addition, Taxpayer has been involved with various state and national "hospitality industry" trade associations. This involvement has consumed about ***** to ***** percent of Taxpayer's time with no compensation.

The central issue in the request for technical advice concerns the proper tax treatment of certain expenses incurred by Taxpayer in years a through c. The expenses in question were deducted by Taxpayer on Schedule C of his calendar year a, b, and c federal income tax returns. Taxpayer treated the expenses as an extension of his business activities with Corp A and the pass-through entities. In addition, Taxpayer attached a statement to his calendar year a tax return stating that he was making a protective election under section 195 of the Code if it was subsequently determined that the amounts expensed on Schedule C are subject to amortization under section 195.

In year a Taxpayer undertook to establish a consulting business that would assess the level of services being provided to customers of service oriented companies. The activity was later

[1] For purposes of this technical advice memorandum, the memorandum will refer to the husband and wife taxpayers as Taxpayer because the activities in question were undertaken solely by Taxpayer.

incorporated as Corp B on date aa, a State D corporation, of which Taxpayer and his wife are the sole shareholders, as the vehicle for marketing his services. Corp B made an election to be treated as an S corporation. Because the expenses in question were incurred in Taxpayer's consulting activities, and because, as explained below, the tax treatment of the expenses are determined by the facts and circumstances surrounding how and why the expenses were incurred, it is necessary to give a detailed history of Taxpayer's activities.

Taxpayer's consulting activities involved using Taxpayer's skills to assimilate and analyze the comments of both a client's customers and employees concerning the services the client was providing. Taxpayer would provide the client with an assessment of the client's services with recommendations for changes and improvements. Taxpayer described this process as a "service assessment system". A system already operating in the restaurants and motels managed by Taxpayer used a manual data entry system. Taxpayer decided that the system would be more marketable if a mechanical data entry system was used. Thus, taxpayer decided that an electronic device would be used to record the comments of a client's customers and employees.

In date e, Taxpayer corresponded with Individual Q of City E concerning the initial development of the system. The discussions with Individual Q also dealt with making a patent application on an electronic device then under consideration. Also, in date e Taxpayer contracted with Corp C, a design and marketing firm in City F, to assist in implementing and marketing the system. Corp C's initial work involved examining three alternatives for the electronic data gathering device. Two of the alternatives, a hand-held device and a voting machine, would require hardware development and possible patent protection. Although a patent application was filed for the hand-held device, in date g Taxpayer decided to use a third alternative involving a central stand-along unit that would use "off the shelf" hardware and require no hardware development.

In date f, Taxpayer began making preliminary marketing contacts with Individual R of Corp I. Taxpayer decided that the initial marketing of the system would be directed at Corp I because of the close association Taxpayer had with that company as franchisee and consultant. Also, in date f Taxpayer corresponded with a patent attorney at Firm concerning the patent application process for the voting machine hardware (the patent on both the hand-held device and voting machine were denied).

In date f Taxpayer made efforts to market the system to Individual R of Corp I. At the same time, Corp C published Document, which described the system to be marketed to Corp I. In date i Corp C corresponded with various companies about supplying the housings or "kiosks" needed for the system. Also, according to Taxpayer Corp C improved its sales presentation to Corp I resulting in the printing in date i of Pamphlet, a proposed service assessment system for Corp I.

Taxpayer, with the assistance of Corp C, made a marketing presentation of the system in date j to Corp J, a multi-restaurant franchisee of Corp I located in State K. Following this presentation, Taxpayer contacted Individual BB, a sales representative associated with Corp M, to elicit assistance in marketing the service assessment system to other prospective clients. Taxpayer did not secure a contract from Corp I in year a. In addition, Taxpayer's "Critical Dates" outline confirms that no final product or service was available for sale in year a.

In the technical advice request Taxpayer states that as a result of his marketing efforts directed at Corp I, discussions were held in date k with Individual W of Corp I concerning the possibility of a Corp I/Taxpayer joint venture. Later that same month a marketing presentation of the system

was made to Individual W. Taxpayer claims that Individual W was favorably impressed with the system and suggested that demonstration units be set up in some Corp I restaurants.

In date l Corp C began preparing for the introduction of the system in Corp I restaurants operated by Taxpayer using promotional materials supplied by Corp I. In date l a presentation was made to Individual Z, a vice president of Corp P. Also, in date 1 Corp C prepared a document entitled "Plan of Work and Timeline for Initial Product" showing the steps to be taken before Taxpayer would be able to sell the system's services.

As part of Taxpayer's services, Taxpayer asserts that he wanted to be able to tailor the software that the computer system would use to each client. Thus, in date m Taxpayer purchased computer equipment for use in customizing the software that each client's system would use to gather information from customers. At the same time Taxpayer purchased "off the shelf" components for demonstration systems. In date n the kiosks for the demonstration systems were received. In the summer of year b customized demonstration systems were in place in two Corp I restaurants in State X operated by Taxpayer. Taxpayer did not need Corp I's approval for placing the systems in the restaurants. The systems were installed and operational in date o.

The service assessment system was also presented to executives of Bank G in the spring of year b, and a customized demonstration system was installed and operated in a branch of that bank in City H in date p. The data collected by the demonstration units from the Corp I and Bank G locations were analyzed and results were shared with both potential clients. Taxpayer claims that upon completion of the two demonstration projects he was in a position to offer for sale the complete "hybrid/bundled consulting product/services". However, Taxpayer admits that the demonstrations showed the need for further refinements of the system.

With technological changes, Taxpayer's system continued to evolve. Black and white monitors were replaced with color monitors, touchscreens were added to the monitors, and larger disk drives and laser disks were added. Thus, Taxpayer admits that even through the end of calendar year b, the software and proprietary systems were continually being updated as Corp I and Bank G made suggestions and requests for changes.

Beginning in the third year under examination in date r, a marketing presentation was made to the Corp I Vice President group. As a result of the presentation, a component list and timetable for delivery of the system to ten Corp I restaurants was developed in date s. In the same month, Individual S, a vice president with Corp I, assisted Taxpayer in preparing the proposal for the Corp I president, Individual T. It was during the spring of year c that Taxpayer developed the name System for his service assessment system. In addition, in date v the logo and letterhead for the System were developed.

In date t Taxpayer had a discussion with Individual U of Corp P to obtain feedback and possible future client references. In date u a similar meeting was held with Individual V of Corp N.

Financing for the possible Corp I systems was arranged in date v through Individual X of Bank G. At that time Corp I wanted Bank G to purchase the computer components and kiosks and lease them to Corp I. Taxpayer would supply the customized software, which had been written to Corp I specifications. In date w the computer component list was upgraded for technological changes in preparation for the presentation to the Corp I president, Individual T.

In date x until date y numerous meetings were held with a Corp I vice president, Individual S, in preparation for presentation to the Corp I president, Individual T. Presentation to Individual T was made in date y. Taxpayer claims that due to personnel changes at Corp I Taxpayer's proposal for the System was rejected by Corp I.

In date y Taxpayer developed a standardized contract for the System. The contract provided a schedule for listing the computer components to be purchased along with the monthly lease amounts for the equipment. The contract also provided for monthly fees to be charged for analyzing the information gathered by the System along with schedules for listing the number and type of reports to be furnished to the client. Monthly fees were also to be included for the customized software developed for the client. Another fee involved training the client's personnel in using the equipment. Also, in date y Taxpayer secured lease financing for prospective clients through Bank G.

In the fall of year c Taxpayer decided to pursue other potential clients and developed an alternative customer list. In date y a marketing presentation was made to Individual Y, a sales representative with relationships to Corp O and other service industry clients. In date z Taxpayer contacted Individual AA, who had close relationships with many Fortune 500 companies, for the purpose of familiarizing Individual AA with the System.

In date z discussions were held with one of Corp I's vice president relating to setting up a presentation to Corp L, the parent company of Corp I. Following these discussions presentation materials were sent to Corp L. Because the request for technical advice does not ask us to address Taxpayer's activities and expenses in years after calendar year c, we have few facts regarding Taxpayer's activities in year d.

During the years under examination, Taxpayer or Corp B made no actual sales nor received any compensation for developing the System from any client or potential client. Corp B's first income came from Bank G in calendar year d. Thus, the District Director concludes that Taxpayer never started an active trade or business because "there were no orders received during these years, no capacity developed for manufacture/assembly, no equipment other than the prototypes, no property rights, no signed written agreements, no patents granted, no employees, no financing other than [Taxpayer's] money, no business licenses obtained for manufacture, and no actual operations."

In the materials submitted by Taxpayer, Taxpayer admits that the potential clients in those years requested more sophisticated consulting and promotional services than technological available. However, because Corp M's multi-media division requested that Corp B appear at a Corp M trade show, Taxpayer believes that Corp M's interest validates the System's technology. Moreover, Taxpayer claims that it continues to offer for sale or lease its simple, basic system developed in year b and is negotiating with two customers to sell the simpler system. In the technical advice request Taxpayer contends that creating the System was an expansion of his existing business activities and, therefore, he correctly treated the expenses as deductible on his tax returns. Alternatively, Taxpayer argues that if creating the System resulted in a new trade or business, he started the active trade or business on date p.

LAW AND ANALYSIS

Section 162(a) of the Code provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

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 nay 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. To date no such regulations have been published.

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).

In Ann. 81-43, 1981-11 I.R.B. 52, the Service provided guidance on filing an election under section 195 of the Code. The announcement provided that the election should be made by attaching a statement to the return for the tax year in which the amortization period begins.

An active trade or business begins under section 195(b)(1) of the Code at the point in time a taxpayer is carrying on a trade or business under section 162(a). Start-up expenditures are expenses of a taxpayer that would have been ordinary and necessary business expenses, 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.

The beginning point of a trade or business under section 195 of the Code has two consequences. First, the 60 month or longer amortization period cannot commence until the trade or business begins. Second, if an activity never reaches the point where the trade or business begins, start-up costs incurred in the activity cannot be amortized under section 195.

In order for a particular expenditure to be deductible under section 162(a) of the Code, it must be paid or incurred while the taxpayer is engaged in a trade or business. Thus, to the extent Taxpayer's consulting activities constituted an ongoing trade or business at some point during the period under examination, any ordinary and necessary expenses incurred in connection with such activities prior to the commencement of active business operations (as determined under the standards set forth below) may be amortizable under section 195, and any subsequent expenses should be deductible under section 162(a).

The term "trade or business" is not defined by the Code or by the regulations, and the courts have not announced a definitive interpretation of that term. Although courts have developed a number of formulae for defining a trade or business, "under any definition, a business means a course of activities engaged in for profit." Industrial Research Prods., Inc. v. Commissioner, 40 T.C. 578 (1963), acq. 1966-1 C.B. 2. While expressly leaving to Congress the task of defining the term,

the Supreme Court has indicated that to be engaged in a trade or business, the taxpayer oust be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. Commissioner v. Groetzinger, 480 U.S. 23, 94 L. Ed. 2d 25, 107 S. Ct. 980 (1987).

In determining whether the System venture constituted a trade or business for purposes of section 162(a) of the Code, it is necessary to determine whether the venture was either an expansion of Taxpayer's existing business activities, or a new activity that became an active trade or business during the years under examination.

Whether an economic venture constitutes an expansion of an existing business rather than a new activity is essentially a question of fact. Nonetheless, in making this factual determination, it is appropriate to consider whether the new pursuit or activity is one for which the original business was organized and in which it has been engaged. Mid-State Prods. Co. v. Commissioner, 21 T.C. 696 (1954), acq. 1955-2 C.B. 7. If it is not, it must be determined whether the new activity is within the compass of the taxpayer's existing trade or business. See, e.g., York v. Commissioner, 261 F.2d 421 (4th Cir. 1958).

If two separate activities or pursuits are related in such a fashion that the average trade or business in a particular field of endeavor that includes one of the activities would be likely to include the other, and could be included as a matter of course, then it would be reasonable to conclude that the other pursuit or activity is not a new and additional trade or business. If, however, substantial amounts of new skills and expertise are required to enable the existing trade or business to include the other activity or pursuit, then it would be reasonable to conclude that the other activity is a new and trade or business for purposes of section 162 of the Code.

To show that the System venture was merely an expansion of the taxpayer's existing trade or business, Taxpayer must show either that he was actively engaged in an ongoing consulting business prior to the formation of the new endeavor, or alternatively, that an enterprise whose trade or business can be attributed to Taxpayer was engaged in such an ongoing business.

Courts have consistently and repeatedly held that an executive of a corporation is not entitled to claim as his own trade or business for purposes of section 162 of the Code the trade or business in which his employer corporation is engaged. In Burnet v. Clark, 287 U.S. 410, 77 L. Ed. 397, 53 S. Ct. 207, 1933-1 C.B. 175 (1932), the long-time president and principal stockholder of a corporation endorsed notes for the company which he was subsequently forced to pay. Although the amounts were currently deductible, the taxpayer sought to characterize the losses as having derived from the operation of a trade or business, so as to allow the losses to be carried forward to later years.

In finding that the taxpayer was not engaged in a trade or business, the Court held that although the respondent was employed as an officer of the corporation, "the business which he conducted for it was not his own." The Court has adhered to this principle in numerous subsequent decisions. See Dalton v. Bowers, 287 U.S. 404, 77 L. Ed. 389, 53 S. Ct. 205, 1933-1 C.B. 177 (1932) (business of corporation not attributed to officer because each is a distinct entity); Whipple v. Comm'r, 373 U.S. 193, 83 S. Ct. 1168, 10 L. Ed. 2d 288, 1963-2 C.B. 642 (1963) (full-time service to a corporation does not amount to a trade or business). See also Tibbals v. United States, 362 F.2d 266, 176 Ct. Cl. 196 (1966) (in determining the trade or business of an

individual taxpayer, the business activities of his closely held corporation will not be attributed to him).

A different rule applies in the area of partnerships, however, so that partners are deemed to be in the trade or business conducted by the partnership. See, e.g., Butler v.Commissioner, 36 T.C. 1097 (1961), acq. 1962-1 C.B. 3; Ward v. Commissioner, 20 T.C. 332 (1953), aff'd 224 F.2d 547 (9th Cir.1955); A.L. Stanchfield v. Commissioner, T.C. Memo 1965-305, 24 T.C.M. 1681 (1965).

After examining the facts presented in the technical advice request, we conclude that Taxpayer's consulting activities are neither an expansion of Taxpayer's own trade or business, nor an expansion of a trade or business that may be attributed to Taxpayer by means of his ownership of Corp A and in the various pass-through entities.

Although Taxpayer participated in a number of consulting activities related to the hospitality industry prior to creating the System, Taxpayer has represented that he was at no time directly compensated for such activities. There is no evidence that Taxpayer maintained separate office facilities, phone lines, accounting records, or any other indicia that would support treating Taxpayer's consulting venture prior to the development of the System as an expansion of an existing trade or business for purposes of section 162 of the Code.

Taxpayer's pre-System consulting activities are similar to the activities in Industrial Research Prods., 40 T.C. at 578, where the Tax Court refused to characterize noncompensated consulting activities as a trade or business. In Industrial Research Prods., the taxpayer owned all of the stock of Industrial Research Products, Inc. (Industrial), and also served as the president and a director of the company. In addition to his duties with Industrial, the taxpayer served on a number of panels and professional committees related to his profession as an engineer, and performed independent consulting services for various universities and government agencies. The taxpayer was not compensated for such consulting services. Nonetheless, the taxpayer claimed that he was actively conducting an independent consulting business unrelated to his position with Industrial, and accordingly, sought to deduct related expenses as business expenses under section 162 of the Code. The Tax Court denied the deduction, finding that because the taxpayer was not compensated for his consulting services, the taxpayer was not involved in a "trade or business." See also Goldman v. Commissioner, T.C. Memo 1975-138, 34 T.C.M. 639 (1975) (taxpayer held not to be in trade or business of consulting absent proof that taxpayer received compensation for such services).

Accordingly, for purposes of sections 162(a) and 195 of the Code, Taxpayers noncompensated participation in various hospitality industry committees and associations is insufficient to characterize Taxpayer as having been engaged in his own active consulting business prior to the period under examination.

Similarly, none of Taxpayer's S corporations or partnerships were actively engaged in an ongoing consulting business during the relevant period. Because Corp A is a C corporation, the Supreme Court's decisions in Clark and Whipple, supra, prevent Taxpayer from claiming as his own trade or business the activities in which Corp A was involved. Nevertheless, because Taxpayer has represented that he was a principal in at least one partnership involved in the hospitality industry (specifically, the ownership of franchised hotels and restaurants), Taxpayer

will be entitled to claim that he was actively involved in an ongoing hospitality business prior to year a.

However, providing third-party consulting services is a new activity and is not a mere extension of Taxpayer's existing hospitality business. Providing "service assessments" to third-parties engaged in the hospitality industry does not appear to be the purpose for which the partnerships were organized or in which they are engaged. The partnerships were organized to provide temporary lodging and meal service. Further, there is no evidence that third-party consulting services are provided as a matter of course in the hospitality industry, i.e., third-party consulting services are not within the "compass" of the hospitality industry. As shown in the facts above, creating the System was a new business endeavor unrelated to Taxpayer's activities with Corp A or the pass-through entities. Accordingly, the System is a new activity for purposes of sections 162(a) and 195 of the Code, whether conducted directly by the partnerships or by Taxpayer himself.

To the extent creating the System was not an expansion of an existing business, but was instead a new activity, sections 162(a) and 195(b)(1) require the new activity to have become an active trade or business at some point during the years under examination. Determining the point in time when an economic activity constitutes the carrying on of an active trade or business is essentially a question of fact. In making this factual determination, courts have consistently ruled, and it is the position of the Service, that a taxpayer is not engaged in an active trade or business within the meaning of section 162(a) of the Code until such time as the business begins to function as a going concern and to perform those activities for which it was organized. Richmond Television Corp. v. United States, 354 F.2d 410 (4th Cir. 1965), on remand from 382 U.S. 68, 15 L. Ed. 2d 143, 86 S. Ct. 233 (1968), vacating and remanding per curiam, 345 F.2d 901 (4th Cir. 1965). See also Bennett Paper Corp. 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 (3d Cir. 1982).

In Richmond Television, the taxpayer was formed for the purpose of owning and operating a television station. After applying for an FCC broadcasting license, but before the actual issuance of the license, the taxpayer incurred various expenses in developing and training the workforce that would be needed to operate the station profitably upon receiving the broadcasting license. The taxpayer sought to deduct these costs as business expenses under section 162(a) of the Code. In determining at what point in time the taxpayer's trade or business began for purposes of section 162(a), the court determined that the trade or business began only when the FCC issued a broadcasting license and the taxpayer began broadcasting. Only then did the business begin to function as a going concern and to perform those activities for which it was organized.

Accordingly, under the Richmond Television "going concern" test, a trade or business does not begin until it acquires the necessary operating assets to conduct its business. See Bennett Pager Corporation, 78 T.C. at 469-70. However, it is not enough to merely acquire the necessary operating assets, they must also be put to productive use in the trade or business, that is, "actual business operations" must commence. See Goodwin, 75 T.C. at 433.

Under the Richmond Television "going concern" test, an activity does not become an active trade or business until the business begins to function as a going concern and performs those activities for which it was organized. Based upon the facts presented, we do not believe that Taxpayer's activities during the period under examination meet the requirements of the "going concern" test.

During the period under examination, Taxpayer did expend considerable effort in developing a prototype of the service assessment system, and make numerous presentations and marketing efforts aimed at securing clients for his service. However, we believe that Taxpayer's service assessment system was still evolving. Throughout the period under examination, the system constantly evolved in response to technological advances and to suggestions made by potential customers. Taxpayer readily admits to the evolving nature of the activity. Moreover, it appears the potential clients were unsure what information and analysis they needed from the system. See Polachek v. Commissioner, 22 T.C. 858, 863 (1954) (where the Tax Court held that allowing a business deduction is not appropriate where the taxpayer's business idea was still in its formative stages). Accordingly, Taxpayer's and Corp B's activities did not rise to the level of a trade or business for purposes of sections 162(a) and 195 of the Code during the period under examination.

The third issue raised in the technical advice requests concerns whether a taxpayer who incorrectly claims in an earlier taxable year that certain expenditures are attributable to an existing trade or business, but files a protective election in the event that the expenditures are attributable to a new trade or business, would be permitted to amortize the expenditures in a later year under section 195 of the Code. However, given our conclusion that Taxpayer never started an active trade or business for purposes of section 195(b)(1) of the Code during the years under examination, the issue of whether Taxpayer's protective election would permit Taxpayer to amortize start-up expenditures beginning in years b or c is moot.

CONCLUSION

1. Taxpayer's activities in calendar years a, b, and c were not an expansion of an existing trade or business for purposes of sections 162(a) and 195 of the Internal Revenue Code.

2. Taxpayer never began a trade or business in calendar years a, b, and c for purposes of section 162(a) or 195(b)(1) of the Code.

3. Because Taxpayer never started an active trade or business for purposes of section 195(b)(1) of the Code in either calendar years b or c, Taxpayer cannot start amortizing start-up expenditures in either year.

A copy of this memorandum should be provided to the taxpayers. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.