Private Letter Ruling 9331001

ISSUES

(1) Was Taxpayer's first boutique an expansion of an existing trade or business or the creation of a new trade or business?

(2) When Taxpayer opened the additional boutiques, did it expand its trade or business or create new trades or businesses?

(3) Does *section 195* apply to the expenses incurred in the opening of the additional boutiques by Taxpayer?

FACTS

Taxpayer, the parent of a consolidated group of corporations, was incorporated on a. Corporation B is the 100 percent shareholder of Taxpayer. Through various divisions, Taxpayer manufactures and sell fragrances and cosmetics, and imports and distributes ready-to-wear clothing and accessory items. Through a separate division, Taxpayer is also engaged in the retail sale of these items through its boutique operations.

Taxpayer's merchandise was sold in the United States solely through its wholesale distribution network prior to the start of its retail business. Taxpayer began its retail business when it opened its first boutique under its tradename on b, in City B. The boutique operation expanded Taxpayer's distribution network and extended its reach to its customers. The start-up expenses incurred for the opening of the first boutique were capitalized and amortized pursuant to *section 195 of the Code*, beginning with Taxpayer's federal income tax return for the year ending c.

Since n, Taxpayer has expanded its retail business by opening boutiques in various cities throughout the United States. The locations and opening dates are as follows:

Location	**Opening Date**
City C	d
City D	e
City E	f
City F	g
City G	h
City H	i
City I	j
City J	k
City K	l
City L	m

From a strategic standpoint, the selection of the location of each new boutique is based upon the potential of the boutique to generate sufficient sales to enable Taxpayer to meet its return on investment requirements while maintaining and enhancing Taxpayer's image.

The boutiques are operationally indistinguishable from one another. The site of each new boutique is usually in the same part of a particular city as Taxpayer's principal competitors. The interior design of each boutique follows a standard and consistent theme that is dictated by Taxpayer, adapted only to fit the existing structure of the leased space. During the construction period of each boutique, Taxpayer retains the services of the same independent contractor to oversee and coordinate the activities of the various contractors and to serve as liaison with Taxpayer.

Three or four months are usually required to build a boutique. Taxpayer regularly assigns employees to the various tasks involved in opening a boutique, including stocking merchandise and hiring sales staff. In the two weeks before completion of construction of a boutique, Taxpayer sends a team of three employees who are experienced in store openings to the new location to prepare for opening day. One of these individuals usually remains at the new location for a few weeks after opening to oversee initial operations, and to train the newly-hired manager in Taxpayer's methods and procedures.

Each boutique is stocked with Taxpayer's ready-to-wear clothing, accessory items, and cosmetics and fragrances. All boutiques are totally dependent on Taxpayer, which provides their accounting, financing, management, purchasing, and advertising services.

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 263(a) of the Code, in essence, provides that no deduction shall be allowed for capital expenditures. Section 1.263(a)-1(a)(1) of the Income Tax regulations provides that generally no deduction is 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.

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

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

Section 195(c)(1)(A) of the Code defines the term "start-up expenditures" as any amount paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, or (2) creating an active trade or business, or (3) engaging in any activity for profit and for the production of income before the day on which the active trade or business begins in anticipation of the activity becoming an active trade or business. *Section 195(c)(1)(B)* provides that the amount paid or incurred in one of these manners is a start up expenditure only if the amount would be deductible if paid or incurred in connection with the operation of an existing trade or business.

Whether a business is an expansion of an existing trade or business or new trade or business depends on the facts and circumstances of each case. S. Rep No. 1036, 96th Cong., 2d Sess. 12

(1980); see also *Higgins v. Commissioner, 312 U.S. 212, 217, 85 L. Ed. 783, 61 S. Ct. 475, 1941-1 C.B. 340 (1941)*. We have found no authorities that provide a test for determining when an existing business begins a new trade or business. However, we believe that the law defining when a trade or business begins for a new enterprise or entity provides the most likely approach for answering this question.

The leading case defining when a trade or business begins is *Richmond Television Corp. v. United States, 345 F. 2d 901 (4th Cir. 1965)*. In Richmond Television, the taxpayer was a corporation organized to operate a television station. It applied for a broadcasting license in 1952. Prior to receiving its broadcasting license and commencing its broadcasting activities in 1956, the taxpayer incurred expenses in training prospective employees. The taxpayer deducted these costs as business expenses under *section 162 of the Code*.

In addressing the issue of deductibility of business expenses, the court in Richmond Television stated that a taxpayer "has not `engaged in carrying on any trade or business' within the intentment of *section 162(a)* until such time as the business has begun to function as a going concern and performed those activities for which it was organized." *345 F.2d at 907*. The court held that the taxpayer was not a "going concern" until the broadcasting license was issued and broadcasting commenced. Because the costs of training prospective employees were incurred before the license was issued and before broadcasting commenced, the court held that the costs were capital expenditures and were not deductible under *section 162(a) of the Code*.1

The Service follows the "going concern" test of Richmond Television. For example, *Rev. Rul. 81-150, 1981-1 C.B. 119*, cites Richmond Television to support its holding that a partnership, which was formed to engage in the offshore oil drilling business, and which had to construct an offshore drilling rig before it could begin operations, was not carrying on a trade or business until the drilling rig was completed and placed in operation.

The authorities cited can be summarized by stating that the crucial prerequisite for deductibility of trade or business expenses under *section 162 of the Code* is that the enterprise incurring them must be beyond the point of mere preparation and actually be engaged in the primary activities intended. Applying this rule to the question of when an entity already engaged in a trade or business begins a new trade or business, it is appropriate to look for a change in the nature of the activities engaged in by the entity.2 We believe that the activities involved in operating a retail operation, such as a boutique, are substantially different from those of a manufacturer or wholesale distributor. On b, when Taxpayer opened its first boutique for business, Taxpayer began performing the activities that its retail establishment had been organized to perform. Therefore, Taxpayer should be considered to have begun a new trade or business on b.

However, as Taxpayer opened new boutiques in different parts of the country, it was expanding its existing retail business, rather than starting new businesses. This conclusion is indicated by facts showing that Taxpayer had established a system of operation for its retail enterprise at the beginning of the enterprise. This system included established management procedures, a package of accounting, management, financing, advertising, and purchasing services furnished to each boutique, and even a standard interior decor at each location.3 Therefore, Taxpayer's expenses paid or incurred in connection with the operation of the boutiques during the years in question were paid or incurred in connection with the operation of an existing trade or business.

Because *section 195 of the Code* does not apply to expenditures paid or incurred in connection with the operation of an existing trade or business, *section 195* does not apply to the boutiques opened in Cities C through L.

In light of *INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 117 L. Ed. 2d 226, 112 S. Ct. 1039, 1044-45 (1192)*, even though the opening of the additional boutiques constituted business expansion, rather than a new trade or business, the expenditures paid or incurred by Taxpayer regarding the opening of the additional boutiques might not be currently deductible. If you wish to challenge certain deductions taken by taxpayer during the years involved, and require technical assistance regarding the deductibility of certain expenses, we recommend that you request technical assistance from Income Tax & Accounting CC:IT&A, which has jurisdiction over *section 162 of the Code*.

CONCLUSIONS

(1) Taxpayer's first boutique was a new trade or business.

(2) When Taxpayer opened additional boutiques, it expanded its trade or business.

(3) *Section 195 of the Code* does not apply to the expenses incurred in the opening of additional boutiques by Taxpayer.

FOOTNOTES:

1

The United States Tax court and all but one of the federal circuits that have considered this issue follow the "going concern" test of Richmond Television. See, e.g., *Goodwin v. Commissioner, 75 T.C. 424 (1980)*, aff'd mem., *691 F.2d 490 (3d Cir. 1982)*; *Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521 (1979)*, aff'd, *633 F.2d 512 (7th Cir. 1980)*; and *Hoopengarner v. Commissioner, 80 T.C. 538 (1983)*, aff'd, *699 F.2d 450 (8th Cir. 1983)*.

2

For example, in *Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228-29 (1985)*, the court noted that nuclear generation of electricity differs substantially from the production of electricity in conventional fossil fuel plants. The employees must be trained to a higher degree. Heat is produced by different means. Finally, support systems are required at a nuclear reactor that are not required for conventional plants. Therefore, the court concluded that the training expenses incurred in connection with the opening of the nuclear plant should be capitalized as a one-time expenditure necessary to begin a new business. See also Radio station *WBIR v. Commissioner, 31 T.C. 803 (1959)* (holding that the operation of a radio station is not the same business as the operation of a television station).

3

Cases dealing with similar fact patterns are generally consistent in finding that an entity is not beginning a new trade or business when it seeks to expand its customer base by adding a new product, opening new stores, outlets or branches, or by changing its marketing strategy. See, e.g., *NCNB Corp. v. United States, 684 F. 2d 285, 290 (4th Cir. 1982)*; *Malmstedt v. Commissioner, 578 F. 2d 520, 525 (4th Cir. 1978)*; *Colorado Springs Nat'l Bank v. United States, 505 F. 2d 1185, 1190 (10th Cir. 1974)*; and *Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973)*.