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DEDUCTING HIGH-TECHNOLOGY START-UP EXPENDITURES

Michael D. Rashkin*

I. INTRODUCTION

In the world of high-technology, a “start-up” is a new business venture in the beginning stages of development which has not yet reached the point where there is any degree of certainty that the business will survive. There is no bright line that defines when a business passes from its start-up phase to becoming a self-sustaining enterprise. Ordinarily, this is not very troublesome as there is no critical business need to precisely classify a business as being in its start-up phase or as being in some other stage of business development.

In the tax world, however, it is important to determine whether a company is a start-up. Under recent case law and legislative developments, start-up expenses receive much less favorable treatment than expenses incurred after the start-up phase has passed. Section 195 of the Internal Revenue Code of 19541, as amended by the Tax Reform Act of 19842, provides that expenditures incurred in investigating and creating a new active trade or business are nondeductible start-up expenditures. Such expenses may be amortized under section 195(b) over a period of not less than sixty months, beginning after the start-up phase has ended. Similar treatment is provided for corporate and partnership organizational expenses under sections 248 and 709.

An important exception to the general rule of non-deductibility involves research and experimental expenditures, which may be de-

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1. Unless otherwise indicated all references and citations to sections in this article are to sections of the Internal Revenue Code of 1954 [hereinafter cited as “Code”], as amended to date of publication, and all references and citations to regulations are to Treasury Regulations under the Code, as amended to the date of publication.

ducted on a current basis under section 174 even during the start-up phase.

The deductibility of start-up expenditures has a direct impact on the cost of and the return on an investment, and there has been much judicial and legislative activity concerning the duration of the start-up period. The prevailing judicial rule is that the start-up period ends when a business has reached the stage of development where it is ready to generate revenue. Thus, a new business with nominal sales and large net losses will not be considered a start-up even if there is little certainty that sales will eventually increase to provide economic viability. If a business has no sales, however, it will be considered a start-up even if there is no fundamental difference in its economic and business position.

The doctrine that prevents start-ups from deducting current expenditures puts them at a disadvantage with respect to businesses already in existence. A retail computer store chain can deduct the start-up expenses of putting a store in a new geographic location, but an entrepreneur who decides to begin his first retail computer store cannot deduct any business expenses until the store opens its doors to customers. It is unclear from case law and legislative history why tax policy has developed in this manner so as to create the inconsistencies inherent in application of the current rules.

It is also unclear whether the judicial rule preventing deduction of business expenses until revenue is generated is founded on correct tax principles. There has been conflicting case law on the subject and even certain tax regulations leave doubt as to what is the correct rule. In a recent case, the court of claims stated that it cannot be Congress' intent to disallow recurrent business expenses during the period prior to revenue generation. Legislative history of the amendments to section 195 enacted by the Tax Reform Act of 1984, however, indicates that Congress intended to overrule this case.

In the Tax Reform Act of 1984, Congress delegated its responsibility for determining the start-up period by authorizing the Commissioner of Internal Revenue ("Commissioner") to specify in regulations when an active trade or business begins. Expenses incurred after an active trade or business begins are not considered start-up expenses and are deductible under general rules. However,

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the Commissioner is not completely unfettered. The legislative history of the Tax Reform Act of 1984 indicates that it was not Congress' intent to change the definition of start-up expenses from current law. Therefore, the Commissioner will have to consider current case law in defining the start-up period.

The problems regarding deductibility of start-up expenses affect not only incipient businesses but existing businesses which want to increase the scope of their activities. The issue in such cases is whether the new activity represents an expansion of a current business, which most courts hold is not a start-up activity, or whether the new activity represents the beginning of a new trade or business, which most courts treat as a start-up activity subject to the same rules as new businesses. Existing businesses seeking to increase the scope of their activities also encounter problems if a different legal entity is used in implementing their growth plans. In dealing with start-up expenses, courts have looked at each legal entity separately and have not attributed the activities of the owners to the new entity. Thus, if a computer retail chain incorporates each new store it opens, the start-up expenses of each of these stores will not currently be deductible even though, on a consolidated basis, the incorporated store merely represents an expansion of the chain's business rather than the start-up of new businesses.

Part II of this article will discuss the statutory rules dealing with start-up expenditures. Part III will examine how the courts have interpreted these rules, and Part IV will analyze the impact of the newly amended section 195. Finally, Part V will offer some conclusions and suggestions in dealing with the murky subject of start-up expenses.

II. THE STATUTORY PUZZLE

No one section of the Code covers the various forms of start-up expenditures incurred by a business. The following discussion will identify and explain the operation of different sections of the Code as they affect start-up expenditures.

A. Capital Expenditures Under Section 263

The initial obstacle to be overcome in deducting start-up expenses is section 263. Section 263(a) provides as follows:

(a) General Rule.—No deduction shall be allowed for—
(1) Any amount paid out for new buildings or for permanent improvements of betterments made to increase the value of any property or estate . . . .
(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Section 263 expresses one of the fundamental principles of tax law: a capital expenditure is not deductible. Section 263 takes precedence over other sections of the Code allowing business deductions, so that even if a deduction is authorized under section 162, such expenditure will not be deductible if section 263 applies.

B. Business Expenses Under Section 162

If a general business expenditure is not capital in nature it may be deductible under section 162. Section 162(a) provides that there shall be allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. Since business deductions are allowable under section 162 only after a taxpayer has begun carrying on a trade or business, an important date for a business is the date it commences carrying on a trade or business. This determination is made difficult by the fact that the term "trade or business" is not defined in the Code or Regulations, and there is no precise judicial definition of the term.5

C. Start-Up Expenditures Under Section 195

The controversy which developed over the deductibility of start-up expenditures caused Congress to intervene and attempt to resolve uncertainties. Congress decided to treat start-up expenditures as capital expenditures and enacted section 195(a) which provides that "start-up expenditures" incurred in creating or acquiring an active trade or business are not deductible. "Start-up expenditures" are defined as noncapital expenditures incurred after a taxpayer has decided upon acquiring a particular business and prior to the beginning of an active trade or business. Section 195(b) permits the amortization of start-up expenses over a period of not less than sixty months beginning the month the active trade or business begins. Although the Commissioner is given authority to specify under regulations when an active trade or business begins, it is still unclear as to where the Commissioner should draw the line. Thus,

5. 1 B. Bittker, Federal Taxation of Income, Estates and Gifts § 20.1.2 (1981). There have been some imprecise definitions of the term "trade or business." Flint v. Stone, 220 U.S. 107, 171 (1911) ("Business' is a very comprehensive term and embraces everything about which a person can be employed."); Deputy v. DuPont, 308 U.S. 488, 499 (1940) (Justice Frankfurter in a concurring opinion: carrying on any trade or business "involves holding one's self out to others as engaged in the selling of goods or services.")
much of the uncertainty that existed prior to the enactment of section 195 still remains. Research expenditures, interest and taxes are specifically excluded from the scope of section 195 and are treated under the provisions specifically dealing with those expenditures.

D. Expense for Production of Income Under Section 212

Section 212 provides that in the case of an individual, a deduction is allowed for ordinary and necessary expenses paid or incurred for the production or collection of income, or for the management, conservation or maintenance of the property held for the production of income. Section 212 does not contain a trade or business requirement as does section 162, but it has been held to require a proprietary interest in property. Investigatory expenditures have been disallowed as deductions under section 212 because they relate to the acquisition or finding of income producing property rather than the production of income from, or the management and maintenance of existing property.

E. Research and Experimental Expenditures Under Section 174

Section 174(a) allows a taxpayer to elect to expense or to amortize research and experimental expenditures which are paid or incurred “in connection with his trade or business.” The United States Supreme Court in Snow v. Commissioner held that the “in connection” language of the statute represents an intent by Congress to require a lesser degree of business activity than is required under section 162, but the Court did not establish any test to differentiate “in connection” activity from “carrying on” activity.

F. Depreciation Deductions Under Section 167

A start-up business will generally acquire and create tangible and intangible assets in the process of developing a business. Capital expenditures are not currently deductible under section 263, but

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6. Section 212 also allows a deduction for expenditures incurred in connection with the determination, collection or refund of any tax.
9. In addition to the deduction for research expenditures under § 174, § 30 provides a tax credit equal to 25% of the excess of qualified research expenses for the year over the average qualified research expenses incurred in a base period. The credit is available only for research expenditures incurred “in carrying on any trade or business of the taxpayer,” indicating that Congress chose to require the same level of business activity employed by § 162, rather than the lesser amount of activity required by § 174.
may be deductible over time under section 167. Section 167 provides in pertinent part:

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

Section 168 (Accelerated cost recovery system) provides rules for calculating the depreciation allowance for tangible property built or acquired. Under these rules, property is placed in 3-year, 5-year, 10-year, 15-year, and 19-year categories and depreciation is computed under tables provided in section 168, and the regulations thereunder. Property used in research falls into the 3-year category, and most manufacturing equipment falls into the 5-year category. 10

Intangible property can be depreciated only if it has a limited useful life and if the length of the useful life can be estimated with reasonable accuracy. 11 Examples are patents and copyrights. 12 An intangible asset without a limited useful life is not subject to the allowance for depreciation. Accordingly, no deduction for depreciation is allowed with respect to goodwill or going concern value. 13 Intangible property which has a determinable useful life is depreciated on a pro rata basis over such life. 14 However, in the case where a taxpayer acquires an intangible asset in a transaction in which he is required to make payments contingent on future revenues from the use of the acquired asset, he has been permitted to deduct the royalty payments as depreciation allowances. 15 Furthermore, section 1253(d)(1) allows the deduction of payments under section 162 on the acquisition of a trademark, trade name or franchise where the payments are contingent on sales and the transferor retains a significant right, power, or continuing interest in the property transferred; and section 1253(d)(2) allows lump sum payments to be amortized and deducted under section 162 on transfers of trademarks, trade names, and franchises where the transferor retains a significant right, power or continuing interest. 16

10. I.R.C. § 168(c)(2)(A) and (B) (1982).
12. Treas. Reg. § 1.167(a)-6(a) (1960) provides that patents and copyrights shall be depreciated over their remaining useful life.
15. See Associated Patentees v. Commissioner, 4 T.C. 979 (1945); Allied Tube & Conduit Corp. v. Commissioner, 34 T.C.M. (CCH) 1218 (1975).
The period for taking depreciation begins when the asset is placed in service. An asset is considered placed in service when the property is in a condition or state of readiness and availability for a specifically designed function. In the case of a start-up, however, the same issue arises under section 167 as arises under section 162: Can a taxpayer place an asset in service and begin taking depreciation deductions prior to the taxpayer opening its doors and being ready to generate revenue? The trade or business requirement under section 167 has been interpreted similarly to the trade or business requirement under section 162 so that if one is not carrying on a trade or business as interpreted under section 162, no depreciation deductions will be allowed. If the property is used for research activities in connection with a trade or business, however, a depreciation allowance will be allowed as a research and experimental expenditure under section 174.

G. Losses on Business Activities Under Section 165

If a start-up does not succeed, a loss deduction may be available under section 165. Section 165 allows a deduction for losses sustained during the taxable year, limited to the adjusted basis of the property involved. In the case of a start-up, the adjusted basis would consist of the amount of nondeducted and unamortized items. A loss must be evidenced by a closed and completed transaction, fixed by identifiable events. A loss would be sustained on the abandonment or sale of a start-up project.

H. Organizational Expenditures for Corporations and Partnerships Under Section 248 and Section 709

Expenditures for the creation of a corporation or a partnership are capital expenditures, and in the absence of a special rule, are not deductible. However, section 248 provides that the taxpayer may elect to amortize the "organization expenditures" of a corporation

19. 1 BITTKER, supra note 5, at § 23.2.1.
20. Treas. Reg. § 1.174-2(b)(1) (1960) provides in pertinent part as follows:
      “However, allowances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of § 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. . . .”
over a period selected by the taxpayer of not less than sixty months. The amortization period begins with the month the corporation begins business. "Organization expenditures" means any expenditure incident to the creation of the corporation, chargeable to the capital account, and of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. Section 709 provides similar rules for the organization of a partnership and, in addition, provides that if the partnership is liquidated before the amortization period expires, the unamortized amount may be deducted under section 165.

I. Trademark and Trade Name Expenditures Under Section 177

Start-ups will generally be involved in acquiring trademarks and a trade name. Expenditures incurred for acquiring, developing or protecting a trademark or trade name are capital expenditures without a determinable life and are not deductible in the absence of a special provision. Section 177 provides that a taxpayer may elect to amortize "trademark or trade name expenditures" over a period selected by the taxpayer but not to be less than sixty months. The term "trademark and trade name expenditures" means any expenditure directly connected with the acquisition, protection, expansion, registration, or defense of a trademark or trade name which is chargeable to capital and which is not part of the consideration paid for a trademark, trade name or business. The amortization period begins with the first month of the taxable year and, unlike the amortization provisions of sections 248 and 709, is independent of the beginning of a business. Thus, a start-up can begin amortizing such expenditures prior to actually generating revenue.

If a taxpayer makes a section 177 election but fails to include all trademark and trade name expenditures in the election, the taxpayer cannot, according to the Commissioner, subsequently expand his election to include the items not originally included in his election.

J. Interest Expenditures Under Section 163 and Tax Expenditures Under Section 164

Neither section 163 nor section 164 have a trade or business or

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production of income requirement. Therefore, interest expenditures made by a start-up will be deductible under section 163 regardless of whether business has commenced. Likewise, payments for property, sales, and income taxes are deductible under section 164 regardless of whether the taxpayer is actively engaged in business. Section 266 allows a taxpayer to elect to capitalize certain taxes and carrying charges incurred with respect to property held, acquired or constructed by the taxpayer.

K. Use of Personal Residences for Business Purposes Under Section 280A

Entrepreneurs often use their residences as a place to begin developing a business. Garages have been the incubators of many successful businesses and continue to be used by new businesses today. Section 280A imposes severe restrictions on the ability of start-ups to qualify for deduction of expenses related to the use of the personal residence, and cuts-off all possibility of deductions for start-ups which are not generating revenue.

To qualify for a deduction, the maintenance, utilities expense, and the depreciation of a residence, including a garage, must meet the general rules of sections 162, 167, and 174. Thus a deduction will be allowed only if the taxpayer can show that the personal residence, or a portion of it, is used in carrying on a trade or business or in connection with a trade or business. In addition section 280A imposes some qualifications and limitations on the deductibility of expenses related to a personal residence. Section 280A(a) provides, as a general rule, that no deduction otherwise allowable shall be allowed with respect to the use of a dwelling unit which is used by

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28. However, individuals will have to be concerned with the limit on deductions for investment indebtedness under § 163(d).
29. It would seem that some taxes, such as sales taxes on the purchase of equipment, are capital in nature and should be capitalized. However, in Commissioner v. Idaho Power Co., 418 U.S. 1, 18 n.13 (1974), the United States Supreme Court considered § 266 to represent an exception to § 263. However, Treas. Reg. § 1.266-1(b)(3) (1960) states that § 266 has no effect on the treatment otherwise accorded an item, and that items which are otherwise capital in nature are to be so treated.
30. See Larimer, Car Computer Deters Drunken Driving, San Jose Mercury News, Aug. 9, 1985, at 1, col. 4. The article concerns a 66-year old inventor of a device called "Stay Alive" which will not allow a car to be started unless the driver passes a blood-alcohol test. The article indicates that the inventor developed the device after three years of tinkering in his garage.
31. Treas. Reg. § 1.280A-1(c)(1) (proposal Aug. 7, 1980) defines a dwelling unit as including a house, apartment, condominium, mobile home, boat, or similar property; the term also includes all structures and other property appurtenant to a dwelling unit which do not themselves constitute dwelling units.
the taxpayer as a residence. However, section 280A(c)(1) provides some important exceptions to the general rule, providing in pertinent part as follows:

Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—

(A) [as] the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.  

Accordingly, if the use of a personal residence is otherwise deductible under sections 162, 167, or 174, section 280A will not disqualify the deduction if the requirements of section 280A(c) are met. However, these requirements are quite stringent. The portion of the residence used for business must be exclusively used for business and must be used as such on a regular basis. Thus, a room or garage which is used for both business and personal purposes would not qualify. In addition, the portion of the residence used for business must be used either as the principal place of business of the taxpayer or as a place of business which is used by customers in meeting or dealing with the taxpayer. In the case of a separate structure, however, in addition to exclusivity, the taxpayer need only show that it is used in connection with the taxpayer's trade or business. Thus, it appears that an unattached garage is given more liberal treatment than an attached garage.

A further limitation, and one which will disqualify start-ups which are not generating any revenue, is the limit on allowable de-
DUCTIONS UNDER SECTION 280A(c)(5). SECTION 280A(c)(5) LIMITS THE AMOUNT OF DEDUCTIONS ATTRIBUTABLE TO A DWELLING UNIT TO THE GROSS INCOME DERIVED FROM THE USE OF THE FACILITY OVER THE DEDUCTIONS ALLOWABLE FOR SUCH USE. AS START-UPS IN THE PRODUCT DEVELOPMENT STAGE GENERALLY DO NOT GENERATE ANY REVENUES, NO DEDUCTIONS WILL BE ALLOWED FOR THE USE OF A PERSONAL RESIDENCE OR GARAGE. THOSE START-UPS WHICH HAVE REACHED THE REVENUE Generating STAGE WILL BE ENTITLED TO DEDUCTIONS, SUBJECT TO THE REVENUE LIMITATIONS IMPOSED BY SECTION 280A(c)(5). 36

If a business has reached the point of having an office outside the residence of the entrepreneur, it may be difficult to prove that the residence is the principal place of business, 37 and if such an of-

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Business deductions with respect to the business use of a dwelling unit are allowable in the following order and only to the following extent:

(i) The allocable portions of amounts allowable as deductions . . . without regard to any use in trade or business, e.g., mortgage interest and real estate taxes, are allowable as business deductions to the extent of the gross income derived from use of the unit.

(ii) Amounts otherwise allowable as deductions . . . by reason of the business use of the dwelling (other than those which would result in an adjustment to the basis of the property) are allowable to the extent the gross income derived from the use of the unit exceeds the deduction allowed or allowable under subdivision (i).

(iii) Amounts otherwise allowable as deductions . . . by reason of the business use of the dwelling which would result in an adjustment to the basis of property are allowable to the extent the gross income derived from the use of the unit exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph.

The effect of these ordering rules is that the taxpayer is first allowed those deductions which he would have otherwise been allowed whether or not he is in a business; secondly, the taxpayer is allowed to deduct out-of-pocket type trade or business expenses to the extent any limitation is remaining; and, finally, is allowed any depreciation if any limitation is remaining after deduction of the first two categories.

Treas. Reg. § 1.280A-2(2)(2)(ii) (proposal Aug. 7, 1980) defines gross income as income derived from the business activity in the unit reduced by expenditures required for the activity but not allocable to use of the unit itself, such as expenditures for supplies and compensation paid to other persons. This interpretation was rejected by the tax court in Scott v. Commissioner, 84 T.C. 45 (1985), where the tax court indicated that gross income was computed without reduction for the expenditures mandated by the proposed regulation. See Hira, Murphy and Lacock, Home Office Deductions May Be Significantly Increased After Scott, 63 TAXES 631 (Sept. 1985).

37. Treas. Reg. § 1.280A-2(b)(3) (proposed Aug. 7, 1980) provides that where a taxpayer engages in a single trade or business in more than one location, it is necessary to determine the taxpayer's principal place of business in light of all the facts and circumstances. The proposed regulation provides that the following be considered with all of the facts and circumstances:

(i) The portion of the total income from the business which is attributable to activities at each location;
office is used to meet customers, it may be difficult to prove that the residence is a place that is used in dealing with customers in the ordinary course of business. However, even if the business uses an office away from the residence as a principal place of business or for meeting customers, an unattached garage can qualify under section 280A(e)(1)(C) since it would probably meet the "in connection with a trade or business requirement."

If a taxpayer meets all the requirements of section 280A and is entitled to deductions, the Commissioner's proposed regulations state that the taxpayer may determine the expenses allocable to the portion of the unit used for business purposes by any method that is reasonable under the circumstances. If the rooms in the dwelling unit are of approximately equal size, the taxpayer may allocate the general expenses for the unit according to the number of rooms used for business purposes. The taxpayer may also allocate general expenses according to the percentage of total floor space in the unit that is used for business purposes. Expenses which are attributable to only certain portions of the unit, e.g., repairs to kitchen fixtures, shall be allocated in full to those portions of the unit. Expenses which are not related to the use of the unit for business purposes, e.g., expenditures for lawn care, are not taken into account for the purposes of section 280A.

L. Activities Not Engaged in for Profit Under Section 183

Section 183 applies to individuals and provides that no deduction is allowable for activities not engaged in for profit except as provided in section 183. Section 183 generally provides that an individual engaged in a not-for-profit activity will be allowed deductions to the extent of the gross income received from the activity.

(ii) The amount of time spent in activities related to that business at each location; and
(iii) The facilities available to the taxpayer at each location for purposes of that business.

The issue of where the principal place of business is located appears to be one subject to much controversy. In Drucker v. Commissioner, 715 F.2d 67 (2d Cir. 1983), rev'd 79 T.C. 605 (1982), a musician for the Metropolitan Opera was allowed to treat his apartment as his principal place of business because he spent a great deal of time practicing at home. See Note, Sweet Music to Taxpayers' Ears: Section 280A and the Home Office Deduction After Drucker v. Commissioner and the New Proposed Regulations, 4 VA. TAX REV. 163 (1984).

38. Treas. Reg. § 1.280A-2(c) (proposal Aug. 7, 1980) provides that customers must be physically on the premises; conversations by telephone do not qualify. The use of the dwelling by customers must be substantial and integral to the conduct of the taxpayer's business. Occasional meetings are insufficient.
40. Id.
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The significance of section 183 in the case of start-ups is that section 183(c) and the regulations thereunder basically provide that if an activity is not a not-for-profit activity, then the deductions are allowable under section 162 or section 212. The regulations under section 183 provide guidelines as to what is a not-for-profit activity and what is not. These guidelines can help a taxpayer determine if he meets the trade or business requirement of section 162, and are further discussed in Part III. C. below.

III. JUDICIAL INTERPRETATION PRIOR TO THE 1984 AMENDMENTS TO SECTION 195

The statutes discussed in Part II above have generated much judicial controversy, as the Commissioner and taxpayers have fought in the courts over the deductibility of start-up costs. The following discussion will analyze the state of the law prior to the amendments to section 195 made by the Tax Reform Act of 1984. As will be discussed in Part IV, the impact of these amendments is not clear and the existing case law should have continued validity.

A. Start-Up Costs as Capital Expenditures

Expenditures made during a year must be properly classified between capital and expense. As explained in the regulations: "... expenditures which have a useful life extending substantially beyond the taxable year shall be charged to the capital account and not to an expense account."41 This general rule has been accepted in the case law, as exemplified by the following statement made by the Tenth Circuit Court of Appeals in United States v. Akin:42

[A]n expenditure should be treated as one of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year, or if it secures a like advantage to the taxpayer which has a life of more than one year.

In practice, however, the Commissioner and the courts have not attempted to capitalize every expenditure that produces a benefit that carries into future years. Advertising, training, long-term planning, and employee relations are examples of activities which carry future benefits to businesses, but which the Commissioner and the courts have allowed existing businesses to expense on a current basis. In Commissioner v. Tellier43, the United States Supreme

42. 248 F.2d 742, 744 (10th Cir. 1957).
Court stated:

The principal function of the term 'ordinary' in section 162 is to clarify the distinction . . . between those expenses that are currently deductible and those that are in the nature of capital expenditures, which if deductible at all, must be amortized over the useful life of the asset.

Courts have also allowed expenditures to be currently expensed when the expenditure does not create or enhance any distinct and separate asset. This test was first developed in Commissioner v. Lincoln Savings and Loan Ass'n.,\(^4\) where the court stated the following:

\[\text{T]\&e 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 . . . 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.\(^5\)

In the case of start-ups, however, the Commissioner and most courts have not been so liberal in their application of section 263. A common view is that all expenditures incurred prior to the commencement of business, whether ordinary or not, are capital expenditures.\(^6\) Thus, while existing businesses can expense many arguably capital-type expenditures as ordinary and necessary business expenses, start-ups cannot.

There are probably several reasons for this dichotomous treatment. The most likely reason is that the start-up situation lends itself to taxpayer abuse of treating personal expenses as business expenses. Rather than police this area, the Commissioner would rather disallow all start-up expenditures. A second reason is that expenditures of start-ups are less likely to provide a current benefit than in the case of an existing business, and it may be more appropriate to capitalize expenditures for such expenses as advertising and training. However, not all expenditures incurred by a start-up provide value beyond the taxable year when made. For example, if an employee is trained and leaves the company during the same

\(^4\) 403 U.S. 345 (1971).
\(^5\) Id. at 354.
\(^6\) See Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), rev'd and remanded on another issue, 382 U.S. 68 (1965).
year, the training does not provide value beyond the taxable year. Similar problems are incurred with many other expenses. Unsuccessful attempts to obtain suppliers or distributors, unsuccessful attempts to hire employees, abandoned marketing plans, and recurring rent, utility and maintenance expenses all represent expenses that do not create value that last beyond the taxable year.

A final reason may be that the Commissioner views a trade or business as a self-constructed asset, and that the expenditures incurred in building a trade or business must be capitalized in the same way that depreciation of trucks was required to be capitalized in Commissioner v. Idaho Power. In Idaho Power the taxpayer used trucks in constructing relatively long-lived assets, and attempted to depreciate the trucks over their useful life. The United States Supreme Court indicated that there was no doubt that the depreciation of the trucks, as well as supplies, materials and wages in constructing the assets of the taxpayer, had to be capitalized and depreciated over the life of the assets being constructed. If a trade or business is analogized to the tangible assets being constructed in Idaho Power, then all expenses incurred in building a trade or business must be capitalized.

But the Idaho Power analogy presents some difficulties. A trade or business is not a single asset. It is an aggregation of assets. It may include trade names and trademarks, patents, copyrights, prototypes, a trained staff, a favorable lease, goodwill and the like. In the case of an ongoing business, expenditures are made for the same purposes as in the start-up. Amounts are spent to build prototypes, train staff, find and develop favorable locations and the like. But the Commissioner does not invoke section 263 to disallow such expenditures of existing businesses unless the expenditure is incurred to build or enhance a tangible asset or a separate and distinct intangible asset.

47. 418 U.S. 1 (1974).
48. In explaining the priority given to § 263, the United States Supreme Court stated: Finally, the priority ordering directive of § 161 — or for that matter, § 261 of the Code, . . . requires that the capitalization provision of § 263(a) take precedence, on the facts here over § 167(a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are “subject to the exceptions provided in Part IX.” Part VI includes § 167 and Part IX includes § 263. The clear import of § 161 is that, with stated exceptions set forth in § 263 itself or provided elsewhere . . . none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even if the expenditure might be deductible under Part VI.

Id. at 17.
49. See Letter Rul. 8423005.
B. Investigatory Expenses

Businesspersons generally incur investigatory expenses prior to acquiring or entering into a business. The investigatory activity may involve deciding whether to enter into business in the first place, selecting a particular industry, and choosing a particular business within an industry. Investigatory activities usually include travel, legal and other professional advice, marketing surveys and other similar type expenses.

The most instructive and probably the leading case dealing with investigatory expenses is Frank v. Commissioner. Morton Frank was released from the Navy in November of 1945, after which he and his wife Agnes decided to investigate the purchase of either a newspaper or radio station. Frank was a newspaperman, and had considered purchasing a newspaper or radio station prior to and during his Navy service. At the end of November, 1945 the Franks began a trip to investigate businesses in Ohio, Minnesota, Wisconsin, Oklahoma, California, and New Mexico. The Franks temporarily halted their search, however, when they were offered employment by a Phoenix, Arizona newspaper. While residing in Phoenix they continued looking for a business and made several offers to purchase newspapers. In 1946, Morton and Agnes spent approximately $7,000 on investigatory expenses including $1,000 paid to an attorney in connection with unsuccessful negotiations to purchase a newspaper in Wilmington, Delaware. In November, 1946, the Franks purchased a newspaper in Canton, Ohio, and commenced publication of the Canton Economist that month.

The Franks deducted their investigatory expenses on their tax return for 1946, and the Commissioner disallowed the deduction. Thereafter, tax court determined that the Franks were not entitled to deductions under the precursors of sections 162 and 212, and were not entitled to a loss deduction under the precursor of section 165. Although based on prior law, the tax court opinion retains its vitality since the current statutes are not significantly different from prior law.

The tax court's denial of a deduction under the precursor of section 162 for the Frank's expenses incurred in investigating and looking for a business was based on its belief that such expenses had

50. See supra note 11.
51. See supra note 7.
not been incurred in carrying on a trade or business. The court noted that the law presupposes an existing business with which the taxpayer is connected, and found that the taxpayers’ expenses of looking for the business were incurred before they actually began carrying on a trade or business.

The tax court in *Frank* also denied any deductions under the precursor of section 212. There is a basic distinction between allowing deductions for the expense of producing or collecting income in which one has an existent right, and expenses incurred in an attempt to obtain income by the creation of some new interest. The tax court found that the taxpayers’ expenditures were of the latter category.

Lastly, the tax court denied the Frank’s deduction under the precursor of section 165 noting that this section allows deductions for transactions entered into for profit. The court found that the only transaction entered into for profit by the Franks was the purchase of the newspaper in Canton, Ohio. The court rejected the notion that the Franks entered into a transaction for profit each time they visited a new city and examined a new business property. Rather, the Franks had refused to enter into such transactions after the preliminary investigation.

However, if a taxpayer decides to acquire a specific business but the transaction falls through, the expenses with regard to pursuing such transaction are deductible as a loss under section 165. 55

The only way a taxpayer can deduct general investigatory expenditures incurred with respect to an unacquired business is to add these expenditures to the basis of an acquired business. In *Akers v. Commissioner*, 56 the Commissioner did not dispute that expenditures to investigate various sites for a waterslide amusement business were capital expenditures incurred in the formation of the business at the site ultimately chosen. It is not clear if the Commissioner would have taken the same position if the case involved the sale or abandonment of the waterslide. 57 If the Commissioner were

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55. Rev. Rul. 77-254, 1977-2 C.B. 63 (taxpayer had decided to acquire a particular business and incurred legal fees in drafting purchase documents, but after disagreements between the owner of the business and the taxpayer, the taxpayer abandoned his attempts to acquire the business); Seed v. Commissioner, 52 T.C. 880 (1969) (taxpayer had decided to begin a savings and loan association and incurred legal expenses in seeking a charter, but abandoned the project when the application for the charter was rejected.)

56. 42 T.C.M. (CCH) 1458 (1981).

57. Rev. Rul. 73-421, 1973-2 C.B. 33 (the issue was not specifically addressed but the ruling indicates that the cost of inspecting several sites for a boys’ camp was not added to the cost of the site finally chosen).
to adopt this position, taxpayers could add investigatory costs to the basis of their business eventually formed, and receive a benefit from those expenditures when the business is sold or abandoned.

_Frank_ dealt with investigatory expenses of finding a particular business within a particular industry. Expenditures incurred in deciding on a particular industry would be one step removed from the investigatory expenditures in _Frank_, however, and expenditures incurred in deciding to enter into business at all would be two steps removed. Presumably, neither expenditures would be deductible under sections 162, 212 and 165 for the same reason "particular business" investigatory expenses were denied deductibility in _Frank_. Moreover, such expenses are probably too remote to be considered business formation costs as was found in _Akers_.

C. The Trade or Business Requirement

In order to obtain a deduction under section 162 a taxpayer must be carrying on a trade or business. In connection with start-ups the critical question is whether a taxpayer can be carrying on a trade or business prior to generating revenue. The leading case on this question is _Richmond Television Corp. v. United States_. In _Richmond_, the defendant taxpayer attempted to deduct expenditures incurred prior to obtaining an FCC broadcasting license for the training of staff necessary for the operation of a television station. The court found the issue to be whether the defendant taxpayer was "in business" during the period in question. The court analyzed existing case law dealing with the start of a trade or business, and concluded:

The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into a business and over a considerable period of time spent money in preparation for entering that business, he still has not "engaged in carrying on any trade or business" within the intendment 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.

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58. In _Kilroy v. Commissioner_, 32 T.C.M. (CCH) 27 (1973), the taxpayer had considerable sources of nonbusiness income and spent 20 years investigating various trades and businesses; during the years in question he had paid for a study regarding the feasibility of lasers in mining, but had no gross income from mining and owned no mines. The court found that the taxpayer was not carrying on a trade or business and did not allow a deduction for the fee for the laser study.

59. 345 F.2d 901.

60. _Id._ at 907.
Applying this teaching to the facts of the instant case, the court reversed the district court's judgment for taxpayer finding that the court had erred in failing to find, as a matter of law, that Richmond Television was not "in business" until it obtained its license and began broadcasting.

Richmond has been followed in several recent cases and has come to stand for the principle that a trade or business does not begin until the taxpayer is ready to produce revenues.

In Madison Gas & Electric Co. v. Commissioner, the taxpayer was involved in a joint venture for the construction of a nuclear power plant. The Seventh Circuit Court of Appeals disallowed expenditures incurred during construction of the plant for training employees and other expenses relating to the start-up of the nuclear power plant, citing Richmond as its authority. In Kennedy v. Commissioner, a pharmacist started his own retail drugstore and incurred certain expenses prior to actually opening the doors. These expenses included a three months supply of prescription labels, maintenance fee for burglar alarm, hardware, and rent. Citing Richmond, the tax court found that the pharmacy did not begin to function as a going concern until it opened its doors to the public, and that as a result, all expenditures incurred prior to opening its doors were nondeductible.

In view of the credence given to the holding in Richmond by other courts, it is worthwhile to determine if the analysis made by the Richmond court can withstand close scrutiny. The Richmond court cited five cases in support of its position: Frank B. Polachek v. Commissioner, Radio Station WBIR v. Commissioner, KWTX Broadcasting Co. v. Commissioner, Petersburg Television Corp. v. Commissioner, and Cohn v. United States.

An examination of these cases reveals that none support the broad principle of law that a taxpayer is not engaged in carrying on a trade or business until the business reaches the point where it is ready to generate revenue.

In Polachek, the taxpayer spent $544 on planning an investment advisory service in late 1947, but the business was never formally organized and the taxpayer abandoned the project in 1948.

61. 633 F.2d 512 (7th Cir. 1980), aff’d, 72 T.C. 521 (1979).
62. 32 T.C.M. (CCH) 52 (1973).
63. 22 T.C. 858 (1954).
64. 31 T.C. 803 (1959).
65. 31 T.C. 952 (1959), aff’d per curiam, 272 F.2d 406 (5th Cir. 1959).
67. 57 U.S.T.C. ¶ 9457, aff’d on other grounds, 259 F.2d 371 (6th Cir. 1958).
The tax court held that the taxpayer had no business in 1947, that at most he had plans for a potential business, and that the idea was still in the formative stage when it was finally abandoned.

In *Radio Station WBIR*, the taxpayer owned a radio station. In 1951, the taxpayer applied for a television station construction permit. The permit was granted in 1955 and the taxpayer began broadcasting in 1956. Prior to 1956, the taxpayer had incurred various legal, travel and engineering fees in pursuing his application for the license. The tax court stated that at the time the expenses were incurred, the taxpayer was not engaged in the operation of a television station and had no facilities for such an operation. Therefore, the court held the taxpayer's expenses were not incurred in carrying on a trade or business.

In *KWTX Broadcasting*, the taxpayer paid $45,000 to reimburse a competitor for its expenses in seeking a license in exchange for which he received the competitor's promise to dismiss its application for the license. The tax court held that the expenditures were in the nature of a capital expenditure in connection with the acquisition of a television permit and license.

In *Petersburg Television*, the taxpayer was incorporated in 1953 and shortly thereafter filed for a television license. The taxpayer was granted a construction permit in 1954, and began broadcasting in 1955. The taxpayer sought to deduct salary, travel, and professional fees in seeking its license. The tax court held, as a matter of fact, that the taxpayer's business began in 1955, and that the expenditures incurred prior to that point were nondeductible, prebusiness expenses.

Finally, in *Cohn*, the taxpayer contracted with the Army in December, 1940 to operate flying schools which began operating in March, 1941. In preparing for the opening, the taxpayer spent large sums of money on training instructors, legal fees and leases. Without legal analysis, the district court held that these expenses were nonrecurrent capital expenditures not deductible from income.

All of the cases cited by the court in *Richmond*, with the exceptions of *Polachek* and *Cohn*, involved television licenses. *Polachek* should not carry much weight in supporting the *Richmond* rule because it involved a taxpayer who never left the investigatory phase and had not yet made a firm decision to enter a trade or business. *Cohn* is likewise of limited significance because the case contains no legal analysis of the trade or business issue in the court’s decision. The teaching of the remaining cases appears to be that the expenses incurred prior to obtaining a television license and begin-
ning to broadcast are nondeductible. The expenses in these cases were generally nonrecurring expenditures incurred in securing a license, and in the nature of capital expenditures. Thus, disallowance of a substantial amount of the expenses involved in these decisions could have properly rested on the principles of section 263.

The extension of the Richmond principle to cover all businesses and all pre-opening expenditures seems to be an overly broad application. The court of claims in Blitzer v. U.S., 68 recognized the limitations of the Richmond rule and refused to apply it in a case involving the start-up of a real estate project by a limited partnership.

In Blitzer, the taxpayer attempted to deduct management fees paid in 1973 for the performance of various services in connection with an apartment complex which was not completed until 1974. The court of claims disallowed the taxpayer’s deduction on the basis that the taxpayer had not sustained the burden of providing a rational basis for separating deductible fees from nondeductible fees.

The court made clear its belief that the Richmond rule was incorrect. The court found that the function of “trade or business” in section 162(a), as interpreted by the United States Supreme Court in Tellier is merely to provide that family or personal expenses are nondeductible. Construing section 162 in this light, the Blitzer court found that the trade or business requirement was no barrier to the taxpayer’s 1973 deduction because at all times during that year, the partnership was engaged in endeavors serving business or profit-making purposes, rather than personal ones. The court distinguished Richmond and Madison Gas by pointing out that the Tellier principle was never considered by either court. 69 The courts in both cases regarded the expenditures as nondeductible capital expenditures under tax law standards apart from the trade or business requirement of section 162. The Blitzer court stated its position as follows:

If the defendant’s construction of I.R.C. sections 162 and 212 were correct, it would deny the deductions to new corporations or partnerships for amortization of organization and loan costs, for payment of telephone and other utility bills, rent, stationery,

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68. 684 F.2d 874 (Ct. Cl. 1982).
69. Interestingly, in North Carolina Nat’l Bank v. United States, 684 F.2d 285, 289 n. 4, (4th Cir. 1982), the Fourth Circuit Court of Appeals changed its position on capital expenditures and replaced the one year rule with the separate and distinct asset test established by the United States Supreme Court in Lincoln Savings. Consequently, if the Fourth Circuit had a chance to consider Tellier, which was published one year after Richmond, it is probable the Fourth Circuit would have taken a position similar to Blitzer.
and salaries and wages of corporate officers, secretaries, and even for those who sweep the floor, merely because the business enterprise is not yet in a position to earn income. But this goes too far. Neither section 162 nor section 212 require precise matching of income and expenses in the same year. Defendant has supplied no reason why normal recurring expenses to maintain any business enterprise, and which are not in the nature of start-up costs nor intended to provide benefits extending beyond the taxable year in question, should not be deductible as ordinary expenses of such business irrespective of whether or not the business has yet completed construction or acquisition of its income producing asset.\textsuperscript{70}

The Blitzer court's position is clear that if a profit motive exists, deductions should be allowed for normal recurring expenses. The point in time when the taxpayer is ready to earn income is irrelevant.

The difference in interpretation between Blitzer and Richmond is obviously of great importance to high-technology start-ups. A great deal of money is often spent during the period beginning with the product idea and ending with the realization of the product in the marketplace. If high-technology start-ups are unable to deduct start-up expenditures other than research and experimental expenses, entrepreneurs will be less likely to obtain the financing needed to get the project started in the first place.

The Blitzer interpretation is supported by regulations under various sections of the Code. For example, sections 248 and 709 allow corporations and partnerships, respectively, to amortize their organizational expenses beginning with the month the corporation or partnership "begins business." In the case of both code sections the regulations state that the date when a corporation or partnership begins business is a question of fact that must be determined in each case in light of all the circumstances of the particular case.\textsuperscript{71} Ordinarily, a business will be considered to begin when it commences the business operations for which it was organized. If the activities of the business have advanced to the extent necessary to establish the nature of the business operations, it will be deemed to have begun business. Accordingly, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of a business. The term "operating assets," as used in the regulations, means assets that are in a state of readi-

\textsuperscript{70} 684 F.2d at 880.
ness to be placed in service within a “reasonable period” following their acquisition.\(^7\)

The time a corporation “begins business” should equate to the time when a corporation begins to carry on a trade or business. Otherwise there would be different dates for deducting section 162 expenses and for amortizing organizational expenses. There is nothing in the legislative history indicating that Congress intended that organizational expenses should have a different start date for deductibility than other expenditures. Moreover, different starting dates would require a taxpayer to make separate determinations of when a business begins for section 162, and for sections 248 and 709.

If we apply the regulations under sections 248 and 709 to the Richmond facts, we obtain a different result. In Richmond, the court equated the training of the employees prior to the receipt of a license as the acquisition or development of an asset, i.e., a trained staff. By applying the rules of sections 248 and 709, an argument can be made that the acquisition of a trained staff is the acquisition of an asset which is necessary to the type of business contemplated and which is in a state of readiness to be placed in service within a reasonable period following its acquisition. Moreover, it is significant that the section 709 regulations were published in 1983, well after the Richmond decision and after the enactment of section 195 in 1980.

Just as significantly, section 183 and the regulations’ examples thereunder, appear to validate the theory of Blitzer that the purpose of the trade or business requirement is to distinguish between personal and for profit activities.

The regulation under section 183 provides guidelines as to whether an activity is engaged in for profit. If an activity is engaged in for profit, it appears that the expenditures incurred in such activity are deductible under section 162 or section 212.\(^3\) Essentially, section 183 equates an activity engaged in for profit with carrying

\[^7\text{Treas. Reg. § 1.709-2(c) (1983) has a requirement that the assets be in a state of readiness to be placed in service within a reasonable time following their acquisition, but Treas. Reg. § 1.248-1(a)(3) (1960) merely requires acquisition of operating assets which are necessary to the type of business contemplated, without any reference to when they would be placed in service. However, since the § 709 regulations were published after § 248 regulations it is reasonable to assume that this additional modification provided by the § 709 regulations applies to § 248 as well.}\]

\[^3\text{Section 183 applies only to individuals. The regulations under § 183 state that no inference is to be drawn from the rules under § 183 as to whether the activity of a corporation is engaged in for profit. Treas. Reg. § 1.183-1 (1972). However, other than the fact that § 183 applies only to individuals, there does not appear to be any substantive reason not to}\]
on a trade or business. The significance of this result to a start-up business is that the guidelines under section 183 do not adopt the Richmond pre-opening doctrine. An activity can be engaged in for profit before it is ready to generate revenue.

The statutory basis for this result is section 183(c) which provides, in effect, that an activity is engaged in for profit if it is one for which deductions are allowed under section 162 or paragraphs (1) or (2) of section 212. In addition, the regulations under section 183 provide that an "activity not engaged in for profit" means an activity other than one for which deductions are allowable under section 162 and section 212 subsections (1) and (2). Thus, the Code and regulations appear to provide two categories of activities: those activities which are not engaged in for profit, which are subject to the limitations of section 183, and those activities which are engaged in for profit and which are deductible under section 162 or section 212. It is not evident that the drafters of section 183 contemplated a third category of expenditure; namely, an activity engaged in for profit but which does not qualify for a deduction under section 162 or section 212. In general, the section 183 regulation provides as follows:

The determination of whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit may be considered unreasonable.

In particular, the regulations provide nine factors to be considered in determining whether an activity is engaged in for profit. These factors are as follows: 1) the manner in which the taxpayer carries on the activity; 2) the expertise of the taxpayer or his advisors; 3) the time and effort expended by the taxpayer in carrying on the activity; 4) the expectation that assets used in the activity may ap-

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use the guidelines under § 183 for determining whether the activities of a corporation are engaged in for profit and, hence, whether such activities are deductible under § 162.

DEDUCTING START-UP EXPENDITURES

precipitate in value; 5) the success of the taxpayer in carrying on other similar or dissimilar activities; 6) the taxpayer's history of income or losses with respect to the activity; 7) the amount of occasional profits, if any, which are earned; 8) the financial status of the taxpayer; and 9) the elements of personal pleasure or recreation. No one factor is to be determinative, and other factors can be considered as well. Further, the determination should not be based simply on whether the number of factors indicating the lack of profit objective exceeds the number of factors indicating a profit objective.

None of these nine factors was considered in Richmond. Had the Richmond court applied them, the taxpayer likely would have been held to be engaged in a trade or business well before it received its FCC license and started broadcasting, as it is clear that the taxpayer in Richmond had a profit motive from the start of activity. The application of these nine factors to a typical high-technology start-up business would also lead to the conclusion that a trade or business exists and that deductions are allowable during the start-up period. This is made clear by the following example provided in the regulations:

C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet metal in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activi-
ties for profit. (emphasis added)\textsuperscript{77}

This example paints a picture similar to the early beginnings of many high-technology start-ups, and yet, it would allow the chemist-entrepreneur to deduct his start-up expenses, including marketing expenses, even though he has not generated any revenue, has very little expectation of generating revenues in the future and is not in position to generate revenue under the standards of \textit{Richmond} and \textit{Madison Gas}. Moreover, the example follows the teaching of \textit{Blitzer}, which found that the only purpose of the trade or business requirement in section 162 is to distinguish between personal and business activities. The example is hard to reconcile with the \textit{Richmond} line of cases, especially in view of the fact that the regulation was published in 1972, well after the \textit{Richmond} decision.

\textbf{D. Geographic Expansion as a Capital Expenditure}

In the case of geographic expansions, the issue is not whether the business has begun but whether the expenditures relating to the expansion are nondeductible capital expenditures. In analyzing expansions, the principal cases have looked to the rule established in \textit{Lincoln Savings}\textsuperscript{78} providing that an expenditure is not a capital expenditure unless it serves to create or enhance a separate and distinct asset. The Second and Fourth Circuit Court of Appeals have reached the conclusion that a geographic expansion does not create a separate and distinct asset. The Fifth Circuit Court of Appeals has held otherwise. In a recent private letter ruling the Internal Revenue Service appears to accept the position of the Second and Fourth Circuits.\textsuperscript{79}

The position of the Second Circuit Court of Appeals expressed in \textit{Briarcliff Candy Corp. v. Commissioner},\textsuperscript{80} in which a candy manufacturer, which owned its retail stores primarily in urban areas, set up a franchise division within the company to promote sales of its products through other retail outlets, such as pharmacies, primarily in suburban areas. The company adopted the franchise alternative after it found that its company-owned suburban stores failed to attract satisfactory business. Though the sales group handling this business was known as the “Franchise Division,” it was part of the sales department of the company. The company treated the costs of developing the network, such as sales calls and advertisements in

\textsuperscript{77} Treas. Reg. § 1.183-2(c), example (6) (1972).
\textsuperscript{78} 403 U.S. 345.
\textsuperscript{79} Letter Rul. 8423005.
\textsuperscript{80} 475 F.2d 775 (2d Cir. 1973).
trade magazines, as deductible business expenses. The Commissioner disallowed these deductions, reasoning that the expenditures were distinct from the operating expenses of the division and were actually capital in nature because they were incurred in obtaining 159 franchise contracts.

Under the franchise contracts, the retail store proprietor agreed to set aside a space in the store for a refrigerating display and storage counter at his own expense, to be exclusively used for the sale of taxpayer's candies. Taxpayer agreed to supply the retailer with its candies at a discount from retail and to assist the proprietor in setting up and operating the sales area. It also agreed not to enfranchise competing stores within a specified area. The contracts remained in operation for terms varying from one to five years and, after the initial term, were to continue unless terminated by either party upon thirty days notice.

The Second Circuit did not think the franchise contracts represented a valuable right, as the contracts did not give the taxpayer any property interest in the area of the retail store devoted to the taxpayer's products; the retailer did not agree to sell a minimum amount of candy, nor did he agree to any minimum amount of sales, and the store owner did not agree not to sell similar candy products of other manufacturers.

The court held that the expenditures would be capital only if they served to create a separate and distinct additional asset, and that the ordinary use of such term included items of ownership of a permanent or fixed nature which are convertible into cash. The court considered the fruits of the contracts as no different from the results a number of good commission-paid salesmen in the same territory would have achieved and such commission would clearly be deductible under section 162. Accordingly, the court held that the taxpayer did not acquire any new separate and distinct asset in the franchise agreements.

The Fourth Circuit Court of Appeals followed Briarcliff in NCB Corp. v. United States,\(^8\) a case involving a bank which was opening numerous branches throughout the state of North Carolina. As part of the expansion process, NCNB Corporation incurred a variety of expenditures, including expenditures for long-range planning studies, feasibility studies regarding a particular location, and applications to the controller of the currency. The bank capitalized all costs connected with building and equipping the new

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\(^8\) 684 F.2d 285 (4th Cir. 1982).
facilities, but deducted as current expenses under section 162 other costs incurred in the expansion process.

The court found the Briarcliff reasoning applicable to the case before it since both involved expansions into a new territory, and the costs NCNB incurred in exploring expansions were similar to the costs incurred in Briarcliff for developing the franchise network. In determining whether the branches were separate and distinct assets within the meaning of Lincoln, the court indicated that the non-convertibility of the branches into cash was a significant but not determinative factor.

The court cited a line of credit card cases as support for the deduction of NCNB's expenditures under section 162. The court found the facts in each of these credit card cases to be similar. The taxpayer banks involved were issuing credit cards either directly or through cooperative organizations. In the process, the banks incurred start-up expenses such as computer costs, computer services, advertising, credit bureau reports, travel and the like. All of these expenses were claimed as ordinary business expenses. In First National Bank of South Carolina v. United States, the Fourth Circuit had allowed such expenditures as deductions even though the taxpayer had incurred its expenses as an assessment by a cooperative association. The Fourth Circuit quoted approvingly from Colorado Springs National Bank v. United States in which the Tenth Circuit Court of Appeals stated:

The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or saleable. They are recurring. At the most they introduced a more efficient method of conducting an old business.

Based upon Briarcliff and the credit card cases, the Fourth Circuit held in NCNB that the expenditures did not create a separate and distinct asset and should not be capitalized. In particular, the court held that the controller's permission did not create a separate and distinct asset because it did not represent an exclusive territorial franchise, was not transferrable, and the branch bank was not readily saleable as such. The court contrasted a branch bank with a television station and found that a branch bank has no value except

82. First Security Bank of Idaho v. Commissioner, 592 F.2d 1050 (9th Cir. 1979); Iowa-Des Moines Nat'l. Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979); First Nat'l. Bank of South Carolina v. United States, 558 F.2d 721 (4th Cir. 1977); Colorado Springs Nat'l. Bank v. United States, 505 F.2d 1185 (10th Cir. 1974).

83. 558 F.2d 721 (4th Cir. 1977).

84. 505 F.2d 1185 (10th Cir. 1974).

85. Id. at 1192.
its tangible and real assets apart from its parent, as compared to the immense value of a television station with a construction permit or license.

A similar approach was taken in Letter Ruling 8423005 in which training costs were incurred in connection with the establishment of twenty-six new restaurants. The taxpayer had similar restaurants operating in other geographical areas under the same trade name. The ruling cited *Briarcliff* and concluded that “no separate asset is created when the company merely expands the identical business to a new geographical location.”

A conflicting position, however, was taken by the Fifth Circuit Court of Appeals in *Central Texas Savings and Loan Ass’n. v. United States*\(^8_6\). That case, like *NCNB*, dealt with a new bank branch requiring approval from state banking regulators. The court relied on *Briarcliff* as did the Fourth Circuit, but distinguished its facts from *Briarcliff*.\(^8_7\)

Following *Briarcliff* we find that Central Texas had a property interest in its branch offices. It had a separate right to do business in a new territory which it acquired by virtue of the permit. It had the right to receive new accounts for new customers in a new market. It gained the right to challenge the right of entry of competitors into the local market. Even an intangible property right, such as the right to do business may be a capital item.\(^8_8\)

Accordingly, the court held that the taxpayer obtained a separate and identifiable business right and the branch offices were separate and distinct assets within the *Lincoln Savings* definition.

If Letter Ruling 8423005 represents the Commissioner’s position in this area, then the conflict may soon be resolved. The legislative history to section 195 indicates that in the case of an existing business, expenditures for expansion are deductible as ordinary and necessary business expenses, and that the determination of whether

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86. 731 F.2d 1181 (5th Cir. 1984).
87. It appears that the court may have misinterpreted a statement by the *Briarcliff* court in distinguishing its own facts from those in *Briarcliff*. The court stated that *Briarcliff* distinguished itself from the creation of new branches and cities and cited the following from *Briarcliff*:

> [T]he changes which Loft made in its own internal organization to spread its sales into a new territory were not comparable to the acquisition of a new additional branch or division to make or sell a new and different product.

475 F.2d at 782.

The court felt this language indicated that *Briarcliff* had distinguished its facts with regard to the opening of a new branch. But it appears the *Briarcliff* court was only distinguishing its situation from the establishment of a branch to sell a new or different product.

88. 731 F.2d at 1185.
there is an expansion or the start-up of a new trade or business is to be based on the facts and circumstances of each case.\textsuperscript{89} The Commissioner could resolve the judicial conflict by issuing regulations defining the establishment of an additional geographical branch as merely the expansion of an existing trade or business.

E. Doing Business Through Separate Entities

For a variety of legal and business reasons, corporations and individuals often decide to do business through legal entities. A chain of retail stores may decide to incorporate each of its stores as a separate company. An individual entrepreneur may decide to incorporate a business or perhaps form a partnership with some other individuals. Two or more companies may get together to form a joint venture in the form of a corporation or a partnership. In determining whether expenses incurred are start-up expenses or ongoing trade or business expenses, the prevailing rule is that each separate entity is to be considered on its own. This rule can produce some anomalous results. For example, if a retail chain expands by opening a store in a new territory, then the start-up costs would be deductible if the new store is not incorporated, but non-deductible if the store is incorporated as a subsidiary.

A similar result occurs with partnerships. Courts have held that partnerships are separate legal entities for purposes of determining if the requirement of carrying on of a trade or business is met under section 162. This is troublesome since the definition of a partnership under section 7701(a)(2)\textsuperscript{90} is very broad. Thus, any time two individuals get together to develop something for profit there may be a partnership for tax purposes even if the individuals have not formalized their relationship with a partnership agreement. Deductible section 162 expenses can be converted into non-deductible start-up expenditures if a relationship between

\textsuperscript{89} H.R. 96-1278, 96th Cong., 2d Sess. 10, 11 (1980) [hereinafter cited as 1980 House Report]. It is often difficult to distinguish between an expansion and the start of a new business. See Malmstedt v. Commissioner, 578 F.2d 520 (4th Cir. 1978) (entry of residential real estate developer into commercial real estate was an expansion and not entry into a new business); York v. Commissioner, 261 F.2d 421 (4th Cir. 1968) (entry of commercial and residential developer into industrial development was an expansion); and Cleveland Elec. Illuminating Co. v. United States, 85 U.S.T.C. § 9128 (Ct. Cl. 1985) (electric utility operating fossil fuel plant entered new business by operating nuclear powered plant).

\textsuperscript{90} I.R.C. § 7701(a)(2) (1982) provides in pertinent part:

The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation.
individuals or companies is considered to be a partnership. For example, if two individual inventors who are both in the trade or business of inventing get together to invent a product, their relationship may be considered a partnership which is not carrying on a trade or business because there is no history of inventing. Thus, the otherwise deductible section 162 type expenditures of the partnership may be treated as non-deductible start-up expenditures until a product is developed and sold. This result may occur even if the arrangement is not a partnership under legal concepts but is a partnership under tax concepts. In such a case, the tax partnership is considered a separate entity even if the partners are able to elect out of partnership taxation treatment under the special rule of section 761(a).

The leading case involving the treatment of partnerships as separate entities for the purpose of determining whether a trade or business has commenced is Madison Gas and Electric Co. v. Commissioner.91 In that case, MGE, a Wisconsin utility company, had been selling gas and electricity since 1896. The power needs in MGE's area were increasing and MGE decided to expand its capacity by building a nuclear power plant in conjunction with two other utilities. On February 2, 1967, MGE and two other utilities entered into an agreement entitled, "Joint Power Supply Agreement," which called for the construction and ownership of a nuclear generating plant. The utilities were tenants in common, and were considered so by government regulating authorities. MGE owned a 17.8% undivided interest in the project. For tax purposes, the utilities elected out of partnership taxation treatment under subchapter K by making an election-out under section 761(a).92 Electricity produced by the plant was to be distributed to each utility in proportion to its ownership interest, and each utility was to use or sell its portion of the power produced. Maintenance expenses were to be paid in proportion to each utility's ownership interest.

91. 633 F.2d 512 (7th Cir. 1980), aff'd 72 T.C. 521 (1979).
92. I.R.C. § 761(a) (1982) provides in pertinent part as follows:

Under regulations the Secretary may, at the election of all members of an unincorporated association, exclude such organization from the application of all or part of this subchapter, if it is availed of—

(1) for investment purposes only and not for active conduct of a business,
(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or
(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.
In 1969 and 1970, MGE incurred expenses relating to the nuclear training of employees, the establishment of internal procedures and guidelines for plant operation, maintenance, environmental activities, hiring, nuclear field management, and the purchase of spare parts. Commercial operation of the plant began after 1970.

The Seventh Circuit Court of Appeals found that the threshold issue was whether MGE's arrangement with the other utilities constituted a tax partnership. The Commissioner had conceded that if the relationship was not a tax partnership, the expenses would be deductible under section 162(a). MGE argued that a partnership did not exist because there was no anticipated earning and sharing of joint cash profits. The court disagreed, finding that all that was required was a profit motive, which was satisfied here by the distribution of electricity for sale at a profit.93

MGE contended that even if a partnership existed it should be ignored because it lacked economic substance. The court replied as follows:

Here MGE, WPS and WPL are engaged in the joint production of electricity for resale, a joint venture for profit. Because they were each already in the business of selling electricity, it can, of course, be argued that the partnership venture itself is an extension or expansion of their existing businesses. It does not follow from this though that we should ignore the partnership as lacking economic substance. Such reasoning would lead to the absurd conclusion that any partnership established to do collectively what its participants formerly did individually or continue to do individually outside the partnership lacks economic substance and should not be treated as a partnership for tax purposes.94

Madison Gas was followed in United States v Manor Care, Inc.95, which involved separate corporations established to own two new homes in a nursing home chain. The court refused to ignore the substance of these corporations with regard to the deductibility of start-up expenses. The court rejected the taxpayers' argument that the purpose of the consolidated return rules is to facilitate the computation of the "business unit" in question, and that in keeping with this goal the court should allow affiliated corporations to compute their income as one business unit. The court found no author-

93. See also Bentex Oil Corp. v. Commissioner, 20 T.C. 565 (1953).
94. 633 F.2d at 517.
ity for creating a new exception to the general rules whenever an affiliated group can show it operates as one business unit.

A similar result was obtained in Letter Ruling 8423005 where, out of twenty-six new restaurants using the same name as the taxpayer, two were incorporated for valid business reasons. The Internal Revenue Service allowed section 162 deductions for the pre-opening expenditures of the unincorporated restaurants, but ruled that the expenses of the incorporated restaurants were not deductible until the restaurants opened for business.96

Treating legal entities separately for determining start-up expenses appears to be a sound tax doctrine, but it is clearly a trap for the unwary entrepreneur. Thus, businesspersons involved in an ongoing business should scrutinize their business relationships to ensure they are not inadvertently creating a partnership which would result in the disallowance of otherwise deductible expenses.

F. Research and Experimental Expenditures Incurred in Connection with a Trade or Business

Congress has given favored treatment to research and experimental start-up expenditures by allowing taxpayers to currently expense research costs. Section 174, added by the 1954 Code, provides that a taxpayer may elect to expense research and experimental expenditures incurred in connection with a trade or business, or amortize them over a period of not less than sixty months.97 Prior to section 174, no specific treatment was provided for research expenditures and they were often capitalized and amortized over the useful life of the asset created. If there was no determinable useful life, however, a taxpayer could deduct his costs only if a project was abandoned or sold. Where projects were not abandoned or sold, taxpayers had no means of obtaining a tax benefit for research costs.

The regulations under section 174 define "research and experimental" very broadly:

96. See also Bennet Paper Corp. v. Commissioner, 78 T.C. 458 (1982), aff'd, 699 F.2d 450 (8th Cir. 1983).

97. Subsections (a)(1) and (2) of section 174 allow expense treatment to be adopted without the Service's consent for the taxpayer's first taxable year in which research expenditures are paid or incurred. Section 174(b) allows a taxpayer to elect to amortize research expenditures over a period of not less than 60 months as selected by the taxpayer. The amortization period begins with the month in which the taxpayer first realizes benefits from such expenditures. Treas. Reg. § 1.174(a)(3) (1960) provides that, in the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula or invention or similar property to which the expenditures relate to an income producing use.
The term "research or experimental expenditures", as used in section 174 means expenditures incurred in connection with the taxpayer's trade or business which represent costs in the experimental or laboratory sense. The term includes generally all such costs incident to the development of an experimental or pilot model, a plant process, a product, a formula, an invention, or similar property, and the improvement of already existing property of the type mentioned. The term does not include expenditures such as those for the ordinary testing or inspection of materials or products for quality control or those for efficiency surveys, management studies, consumer surveys, advertising, or promotions. However, the term includes the cost of obtaining a patent, such as attorney’s fees expended in making and perfecting a patent application.98

Under these regulations, most forms of new product development by high-technology companies would qualify as research and experimental expenditures, and there has not been much controversy in the courts as to what constitutes a research expenditure and what does not.99

The real controversy in this area has concerned start-ups and whether or not research expenditures have been made "in connection with a trade or business.” Until Snow v. Commissioner,100 the courts and the IRS interpreted “in connection with his trade or business” to have the same meaning as “carrying on any trade or business.” Thus, start-up companies were denied deductions until they became ongoing concerns.

In Snow, the taxpayer was a four percent limited partner in Burns, a partnership formed in 1966 to develop a special purpose incinerator for consumer and industrial markets. The inventor of the incinerator, Trott, was the general partner. Trott had conceived

98. Treas. Reg. § 1.174-2 (1960). With regard to computer software development, Rev. Proc. 69-21, 1969-2 C.B. 303 states that the costs of developing software so closely resemble the kind of research and experimental expenditures that fall within the purview of § 174 as to warrant similar treatment.

99. In one of the few cases to find an absence of a qualifying activity, Mayrath v. Commissioner, 41 T.C. 582 (1964), the tax court held that the expenditures in connection with building an “experimental” house in which the taxpayer resided were not research and experimental expenditures within the meaning of the statute. The court found deductions should be limited to those expenditures of an investigative nature involved in developing the concept of a model or product, and doubted that the taxpayer's actual construction expenditures for a "model" residence met the statutory requirements. Moreover, the court concluded that application of the benefits of § 174 to a situation where a taxpayer seeks to deduct a portion of the cost of an "experimental" house in which he and his family resided would plainly violate the spirit and intent of the statute and produce an absurd result.

100. 416 U.S. 500.
his idea in 1964 and had made a number of prototypes between 1964 and 1966. His patent counsel had advised him in 1965 that several features of the burner were patentable, but in 1966 advised him the invention was not sufficiently reduced to practice to develop it into a marketable product. Thereafter, Trott formed Burns, putting up part of the capital. Various models were then built and tested. During 1966, Burns reported no sales of the incinerator or of any other product but expectations were high. Trott was devoting about one-third of his time to the project and was giving shop work to an outside engineering firm. Trott obtained a patent on the incinerator in 1970 and subsequently marketed it as a product.

The court found that section 174 was enacted to dilute the concept of “ordinary and necessary” as used in section 162, and that by adding “in connection with” into section 174, Congress intended to make section 174 broader than section 162. In addition, the court concluded that legislative history made it clear that Congress intended to encourage small and pioneering firms to invest in developing new products and inventions, and to put these firms on an equal footing with well-established competitors who have ongoing research programs.101 In holding that the taxpayer’s 1966 expenditures were deductible under section 174, the court stated:

Congress may at times in its wisdom discriminate tax-wise between various kinds of businesses, between old and oncoming businesses and the like. But we would defeat the congressional purpose somewhat to equalize the tax benefits of the ongoing companies and those that are upcoming and about to reach the market by perpetuating the discrimination created below and urged upon us here.102

While Snow indicates that section 174 adopts a more liberal approach toward start-up companies, it is not clear just how far this interpretation can be carried. Certain questions arise from the facts of Snow itself. Snow involved a taxpayer who apparently had developed prototypes prior to the tax year in question. Should Trott’s activities be considered “in connection with a trade or business” in 1964 when he conceived of the idea, or in 1965 when he was building the prototypes and was told that his product had patentable features?

The answer to these questions can best be determined by considering the basis upon which the court reached its decision. The court based its decision on congressional intent to equalize the tax

101. Id. at 503-04.
102. Id.
treatment between existing firms and small or pioneering firms. On this basis, there appears to be no reason to distinguish between various categories of small and pioneering firms. That is, a pioneering firm in the process of developing a prototype should be accorded the same treatment as a pioneering firm that has developed a patentable feature, which should be accorded the same treatment as a pioneering firm that is readying models for market.

Using this approach, section 174 should exclude research activities only where there is no profit motive or where the expectation of success is so remote that one cannot reasonably connect the activity with a profit motive. It is only in these cases that it can be said that the research activities are not reasonably connected with a trade or business. For example, in Maxwell v. Commissioner,\(^{103}\) the taxpayer had inherited money and decided to pursue research in marine biology. The taxpayer successfully spawned three different marine species, but it was impossible to patent the techniques, and development into a commercial activity was not foreseeable. The tax court disallowed the taxpayer's research expenses because he could not establish that the research was undertaken to generate profit.

A potentially troublesome case concerning the trade or business requirement is Green v. Commissioner,\(^{104}\) where the tax court held that a partnership that purchased four unpatented inventions and simultaneously resold them for a royalty based upon the future sales of the developed products could not deduct payments made to the transferee as research and development expenses. The tax court held that the payments by the partnership were not in connection with a trade or business, stating that the taxpayer must engage in a trade or business \textit{at some time},\(^{105}\) and that the partnership's activities consisted more of management of investments than of a trade or business. The court concluded that section 174 was enacted to encourage small businesses to engage in research activities, not to create tax deductions for passive investors.\(^{106}\)

While Green directly impacts research and development lim-

103. 44 T.C.M. (CCH) 504 (1982).
105. \textit{Id.} at 686 (emphasis in original).
106. The court stated:

\begin{quote}
An examination of LaSala's limited activity reveals that it functioned only as a vehicle for injecting risk capital into the development and commercialization of the four inventions. Its activities never surpassed those of an investor. It was not the up-and-coming \textit{business} which section 174 is intended to promote.
\end{quote}

\textit{Id.} at 687.
ited partnerships and their investors, it also significantly affects start-ups which often depend upon venture capital money that is raised through such partnerships. It is unclear exactly how far the Green decision will be carried by future courts, but it is very possible that it will turn out to be a case of limited scope as a result of its unique facts. Most research and development partnerships differ from Green in at least two respects: 1) the partnership owns or holds a license for the technology while it is under development, and 2) it is possible at some time after the invention is reduced to a marketable product that the partnership may find itself in the position of having to market it. In Green there was no opportunity for the partnership to become involved in the marketing of the products resulting from the invention since the undeveloped inventions were sold immediately upon their purchase by the partnership. 107

Taxpayers recently received a scare when, in a recent Technical Advice Memorandum, Letter Ruling 8409009,108 the Commissioner applied the tax benefit rule to the sale of patents and know-how, and required a taxpayer to include as ordinary income the amount of deduction taken under section 174(a)(1) attributable to the development of the patents and know-how, to the extent such deductions resulted in a tax benefit. Any remaining proceeds were to be treated as gains from the sale of a capital asset.

However, the Commissioner has since held in Revenue Ruling 85-186 that the tax benefit rule does not apply research and experimental expenditures.109

III. SECTION 195

Section 195 was enacted as part of the Miscellaneous Revenue Act of 1980110 to provide an incentive for the formation of new businesses. Congress was of a mind that the Richmond rule reflected the state of the law under section 162 and that some relief was needed. Rather than change the Richmond rule, however, and allow current deductions to start-up businesses, Congress provided in section 195 that the type of expense disallowed under Richmond could be amortized over a period selected by the taxpayer, but not

107. See Field, Restrictions on R & D Deductions Imposed by Recent Green Decision may be Avoided, 62 J. TAX'N. 322 (1985).
108. Letter Rul. 8409009 was proposed by a General Counsel Memorandum G.C.M. 39162.
less than sixty months. The amortization period begins when the taxpayer begins business.

Subsequent to the enactment of section 195, the tax court held in Hoopengarner v. Commissioner\(^{111}\) that certain lease payments made prior to the start of revenue generation were deductible under section 212, and the court of claims in Blitzer held, contrary to Richmond, that certain recurrent expenditures made prior to revenue generation could qualify under section 162. Congress responded in the Tax Reform Act of 1984 by amending section 195 to provide: 1) no start-up expenditures are deductible except as provided by section 195,\(^{112}\) 2) the amortization period is to begin when an active trade or business begins, rather than when “business begins,”\(^{113}\) 3) the Commissioner is to issue regulations as to when an active trade or business begins,\(^{114}\) and 4) expenditures incurred for the production of income in anticipation of beginning an active trade or business are to be treated as start-up expenses.\(^{115}\) The 1984 General Explanation indicates that Congress intended to overrule Blitzer\(^{116}\), but that intention is not stated in any other prior committee report and is not clear from the amendments made to section 195.

Moreover, the 1984 General Explanation also indicates that Congress did not intend to change the definition of start-up expenditures.\(^{117}\) Taken literally, this would mean that while Congress intended to overrule the Blitzer case, it did not intend to change existing law. This apparent inconsistency can best be explained or rationalized by a closer analysis of section 195.

A. Nondeductibility of Start-Up Expenditures

Section 195(a) provides as follows:

(a) Capitalization of Expenditures — Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

If an item is classified as a start-up expenditure under section 195, section 195(a) would prevent current deductibility and a tax-


\(^{116}\) General Explanation of the 1984 Act, supra note 4 at 296.

\(^{117}\) Id.
payer could only obtain a tax benefit through amortization as provided in section 195(b). According to the legislative history, one of the reasons for this provision is that Congress believed that start-up expenditures generally result in the creation of an asset which extends substantially beyond the year incurred, and that such expenditures should not be fully deductible when paid or incurred but rather should be deducted over a longer term. Consequently, because of the confusion under existing law as to the treatment of start-up expenses, Congress intended to disallow deductions for all start-up expenses (except those specifically excluded under section 195(c)(1)).

Thus, the basis for nondeductibility under section 195(a) rests on a legislative determination that start-up costs are capital in nature, and not solely on the grounds that pre-opening expenses do not meet the carrying on of a trade or business requirement of section 162. Consequently, Congress has adopted a rule, similar to that found in Idaho Power, for new businesses: All expenses incurred in building a new business must be capitalized even if the useful life of any particular expenditure taken by itself would not constitute a capital expenditure, e.g., an expenditure for monthly utilities.

B. Start-Up Expenditures Defined

Another critical issue under section 195 is the definition of a start-up expenditure. Section 195(c)(1) defines start-up expenditures as follows:

Start-Up Expenditures.—The term "start-up expenditure" means any amount—

. (A) paid or incurred in connection with —

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the pro-

118. S. Print No. 169, 98th Cong., 2d Sess. 282-83 (1984) [hereinafter cited as the 1984 Senate Print].

119. In review of the fact that a business is made up of a conglomerate of various assets (for example, trained staff, know-how, trademarks, going concern value) may a taxpayer in the start-up phase of a business take a § 165 loss deduction for assets abandoned during the start-up process? For example, if a start-up fires its sales staff prior to making its first sale because it has decided to use distributors, can it deduct the costs of developing such staff § 165? The availability of such deduction is unlikely as § 195(a) disallows any start-up deductions, even those under § 165. This conclusion is reinforced by § 195(b)(2) which provides that a § 165 deduction for unamortized start-up costs can be taken before the close of the amortization period only if the business is completely disposed of.
duction of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term “start-up expenditure” does not include any amount with respect to which a deduction is allowable under sections 163(a), 164, or 174.

In substance “start-up expenditures” must meet two requirements: 1) they must be paid or incurred in connection with creating or acquiring a trade or business, and 2) they must be the type of expenditures which would be deductible to an existing business. Expenditures which would be capital expenditures for an existing business would not be start-up expenditures. Such “non-start-up” expenditures would apparently be charged to the asset created, and, if a determinable useful life exists, would be eligible for amortization or depreciation at the time business begins and such assets are placed in service. If such assets are abandoned prior to the start of an active trade or business, a loss deduction would apparently be available under section 165.

The statute does not define the period during which an expenditure must be incurred to qualify as a start-up expenditure. According to the legislative history, however, start-up expenditures are costs incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation. Moreover, the 1980 House Report provides the following instruction:

Under the provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc. Eligible expenditures also include start-up costs which are incurred subsequent to a decision to establish a particular business and

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120. The Tax Reform Act of 1984 amended the prior version of § 195 to substitute the word “operation” for the word “expansion.” Thus, under the prior version of § 195, an expenditure was a start-up expenditure only if it would be deductible in connection with the expansion of an existing trade or business. The General Explanation of the 1984 Act states that now: “Under the Act, start-up costs include such expenses if paid or incurred in connection with the operation as well as the expansion of an existing trade or business.” General Explanation of the 1984 Act, supra note 4 at 296-97.

prior to the time when the business begins. For example, start-up costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred in lining up potential distributors, suppliers, or fees paid or incurred for executives, consultants, and for similar professional services.\textsuperscript{122}

Thus, general investigative expenses incurred prior to choosing a particular business would not be deductible, and would be subject to the existing rules discussed in Part III. B. above. Moreover, if a taxpayer makes investigations of multiple businesses before choosing a particular one, these expenditures would not qualify as start-up expenditures. Such investigatory expenditures are ultimately deductible only if they can be added to the basis of a business which is entered into and such business is subsequently abandoned or sold.\textsuperscript{123}

Expenditures for research, interest and taxes are specifically excluded from the definition of start-up expenditures and are deductible in accordance with sections 174, 163 and 164.

C. The Hoopengarner Amendment

In \textit{Hoopengarner v. Commissioner},\textsuperscript{124} a taxpayer held a leasehold on undeveloped land and paid rent on the leasehold prior to constructing and leasing an office building. The tax court found that the taxpayer was not engaged in a trade or business under section 162 prior to leasing the building but that the rent paid on the leasehold was deductible under section 212. The court held that under section 212, a taxpayer does not have to meet the trade or business requirement, but only the express requirements of section 212, namely: 1) ownership of a possessory interest; 2) the interest must be held for the production of income, and 3) the expenditures must not be capital in nature. The court concluded that the second requirement was met even though the property did not generate any current income because section 212 does not require current returns. The third requirement was deemed met because the taxpayer's rent payments did not create a benefit that extended beyond the taxable year.

This decision was seen as an inappropriate means of circumventing the \textit{Richmond} rule, and was quickly dealt with by Congress in the Tax Reform Act of 1984. Section 195(c)(1)(A)(iii) includes

\textsuperscript{122} Id.
\textsuperscript{123} See \textit{supra} Part III. B.
\textsuperscript{124} See \textit{supra} note 115.
as a start-up expenditure any expenditure incurred in an activity for profit and for the production of income before and in anticipation of the activity becoming an active trade or business. Consequently, the type of expenses incurred in *Hoopengarner* are now non-deductible under section 212 and are subject to amortization under section 195(b).

**D. The Active Trade or Business Requirement**

If expenditures relate to creating a trade or business, the business must be an active trade or business within the meaning of section 162 in order for the expenditures to qualify as start-up expenditures. Expenditures attributable to investment activities do not qualify. In the case of rental activities, there must be a significant furnishing of services incident to the rentals to constitute an active trade or business rather than an investment. However, the 1984 Senate Report states that the definition of active trade or business may include a trade or business that is in many respects passive. For example, a business where property is regularly leased on a net lease basis may be considered an active trade or business.

**E. Acquisition of an Active Trade or Business**

Investigatory expenditures incurred with respect to the acquisition of a trade or business will be considered start-up expenditures under section 195(c)(1) only if the taxpayer has an equity interest and participates in the management of the trade or business. A taxpayer will not be considered to have a qualifying interest with respect to bond investments or other debt instruments (even if convertible), preferred stock, or a limited partnership interest. A sole proprietor will always be considered to have an operator equity interest in the trade or business. The acquisition of common stock will generally be considered as the acquisition of an investment interest. However, if the transaction in substance is the acquisition of the assets of a trade or business, e.g., through a liquidation, then the investigatory expenses are eligible for amortization.
tion, a corporate taxpayer will be considered to have acquired the trade or business assets of an acquired corporation if the acquired corporation becomes a member of an affiliated group which includes the taxpayer and a consolidated return is filed for such group. In the case of a general partnership interest, the taxpayer will be considered to have acquired an interest if the taxpayer actively participates in the management of the trade or business.

F. Election to Amortize

Section 195(b)(1) provides that start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses to be allowed as a deduction prorated equally over a period of not less than sixty months as may be selected by the taxpayer. The amortization period begins with the month the active trade or business begins. Since the minimum amortization period is sixty months, the legislative history indicates that the election is inapplicable to businesses which have an ascertainable useful life of less than sixty months. Expenditures relating to such businesses remain subject to existing law. In the case of an amount subject to amortization but which is unamortized upon the termination of the trade or business, a taxpayer may deduct any unamortized amount as a loss under section 162, or an unamortized amount might be carried over to the taxpayer's successor in interest.

Elections may not be made later than the time for filing the return (including extensions) for the taxable year in which the trade or business begins. Elections may not be made conditional, and once an amortization period is selected, it may not be changed. To make the election, the taxpayer must attach a statement to the return for the tax year in which the amortization period begins. The statement must include the description and amount of the expenditures involved, the date the expenditures were incurred, the month in which the taxpayer began or acquired the business, and the number of months of the amortization period.

Elections under section 195(b)(1) will cause trying decisions

131. Id. Compare the treatment of a separate corporation in the context of attributing the activities of an affiliated corporation to the start-up corporation for the purposes of determining whether the start-up corporation is incurring start-up expenditures. See Part III. E., supra.
133. Id. at 13.
for taxpayers. If a taxpayer misjudges when the business begins, the taxpayer may file the election in the wrong year and fail to make a proper election. In addition, section 195 may produce a situation where the Commissioner and the taxpayer reverse roles: the Commissioner may claim a business began prior to the year stated by the taxpayer on his election statement in order to invalidate the election. The election requirements put a premium on good record keeping. If the taxpayer misses any start-up expenditures in his election statement, he may not be able to amortize them if they are subsequently discovered. A similar position is taken by the Commissioner with regard to trademark and trade name expenses amortized under section 177.  

G. When Does an Active Trade or Business Begin?

Section 195(c)(2) provides that the determination of when an active trade or business begins shall be made in accordance with the regulations prescribed by the Commissioner. An acquired active trade or business shall be treated as beginning when the taxpayer acquires it. As of the date of this writing, the Commissioner has not issued any regulations under section 195.

The date on which an active trade or business begins is clearly the most important issue for a start-up. That date determines whether an expenditure is a start-up expenditure or whether it is not. Expenditures incurred after an active trade or business begins are subject to the general rules of the Code. In addition, the period for amortizing start-up expenditures begins at the time an active trade or business begins. The statute itself gives no help in providing a demarcation line, as it delegates this job to the Commissioner and, without the help of the regulations, one must look at the legislative history and existing precedent to determine what the rule should be.

The legislative history of the 1984 amendments fails to cite any judicial authority or statutory language as to when an active trade or business begins. The 1984 Senate Report states: "An active trade or business means the taxpayer is actively conducting a trade or business."  

This circular definition is of little aid in determining when an active trade or business begins.

The term "active" when used in connection with a trade or commerce would be some other date. It is correct to say that section 195 has stirred the pot rather than supporting a particular administrative position. 

138. See General Explanation of the 1984 Act, supra note 4 at 296.
business is generally used to distinguish a passive from an active business. The 1984 Senate Report provides:

Active trade or business means that the taxpayer is actively conducting a trade or business. This definition of active trade or business may include a trade or business that is in many respects passive. For example, a business where property is regularly based (sic) on a net lease basis is an active trade or business for this purpose.\(^{139}\)

This statement can be read several ways, but it appears most consistent as describing the type of business, i.e., passive versus active, rather than the level of activity a business must reach before it passes from the start-up phase.

The only judicial references in the legislative history are to *Hoopengarner*, *Blitzer*, and *Brotherman*,\(^{140}\) cases which are cited in the 1984 General Explanation:

Under the Act, the definition of start-up expenditures is generally the same as under prior law. However the Act modified the definition in two respects. First, the definition of start-up expenditures is broadened to include any expenditures made with respect to any activity engaged in for profit or for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business. For example, Congress intended that the rent expenses permitted as a deduction in the *Hoopengarner* case will be subject to this provision. Likewise, Congress intended that the expenses that were permitted as deductions in cases such as *Blitzer* . . . and *Brotherman* . . . would be subject to this provision.\(^{141}\)

Both *Hoopengarner* and *Blitzer* arose from real estate construction projects, but *Hoopengarner* involved section 212 which does not have a trade or business requirement. Thus, *Hoopengarner* would appear to be of no value in determining when Congress intended a trade or business to begin. The *Blitzer* court found that the taxpayer was engaged in a trade or business prior to finishing construction of its project but disallowed any deductions for lack of proof. In *Brotherman*, the taxpayer owned an unlicensed cable system and was awaiting approval from the FCC to begin operations. Based on *Blitzer*, the court of claims allowed expenses incurred prior to the approval of the FCC license, and specifically did not follow *Richmond*.

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139. Id.
140. 54 A.F.T.R. 2d (P-H) § 84-5394 (Ct. Cl. 1984).
It would appear from its references to *Blitzer* and *Brotherman* that Congress meant to reject the possibility of obtaining a deduction prior to a business being ready to generate revenue. But whereas there is express statutory language to deal with the *Hoopengarner* situation under section 195(c)(1)(A)(iii), no statutory language specifically overrules *Blitzer*. The only statutory reference to *Blitzer* is in the 1984 General Explanation.\(^{142}\) There is no reference to *Blitzer* in either the Senate Finance or Conference Committee reports.

Nonetheless, a change in language between the prior version of section 195 and the amended version of section 195 may support the overruling of *Blitzer*. Under the prior version, amortization began when the "business begins," whereas under the amended version amortization begins when the "active" trade or business begins." However, as previously mentioned, the word "active" appears only to differentiate between an active and a passive business and does not refer to the time a business begins, or to the stage of development of a business.

Prior to the 1984 amendments, section 195 amortization began at the time the "business begins" and the House Report stated that it was anticipated that rules would be formulated that would be similar to the rules under sections 248 and 709.\(^{143}\) Under these rules a business is considered to "begin business" when activities have advanced to the stage necessary to establish the nature of its business operations.\(^{144}\)

The legislative history of the 1984 amendments state that there was no intention to change the definition of start-up expenses. As there is no language (other than the *Hoopengarner* amendment) that would indicate a change in prior law, and since the reports of the two legislative committees involved in the process of amending section 195 did not mention *Blitzer*, consideration has to be given to whether the reference to *Blitzer* in the 1984 General Explanation has any validity. The paragraph (as quoted above) begins by stating that the definition of start-up expenses is to be the same as under prior law, and that it is to be broadened to include the *Hoopengarner* case (support for which exists in express statutory language). The statement then concludes that, "likewise," Congress intends *Blitzer* and *Brotherman* to be overruled. These statements concerning *Blitzer* and *Brotherman* appear to be afterthoughts on

\(^{142}\) *Id.*


\(^{144}\) See *supra* Part III. C.
the part of the writers of the 1984 General Explanation and are not representative of legislative intent. The Commissioner must now decide where to draw the line.

V. CONCLUSION

In his book "The Road to Colossus," Thomas Kiernan describes the career of Samuel Morse, who started out as a portrait painter and eventually invented the telegraph and the Morse Code. Morse was an American residing in England in 1831 when Michael Faraday discovered that an electric current could be produced in metal by changing the metal’s magnetic intensity. Morse wrote to Benjamin Silliman, a scientist at Yale, of the discovery, commenting, "Wouldn't it be a thing of marvel if Mr. Faraday's current could be employed to send these words to you through magnetized wire, in some form of electrical impulses, so that it might reach you more quickly than I daresay they will? Farfetched, no doubt."

Silliman wrote back to Morse that his idea was not farfetched and, thereafter, on his trip back to America in 1832, Morse developed the famous Morse Code. Back in the United States, he began to work on the idea by acquainting himself with the leading scientists in the field of electricity and by learning as much as he could about electricity. He met with Joseph Henry, of Renssalaer, in Troy, New York in 1833 who told him that the idea was practical and gave him valuable information as to how to build a transmitting device.

Morse returned to New York City, gave up portrait painting and took a job teaching art at the University of the City of New York, primarily so that he could use the university’s laboratory. With the help of a science teacher, Morse built a device that was able to transmit pulsations over a short length of wire. However, after consultation with Henry, Morse learned how to increase the length of transmission with the use of relays. Then, in 1835, Morse began construction of a receiving device which would convert the electrical impulses into mechanical signals. In 1836, he developed a receiving device that produced the famous clicking of the telegraph.

145. In considering the effect of the General Explanation of the 1984 Act, the Service should keep in mind the regulations under section 6661 which deals with penalties for substantial understatement of tax liability. Specifically, Treasury Regulation section 1.6661-3(b)(2) (1985), states that descriptions of statutes prepared after the enactment of a statute (such as General Explanations) are not authority for purposes of determining whether a taxpayer has substantial authority for taking a particular position on his tax return.

The device was first publicly demonstrated in 1839, but was met by a lack of enthusiasm and no offers of financial backing resulted. At this time, Morse was both terribly discouraged and poor, and did not bother to apply for a patent. Nevertheless, he continued to work on improvements to his telegraph. Morse was repeatedly rejected in his attempts to obtain financing, however, and it was not until 1843 that he managed to obtain $30,000 from Congress for a long-distance test of his device. In 1844, a wire was placed between Washington and Baltimore, and Morse proved that his invention worked. But it was not until 1855 that AT&T was formed to operate lines in the East, and not until 1856 that Western Union was formed to operate lines in the West.

Thus, it took Samuel Morse more than thirteen years from the time he developed his initial concept until the time he was able to show the world that it worked, and it was not until some time afterward that he began to profit from his years of devotion and work.

The story of Samuel Morse is important because it reflects the way things happen in the United States. A person develops an idea, becomes obsessed with bringing it to fruition, and the public benefits when that person succeeds. The repetition of this story throughout history has made America as great as it is today.

In this context, when one looks at the tax policy that has developed over the past twenty years, one wonders whether the proponents of this policy desire to continue to foster the development of new ideas and products. If the Commissioner adopts the Richmond rule in the regulations under section 195, then people like Samuel Morse, and the investors behind them, would not obtain section 162 deductions until the product is completed, demonstrated, and out in the world generating revenue. Moreover, in order to amortize their pre-opening expenses, they would have to be sure to meet IRS record keeping requirements. Morse would have been required to keep records of all of his expenses, beginning in 1831 and continuing for a period of thirteen years. Samuel Morse's project almost died because he could not obtain private financing. Only when the federal government gave him a subsidy could he continue. We should not make it harder for our entrepreneurs; their task is difficult enough, and only few succeed. The failure to obtain current deductions for operating expenses can mean the difference between obtaining financing and not obtaining financing: the difference between success and failure.

Therefore, what should the Commissioner do when preparing the regulations under section 195 and determining when an active
trade or business begins? The Commissioner should take a look at existing regulations under section 183, which treat a serious investor as being engaged in a trade or business, and should adopt such an approach for section 195. There is nothing in the legislative history which would prevent the Commissioner from adopting this view. The section 183 regulations were in existence when the amendments to section 195 were enacted by the Tax Reform Act of 1984, and such regulations were not overruled.

For reasons previously discussed in this article, the reference to the decision in Blitzer and Brotherman in the 1984 General Explanation to section 195 should not affect the Commissioner's treatment of high-technology start-ups. Using the section 183 regulations and the regulations under sections 248 and 709, the Commissioner can fulfill the congressional mandate under section 195 for high-technology by providing that an active trade or business begins where: 1) the taxpayer has engaged in research that would qualify as research as defined under section 174; 2) the taxpayer is seriously carrying on such research as indicated by the expenditure of significant sums of money or a significant amount of time; and 3) there is a reasonable expectation that the idea, once developed into a product, would represent a saleable product that would lead to a profit making business.

The Commissioner should adopt a liberal attitude towards high-technology start-ups. Failure to adopt such a policy can only lead to a decline in the development of high-technology industry in the United States.