Taxation: Start-up Cost Treatment Under § 195: Tax Disparity in Disguise

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probability of taxpayer success under this test is inversely proportionate to the amount of perceived abuse existing in the transaction. Because the nature of partnership activities is diverse, and therefore the determination of abuse so varied, the outcome of the "substantially all" test will probably depend upon the particular facts and circumstances of each case presented to the court.

Another unresolved issue arises in the event the court finds that less than substantially all of the assets would qualify for section 1031 treatment. The consistent position of the court appears to be that, instead of recognizing gain on the nonqualifying assets individually, the entire transaction would be precluded from nonrecognition treatment. This position follows the court's entity approach, avoiding the numerous administrative problems that would ensue if an alternative approach were adopted.

Long is illustrative of the court's convictions in this area. That case reaffirmed the court's "substance over form" test and illustrated that the manipulation of partnership liabilities in order to avoid gain recognition under section 1031(d) will not be tolerated. In computing the amount of gain recognized under section 1031, the court will again use the entity approach and determine the amount of net liabilities relieved at the partnership level. Although there are numerous unaddressed technical questions at both tiers of the court's analysis, the court has steadfastly used this approach. Accordingly, it is indicative of the court's future resolutions of problem areas in the exchange of partnership interests.

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Incentives for investment in new business have traditionally been derived from sources other than the tax law. In no area is disincentive more clearly evident than in the tax treatment of investigatory expenses and start-up costs. The "trade or business" requirement of section 162 is the device used to deny tax parity between a new or prospective venture and an established business. Neither investigatory expenses nor start-up costs can be currently

1. I.R.C. § 162.
2. See Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir.) vacated on other grounds, 382 U.S. 68 (1965); Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521 (1979), aff'd, 633 F.2d 512 (7th Cir. 1980).
4. Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980); Richmond
deducted as business expenses because they are generally incurred when the
taxpayer is not yet "carrying on any trade or business." Assuming the business
is entered into, the taxpayer is forced to capitalize the expenditures, the amount
recoverable over the life of the business (or asset) depending on whether the
resulting asset has an ascertainable useful life.\(^{7}\) If, however, the expense is
related solely to the establishment of a business in general, the expense is
in the nature of goodwill and not recoverable until the business is disposed of.

Although section 195\(^{4}\) intends to remedy this effect by allowing 5-year amor-
tization of all investigatory and start-up costs incurred by a new trade or
business, it is unlikely to "decrease controversy and litigation arising under
present law with respect to the proper income tax classification of start-up
expenditures."\(^{8}\) No definite guidelines are provided for determining which tax-
payers are subject to its provisions. Presumably, once a taxpayer has reached
the threshold for an "acquired trade or business,"\(^{9}\) which is deemed equivalent
to the month the "business begins,"\(^{10}\) all subsequent recurring start-up costs
would be currently deductible under section 162(a).\(^{11}\) Congress has suggested\(^{11}\)
the applicability of Code sections 248\(^{12}\) and 709 to supply the definition of

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Television Corp. v. United States, 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S.
68 (1963); Goodwin v. Commissioner, 75 T.C. 424 (1980); Francis v. Commissioner, 46 T.C.M.
(P-H) 706 (1977).
5. I.R.C. § 162(a).
depreciable period of a capital expenditure is determined by the life of the asset so created
or enhanced by the expenditure.
7. Treas. Reg. § 1.167(a)-3 provides that an intangible asset may be the subject of a deprecia-
tion allowance if its useful life can be estimated with reasonable accuracy. An investigatory ex-
 pense or start-up cost that is attributed to the creation of a patent, trademark, or franchise, for
 example, may be amortizable. Expenses classified as organizational expenditures are allowed to
be amortized over 60 months, beginning in the month in which the corporation or partnership
12. I.R.C. § 162(a) provides that a deduction shall be allowed for all ordinary and necessary
expenses paid or incurred during the taxable year in carrying on any trade or business.
14. See, e.g., Treas. Reg. § 1.248-1(a)(3), which explains the definition of when a business
begins for purposes of amortizing organizational expenditures:
The determination of the date the corporation begins business presents a question
of fact which must be determined in each case in light of all the circumstances
of the particular case. The words "begins business," however, do not have the
same meaning as "in existence." Ordinarily, a corporation begins business when
it starts the business operations for which it was organized; a corporation comes
into existence on the date of its incorporation. Mere organizational activities, such
as the obtaining of the corporate charter, are not alone sufficient to show the begin-
ning of business. If the activities of the corporation have advanced to the extent
necessary to establish the nature of its business operations, however, it will be deemed

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when a business begins; however, taxpayers are unlikely to remain dormant when the threshold essentially remains a factual determination. In fact, the determination of when a business begins for one Code provision need not be applicable to another because the underlying rationale may be different.\textsuperscript{15} Organizational expenditures\textsuperscript{16} are undoubtedly of a capital nature, whereas start-up costs may be inherently recurring.\textsuperscript{17}

If the taxpayer is within the scope of a prospective business under section 195, amortization of start-up expenditures will only be allowed if the expenditure would be currently deductible if paid or incurred in the expansion of an existing trade or business in the same field as that entered into by the taxpayer.\textsuperscript{18} However, decisions on the current deductibility of start-up costs by an expanding business are presently in disarray. Courts have reached different results depending on whether the "separate and distinct additional asset"\textsuperscript{19} test or the "one-year rule" is applied.\textsuperscript{20}

This note will examine the interplay of these unsettled matters within the terms of section 195. The issue of when a business begins applies in particular to the tax treatment of recurring start-up costs. Section 195 presupposes that such costs are nondeductible and purports to provide relief from capitalization. Taxpayers should not be so easily dissuaded from challenging the concepts upon which section 195 is founded. The applicability of the separate and distinct additional asset test to costs incurred by the expanding business is more relevant to the question of whether certain investigatory and nonrecurring start-up costs can be amortized by the new trade or business. Recurring start-up costs would, of course, be currently deductible by the expanding business, and amortizable by the new business if so elected.

\textsuperscript{15} See generally Snow v. Commissioner, 416 U.S. 500, 503-04 (1974) ("carrying on" requirement of § 162 is not necessarily equivalent with "in connection with his trade or business" in § 174); Higgins v. Commissioner, 312 U.S. 212, 218 (1941) (the definition of business for purposes of determining whether managing securities constitutes carrying on a business is not determined by the definition of business for purposes of an Excise Tax Act); Roth, \textit{Trade or Business Requirement of Sec. 162 and the Deductibility of Preoccupancy Expenses Incurred in Rental Real Estate Projects}, 57 Taxes 33 (1979) (Treas. Reg. § 1.248-1(a)(3) is more applicable to the trade or business requirement in § 162 than is Treas. Reg. § 1.372-4(b)(5), which provides that a corporation commences the active conduct of its business when it first engages in activities designed or intended to enable it to engage in any business operation. But see infra text accompanying notes 16, 17).

\textsuperscript{16} See Treas. Reg. § 1.248-1(b). Organizational expenditures are defined as those that are directly incident to the creation of the corporation. It is well settled that expenses intimately connected with the acquisition of an asset are capital expenditures. See also 4A J. Mertens, \textit{Jr., Federal Income Taxation} § 25.25 (rev. ed. 1979).

\textsuperscript{17} See Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982).

\textsuperscript{18} I.R.C. § 195(b)(2).

\textsuperscript{19} NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (where expenditures do not create or enhance a separate and identifiable asset, they are considered "ordinary and necessary").

\textsuperscript{20} \textit{Id.} (expenditures providing benefits beyond one year must be capitalized).
Trade or Business Requirement: Investigation Expenses

By definition, the "trade or business" requirement is not at issue in the tax treatment of investigation expenses for the prospective venturer. "Investigatory expenses are costs of seeking and reviewing prospective business prior to reaching a decision to acquire or enter any business."21 The "trade or business" requirement refers to an existing business, a condition not met when the taxpayer is merely investigating the possibility of a formal commitment to enter a business.22 As stated in Richmond Television Corp. v. United States, "expenses prior to and for the purpose of reaching a decision whether to establish a business are undisputably capital expenditures."23

On the other hand, the existing business contemplating a new investment is more likely to achieve current deductibility. In York v. Commissioner,24 the taxpayer in the residential and commercial real estate business incurred the cost of an expert survey to determine the potential prospects of nearby land for industrial development. The amount was held deductible as an ordinary and necessary business expense, incurred for land "within the compass of his field"25 and not for an entirely new business.

Commentators have criticized the "existing business" rule contending that deductibility of an investigation expense should not be determined according to when it is incurred, but whether it relates to personal as opposed to business activity.26 In other words, all expenses incurred by a taxpayer are either nondeductible personal expenses under section 262 or profit-motivated business expenses under section 162. If the expenses are conceded for a business purpose, only the "ordinary and necessary" limitation of section 162 should mandate capitalization. Once an individual or corporation has focused on a particular business with a bona fide investigative intent, all subsequent investigatory costs should be currently deductible. The majority of the cases, though, deny section 162 treatment at the investigative stage.27 Accordingly,

23. 345 F.2d 901, 905 (4th Cir. 1965).
25. Id. at 422. See also Malmstedt v. Commissioner, 578 F.2d 520 (4th Cir. 1978) (residential developer undertaking commercial development is within the general scope of real estate); Vanderbilt v. Commissioner, 26 T.C.M. (P-H) 916 (1957) (writer and lecturer attempting to obtain employment as a television narrator was found to be carrying on a trade or business). But see Mid State Products Co. v. Commissioner, 21 T.C. 696 (1954) (taxpayer engaged in business of buying and selling frozen eggs was denied deduction for expenses of investigating the feasibility of entering business of buying and selling dried eggs; the court stated the expenses were similar to organization costs, the corporate franchise, goodwill, and other nonwasting assets).
27. See supra notes 22-23 and accompanying text.
section 195 does not attempt to move backward the point at which a business begins, whenever that might be; rather, it grants amortization as a compromise. The legislative history of section 195 suggests a section 165° loss may be allowable for lost expenses incurred in an unsuccessful attempt to acquire a specific business.29

Trade or Business Requirement: Start-up Costs

Under section 195, start-up costs are categorized with investigation expenses and are apparently intended to receive similar amortization treatment. Start-up costs are defined as those costs incurred subsequent to a decision to establish a particular business but prior to its actual operation.30 Some courts have felt there is no logical reason to deny current deductibility to start-up costs if they are of a noncapital nature.31 Investigatory expenses are generally of a nonrecurring nature, i.e., it is no longer necessary to explore the viability of a particular business once the decision for entry has been made. Further, there is the possibility for taxpayer abuse because bona fide investigation efforts would ordinarily be determined by the taxpayer's testimony.32 To the contrary, recurring start-up costs are easily identified, often identical to those incurred by an operating business, ranging from advertising, employee training, and consultant fees to utility bills and janitorial services. Blitzer v. United States33 suggests that the section 195 election to amortize recurring start-up costs is, perhaps, an alternative to current deductibility and not simply relief from capitalization.

In Blitzer a partnership was formed for the purpose of constructing and operating an apartment complex. Upon making a firm commitment to going forward with the project as a result of financing arrangements, the partnership paid an administrative management fee to the general partner. The general partner's services included both the acquisition of capital assets, such as the organization of the partnership and the approval of the loan, and the performance of recurring administrative services, such as record-keeping. The United States argued that, regardless of the related services or costs, no portion of the fee was deductible because the projects would not be ready for occupancy or producing revenue until the subsequent taxable year, and thus

30. Id. According to the Senate Finance Committee Report, "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 prospective distributors, suppliers, or customers, and salaries or fees paid or incurred for executives, consultants, and for similar professional services.
31. E.g., 379 Madison Ave., Inc. v. Commissioner, 60 F.2d 68 (2d Cir. 1932); Blitzer v. United States, 684 F.2d 874 (Ct. Cl. 1982); Duffy v. United States, 81-1 U.S. Tax Cas. (CCH) ¶ 9467 (Ct. Cl. 1981); Whitman v. United States, 248 F. Supp. 845 (W.D. La. 1965).
32. See, e.g., Stroope v. Commissioner, 44 T.C.M. 1487 (1975) (taxpayer took trip to Hawaii shortly before Christmas and testified his principal purpose was to investigate real estate opportunities).
33. 684 F.2d 874 (Ct. Cl. 1982).
the taxpayer could not have been "carrying on a trade or business" pursuant to section 162. In response, the court stated the function of "trade or business" in section 162 is not to require a "precise matching of income and expenses in the same year," but rather to distinguish between business and personal expenses. The court stated:

Construed in this light, it is clear that the "trade or business" requirement in I.R.C. § 162(a) is no barrier to any deductions for 1973 [operations did not begin until 1974]. For, at all times during that year the partnership was engaged in endeavors serving "business" or profit-making purposes rather than personal ones. Thus the partners would qualify for deduction of non-capital expenditures for the production of income pursuant to I.R.C. § 162(a). . . .

The Blitzer court did not believe that the "trade or business" phrase has acquired a tangential restriction, which, in effect, would classify common business expenses as nonbusiness expenses simply because the enterprise is not yet producing revenue. Rather, it should be construed in its traditional sense. The nondeductibility of personal or family expenses not only limits the expenses of an individual under section 212, but it similarly restricts the availability of a deduction under section 162. A taxpayer, even though in corporate form, must possess a dominant income or profit motive in order to be carrying on a trade or business when the expense is incurred. This determination requires an all-facts-and-circumstances analysis.

Several cases illustrate the emphasis placed on the business nature of the expense, rather than on its timing. In Markovitz v. Commissioner the taxpayer, a promoter and developer of new business, devoted all his time to such business activity in 1946, although he did not receive income until 1947. The taxpayer contended that his efforts were the "groundwork" for income subsequently received. The court held that "[t]he rule to be applied here is set

34. Id. at 879-80.
35. The Blitzer court cited United States v. Gilmore, 372 U.S. 39, 45-46 (1963) for the following proposition:
A basic restriction upon the availability of a § 23(a)(1) deduction [predecessor to § 162] is that the expense item involved must be one that has a business origin. That restriction not only inheres in the language of § 23(a)(1) itself, confining such deductions to "expenses . . . incurred . . . in carrying on any trade or business," but also follows from § 24(a)(1) [predecessor to § 262], expressly rendering non-deductible "in any case . . . [p]ersonal, living, or family expenses."
684 F.2d at 879.
36. I.R.C. § 212.
37. International Trading Co. v. Commissioner, 275 F.2d 578, 584 (7th Cir. 1960) ("A corporation is normally deemed to be engaged in a 'trade or business'; however, to the extent that it is operated solely for the pleasure of its stockholders, it is not engaged in a 'trade or business'.").
forth in Dogget v. Burnet,\(^4\) since the evidence shows that the motive underlying all of petitioner's activities was the profit motive, even though he did not get profits in 1946.\(^7\)

In Bailey v. Commissioner\(^2\) the taxpayer was a retired inventor who remained personally active in his efforts to obtain several patents for his inventions. In holding that the expenses incurred were currently deductible, the court noted:

True, he had not yet received any income from the inventions conceived by him during this period, but we are convinced that he reasonably expected to realize profit from these activities. . . . If he were so devoting his energies it does not matter that his efforts had not yet begun to pay off. . . .\(^4\)

The court further stated the line of cases holding that investigatory expenses are not deductible was not applicable to the treatment of start-up costs.\(^4\)

Richmond Television Corp. v. United States,\(^4\) and its progeny,\(^6\) represent a strict and definitive approach to determining what constitutes "carrying on a trade or business," a position the IRS has adopted nationally on audit.\(^7\) Essentially, subsequent decisions have interpreted Richmond Television to require the simultaneous generation of operational revenues before the current deductibility of "ordinary and necessary" start-up costs. However, the unique fact situation in Richmond Television militates against a broad application of its reasoning to all beginning business.

In Richmond Television, the dispute involved the treatment of employee training expenses incurred after the incorporation of a television station but prior to the taxable year in which the FCC broadcasting license was received and actual broadcasting was begun. Recognizing that case law had not previously established when a business begins for purposes of section 162 deductions, the court stated the determination is usually a factual issue. Nevertheless, the court held, "as a matter of law," that the taxpayer was not in business until the license was obtained \(\text{and}\) broadcasting began.\(^8\) The lack of operating revenue, however, was not explicitly held to be a sufficient factor in itself to justify denial of section 162 deductions. The court did not hold the taxpayer was not in business because \emph{neither} the license was obtained

\(\text{supra}\) note 4.

\(40. 65\) F.2d 191, 194 (D.C. Cir. 1933) ("The proper test is . . . whether it is entered into and carried on in good faith and for the purpose of making a profit.").

\(41. 21\) T.C.M. (P-H) 723 (1952) (citation omitted).

\(42. 32\) T.C.M. (P-H) 1425 (1953).

\(43. \text{Id.}\) at 1427-28.

\(44. \text{E.g.,}\) Walet v. Commissioner, 31 T.C. 461 (1958).

\(45. 345\) F.2d 901 (4th Cir. 1965).

\(46. \text{See cases cited supra note 4.}\)

\(47. \text{EXAMINATION TAX SHELTERS HANDBOOK, ch. 300, Real Estate Tax Shelters, § 370(4) (states that with the exception of § 163 interest, § 164 taxes, and § 165 losses, all costs of the partnership before the transition point should be capitalized, citing Richmond Television).}\)

\(48. \text{Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965).}\)
nor operations had commenced. The facts indicate that the particular nature of the broadcasting industry mandate the receipt of the license before revenues are generated. The commencement of broadcasting was merely incidental to the receipt of the license.

The court's emphasis on the contingent receipt of the license likewise prevents a broader application of the holding than is warranted. Although the corporation had made a "decision" to enter business, the possibility of a denial by the FCC precluded a firm commitment, as emphasized in Blitzer. The preoperations period was referred to as "doubtful prefatory stage," and "there was no certainty that [the station] would obtain a license, or that [the station] would ever go on the air." To the extent the station was pursuing the license acquisition without assurance of receipt, the "business" nature of the enterprise was similar to an investigative stage in that a formal decision to enter business was yet to be reached. Unfortunately, the court failed to distinguish the type of initial decision made in Richmond Television from a firm and unrestricted decision, such as in Blitzer (where the contingency for entry may be no greater than the year-to-year continuance of an established business). The court stated:

The uniform teaching of these several cases is that, even though a taxpayer has made a firm decision to enter into 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

49. Id. at 905.
51. Richmond Television Corp. v. United States, 345 F.2d 901, 905, 907 (4th Cir. 1965).
52. In this limited sense, the courts' reliance on Polachek v. Commissioner, 22 T.C. 858 (1954) would be arguably correct. Polachek involved expenses incurred while investigating a prospective business. To the extent Richmond Television is taken for a case involving start-up costs, the court's reliance on Polachek is improper.
53. Cases cited involving similar fact situations as Richmond Television are Petersburg Television Corp. v. Commissioner, 30 T.C.M. (P-H) 290 (1961); KWTX Broadcasting Co. v. Commissioner, 31 T.C. 952 (1959), aff'd per curiam, 272 F.2d 406 (5th Cir. 1959); WBIR v. Commissioner, 31 T.C. 803 (1959). These cases, from which Richmond Television purports to derive its authority for this original rule of law, have been criticized as inapplicable for various reasons, including the factually distinct nature of the preoperations period in the broadcasting business. See 1 J. Rabkin & M. Johnson, Federal Income, Gift and Estate Taxation 310 ("The Fourth Circuit has adopted the unrealistic rule that carrying on a 'trade or business' requires the performance of the ultimate activities for which it was organized."); Soloman, Tax Treatment of Pre-Opening Expenses, 46 Taxes 521 (1968); Erbacher, Start-Up Costs: Are They Deductible by a Corporation for Federal Income Purposes?, 48 Taxes 488 (1970).
54. Most disturbing is the court's reliance on Cohn v. United States, 57-1 U.S. Tax Cas. (CCH) § 9457 (W.D. Tenn. 1957), aff'd on other grounds, 259 F.2d 371 (6th Cir. 1958). Although the taxpayers in Cohn were denied deductibility of expenses incurred prior to the commencement of operations, the denial was based upon the nonrecurring nature of the expenses. The expenses at issue in Richmond Television were admittedly ordinary and necessary. Nonetheless, subsequent decisions have cited Richmond Television as authority for capitalizing recurring expenses as preoperational costs.
such time as the business has begun to function as a going concern and performed those activities for which it was organized.\textsuperscript{55}

The \textit{Richmond Television} rationale has evolved into a general rule denying section 162 deduction for all preoperating costs, regardless of the existence of a contingent “license” to do business. In \textit{Madison Gas & Electric Co. v. Commissioner},\textsuperscript{56} the taxpayer formed a partnership with other public utilities for the construction and operation of a nuclear generating plant and sought to deduct expenses\textsuperscript{57} incurred both prior to the issuance of an operating license and prior to the commencement of operations. The taxpayer contended that the partnership, assuming one existed, had commenced business not upon receipt of the operating license but upon prior receipt of the provisional construction permit issued by the Nuclear Regulatory Commission (NRC). The Tax Court found the contention “contrary to the well-established case law,”\textsuperscript{58} the situation being factually indistinguishable from \textit{Richmond Television}, despite a finding that the NRC Commissioner never denied an operating license upon completion of a facility under the authority of the provisional construction permit.\textsuperscript{59} Whether the Tax Court found the “trade or business” threshold was reached upon the receipt of the license or the commencement of operations, or both, the Seventh Circuit seemingly resolved all doubt by affirming that the expenses were “non-deductible, pre-operational start-up costs of the partnership venture.”\textsuperscript{60}

The “preoperations” aspect of the \textit{Richmond Television} rule was applied in finding the construction of residential housing did not constitute carrying on of a trade or business until the project was completed and receiving rental income.\textsuperscript{61} A pharmacy, quite capable of filling prescriptions, could not deduct preparation expenses until the business had “opened its doors to the public.”\textsuperscript{62} The portion of a management fee paid by a limited partner to the partnership for the supervision of the construction and financing of an oil rig, which is allocable to recurring start-up costs, was ruled nondeductible until the rig was completed and placed in operation.\textsuperscript{63}

Thus far, \textit{Blitzer} is the only reported case directly challenging the \textit{Rich-

\textsuperscript{55} Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965).

\textsuperscript{56} 72 T.C. 521 (1979), aff’d, 633 F.2d 512 (7th Cir. 1980).

\textsuperscript{57} Start-up costs included expenses for the training of employees, the development of internal procedures and guidelines for plant operation, hiring activities, nuclear field management, environmental activities, and the purchase of spare parts. The Commissioner had conceded that if the expenses were incurred for the expansion of an existing business and not for a new business (or partnership), they would be currently deductible under § 162(a).

\textsuperscript{58} Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521, 566 (1979).

\textsuperscript{59} \textit{Id.} at 539.

\textsuperscript{60} Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 517 (7th Cir. 1980).


\textsuperscript{62} Kennedy v. Commissioner, 42 T.C.M. (P-H) 55 (1973) (“Albeit Mr. Kennedy was legally capable of filling prescriptions at an earlier date because of having acquired the requisite licenses, the ability to transact business does not satisfy the ‘carrying on’ requirement of the statute.”).

\textsuperscript{63} Rev. Rul. 150, 1981-1 C.B. 119.
mond Television concept of simultaneously matching revenues and expenses. The impact of Richmond Television has been lessened, though, by the District Court of Maryland in United States v. Manor Care, Inc., which held certain "preoperating" expenses incurred prior to the receipt of an operating license to be currently deductible. Although the expenses incurred by the nursing home corporation were also prior to the furnishing of nursing home care to patients, the court emphasized the taxpayers were generally assured of receiving a nursing home license if certain objective requirements were met due to the noncompetitive nature of the business.

In distinguishing Richmond Television, the court stated: "While the language of Richmond is broad, it would be reading too much into the case to conclude that, as a matter of law, no company can deduct expenses incurred before it obtains a required license." It is not clear whether the court considered the taxpayers to be carrying on a trade or business when the expenses were incurred since the actual business operations began in the same taxable year.

**Expansion of an Existing Trade or Business**

Existing business can escape the restraints placed on newly created business if the acquisition of the new income-producing entity, or plant, or tract of land, was an expansion of the existing business. In recognizing the expansion issue is involved both in determining whether a new trade or business is created and whether a separate and distinct additional asset is acquired, one can avoid confusion.

Generally, in cases involving customer services, the creation of a new method by which to supply that service is distinguished from entering a new business. For example, an established bank that adopts a credit card program to replace the letter of credit and other traditional loan devices has simply created a new method to conduct an old business. For the same reason, a change of method in making sales or the development of a new sales territory does not create a new business. However, the acquisition of another separate and distinct business entity or the addition of a new branch or division with the purpose of producing a different product is clearly the making of a new

65. Id. at 359.
66. S. Rep. No. 1036, supra note 9, provides as follows: "In the case of an existing business, eligible start-up expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible."
67. See NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) for the presence of both issues.
68. First Sec. Bank 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 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).
70. Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973).
business. The addition of a branch or division or the acquisition of a separate income-producing property—identical in nature to the existing business—may or may not qualify as an expansion depending on the extent of the existing operations.

In NCNB Corp. v. United States, the development of branch banks was considered an established part of the parent bank’s operations. The parent bank in a three-year period opened 57 new branches as part of its statewide banking system. Although the branch bank had no market value apart from the overall branch banking network of the parent bank, this fact is relevant only as to whether a separate and distinct additional asset was created. Therefore, the acquisition of transferable income-producing property, such as rental property purchased by a real estate development company, should likewise be classified as an expansion if part of the normal activity of the existing business. An individual may encounter greater difficulty in establishing the requisite business activity. The leasing of several properties in a different state for both residential and farming purposes is not a basis for deducting preparatory expenses incurred for a newly acquired rental house. The existing rental activity of the taxpayer was not at “such a level and scope” that the newly acquired property “could fairly come under the umbrella” of the other properties.

Similarly, in Francis v. Commissioner, the court considered the strength of the taxpayer’s existing business activity in determining whether the acquisition of an additional rental property is an expansion: “We cannot consider the activities surrounding the construction and development of the Doral project [the additional property] to be an integral part or extension of an unrelated and geographically removed rental property.”

The acquisition, or creation, of a separate and distinct business entity is considered a new business if the entity is more than a mere extension of the existing business. In Interstate Transit Lines v. Commissioner, the parent corporation, involved in interstate bus transportation, formed a subsidiary in California to do business there under California law. The business of the subsidiary involved both interstate and intrastate bus transportation. In holding that one taxpayer cannot deduct expenses incurred for the benefit of another taxpayer, the distinctive nature of the two entities compelled a denial of the parent corporation’s claimed deduction. “This is not the case of a mere branch or division of a business conducted solely for convenience’ sake under a separate corporate form.”

71. Id.
72. 684 F.2d 285 (4th Cir. 1982). This decision was a rehearing en banc reversing an earlier panel decision, NCNB Corp. v. United States, 651 F.2d 942 (4th Cir. 1981). See infra text accompanying notes 86-89.
74. 46 T.C.M. (P-H) 706 (1977).
75. Id. at 709.
76. 319 U.S. 590 (1943).
77. Id. at 593.
When the activity of the separate entity is identical to that of the existing business, Interstate infers substance is superior to form. In Baltimore Aircocil Co. v. United States, a Maryland corporation formed a wholly owned subsidiary to operate a plant in California to adequately meet competition. The United States, conceding that expenses incurred by the parent corporation would be deductible if the parent had opened a plant in California instead of establishing a subsidiary corporation, argued that the two entities were separate and distinct, each engaged in separate, though similar, trades or businesses. The court, comparing the result in Interstate, held that the subsidiary was a "mere branch or division" and that the separate corporate identities should be disregarded.

On the other hand, Madison Gas & Electric declined to ignore the legal form of the newly acquired entity in holding expenses of the existing business were preoperational costs of the partnership. In failing to mention the Interstate rationale, the court stated that "[b]ecause they were each already in the business of selling electricity, it can, of course, be argued that the partnership venture itself is an extension of their existing businesses. It does not follow from this though that we should ignore the partnership as lacking economic substance." Once it is determined that the costs are incurred for expansion, the inquiry becomes whether the expenses are "ordinary and necessary" under section 162. The "carrying on any trade or business" hurdle of section 162 has been cleared and the taxpayer need not be concerned with the elective provisions of section 195.

**Capitalization or Current Expenditure**

For the taxpayer who is investigating the prospects of a new business and is not readily analogous to Blitzer, or who is incurring expenses for planning and promotion purposes, the benefits of which extend beyond one year, section 195 may well provide relief. Start-up expenditures, as defined in section 195, will only be allowed amortization if those costs would be currently deductible if incurred by an existing trade or business. This requirement necessitates an examination of the varying tax treatment of these costs, particularly investigatory and nonrecurring start-up costs, afforded to existing businesses.

Although the trade or business requirement is met, the expenses are subject to restriction by section 263, the limitations of which are inherent in the ordinary and necessary requirement: "The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those

78. 333 F. Supp. 705 (D. Md. 1971). Cf. Bennett Paper Corp. v. Commissioner, 78 T.C. 458 (1982) (The subsidiary, although expanding the business of the parent, was created primarily to avoid the demands of the parent's creditors and was recognized as a separate corporate entity within the general rule of Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943)).
80. 633 F.2d at 517.
81. I.R.C. § 263.
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 life of the asset. But the tests for classifying an outlay in the proper category have been described to be in a state of "hopeless confusion."

The conflict can essentially be separated into two separate views founded on either a balance sheet or income statement line of reasoning. Those emphasizing assets would define a capital expenditure in its ordinary sense, i.e., one relating to an item of ownership of a permanent or fixed nature convertible into cash. The other view emphasizes the need for clear reflection of income, focusing solely on whether the outlay produces benefits beyond the accounting period, regardless of the creation of a separate and distinct additional asset.

NCNB Corp. v. United States, an en banc decision of the Fourth Circuit, exemplifies the tenuous status of the tax treatment of start-up costs incurred in the expansion of an existing business. The taxpayer, a national bank involved in the development of a branch banking system, desired to deduct in the taxable year in dispute the costs of market and feasibility studies made in planning potential branches, internal staff time in implementing the expansion projects, and applications to the Comptroller of the Currency. The panel decision, agreeing with the Commissioner, required capitalization of all costs incurred because of their relation to the production of future income despite there being no identifiable intangible asset produced. The en banc majority reversed, concluding the length of the ensuing benefit is not the major factor in determining a capital expenditure, thus discarding the accounting policy of matching revenues and costs in the appropriate taxable period. The controlling factor is whether the expenditures create or enhance separate and identifiable assets; otherwise, they are considered "ordinary and necessary" expenses under section 162(a).

Under the en banc decision, it is improper to view for capitalization purposes each individual expense, in and of itself, for the length of its ensuing

83. Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 785 (2d Cir. 1973).
84. The panel decision in NCNB Corp. v. United States, 651 F.2d 942, 954 (4th Cir. 1981) discusses recent accounting policy as a premise for rejecting the relevance of the creation or enhancement of an asset for tax purposes:

Many decades ago, when accounting was still primarily on a cash basis, the most important financial statement was the balance sheet, which was used by potential investors in, or creditors of, an enterprise in part to estimate the proceeds which would be available in case of a forced liquidation. Because present-day investors and creditors, however, tend to focus more on an enterprise's earning power than on its liquidation value, the income statement has supplanted the balance sheet as the most important of an entity's financial statements.

85. See Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 786 (2d Cir. 1973).
86. See NCNB Corp. v. United States, 651 F.2d 942 (4th Cir. 1981).
87. NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).
benefit, without considering whether a resulting asset was produced. The costs incurred resulted in the "right" to operate a branch bank in a particular location, but this "right" possessed no objective criteria normally associated with an asset. The en banc court stated:

The money spent or obligated for metro studies, feasibility studies, and application to the Comptroller of the Currency, it seems to us, adds nothing to the value of a bank’s assets which can be so definitely ascertained that it must be capitalized. Certainly no "separate and distinct additional asset" is created. While the benefit of all of those classes of expenses may or may not endure for more than one year, that is but one factor to be considered. The branch has no existence separate and apart from the parent bank; as a branch bank, it is not readily salable and has no market value other than the real estate which it occupies and the tangible equipment therein.99

The majority in NCNB relied on language found in Commissioner v. Lincoln Savings & Loan Ass’n.10 In Lincoln the Supreme Court decided the payment by a savings institution to a reserve fund held by a federal agency was capital, stating:

Further, the presence of an ensuring 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 § 162(a). . . .91

Lincoln has been interpreted as having "brought about a radical shift in emphasis,"92 with new emphasis now upon the identification of a newly created asset, contrary to the frequently applied future benefits rule.93 On the other hand, the Lincoln rule has been deemed an alternative test that need not be applied in every case.94 Another position interprets Lincoln as restating the

89. 684 F.2d 285, 292 (4th Cir. 1982).
90. 403 U.S. 345 (1971).
91. Id. at 354 (the Court defined the fund as a "distinct and recognized property interest" which is both transferable and income-producing and also of a permanent nature because of restrictions placed upon its sale).
92. See Briardiff Candy Corp. v. United States, 475 F.2d 775, 782 (2d Cir. 1973).
93. E.g., United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957) ("[A]n expenditure should be treated as one in the nature 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.").
94. NCNB Corp. v. United States, 651 F.2d 942, 957-58 (4th Cir. 1981). In other words, the Service would rely on the pertinence of the "like advantage" phrase as used in United States v. Akin. See supra note 93.
well-defined rules, the one-year rule being an inherent requirement of the more determinative separate asset test. 95

Perhaps the strict position taken in the NCNB panel decision, which referred to separate asset identification as "verbalisms, talismans, and rules of thumb," 96 is unwarranted. The court believed the controlling factor was the accounting period in which the associated revenues were to be recognized and not the nature of the benefit which helped produce those revenues. Conservative financial accounting policy should be distinct from the policy of taxing net income. "The primary goal of financial accounting is to provide useful information to management, shareholders, creditors and others properly interested. . . . The primary goal of the income tax system, in contrast, is the equitable collection of revenue." 97 Granted, courts have used language defining a capital expenditure as simply a cost having utility beyond the taxable year; 98 but these cases also involved intangible costs as annexed to tangible assets as well as intangible costs, which by themselves became identifiable intangible assets with ascertainable value. 99 There still exist no clear guidelines when the contributing expense is intangible and relates to an intangible asset

95. Jack's Cookie Co. v. United States, 597 F.2d 395, 405 (4th Cir. 1979); Florida Publ. Co. v. Commissioner, 64 T.C. 269, 282 (1975). In fact, the Regulations provide that expenditures that result in the creation of an asset having a useful life that extends substantially beyond the taxable year are not deductible. Treas. Reg. § 1.461-1(a)(1) & (2). The Tenth Circuit in United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) rejected a strict application of the one-year rule: "We think, however, that it was intended to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year."

96. NCNB Corp. v. United States, 651 F.2d 942, 953 (4th Cir. 1981).


98. Georator Corp. v. United States, 485 F.2d 283 (4th Cir. 1973), cert. denied, 417 U.S. 945 (1974) involved legal fees for resisting cancellation of a trademark and in holding that the legal fees constituted capital expenditures, the court noted the test for whether items should be treated as current expenses or capital expenditure is whether the utility of the expenditure survives the accounting period. The district court in First Nat'l Bank of South Carolina v. United States, 413 F. Supp. 1107, 1112 (D.S.C. 1976) held Georator to be consistent with the Lincoln Savings & Loan requirement of an identifiable asset to which expenditures can be related since the court in Georator "assumed the existence of a trademark." For other cases implying future benefit rules, but nevertheless involving ascertainable assets, see American Dispenser Co. v. Commissioner, 396 F.2d 137 (2d Cir. 1968) (outlay for covenant not to compete); Medco Products Co. v. Commissioner, 532 F.2d 137 (10th Cir. 1975) (legal expenses in asserting trademark); Sears Oil Co. v. Commissioner, 359 F.2d 191 (2d Cir. 1966) (bonus for early delivery considered part purchase price for barge); Stevens v. Commissioner, 388 F.2d 298 (6th Cir. 1968) (cost of maintaining horses considered part purchase price of horse). But see Wells-Lee v. Commissioner, 360 F.2d 665 (8th Cir. 1966) (physician paid fee to secure hospital facilities and court held right to practice is an intangible benefit or advantage like a capital asset which must be amortized over life of hospital. The holding appears, however, to be based on the similarity to an asset, and not the future benefits alone).

99. An example of intangible costs incurred to produce an intangible asset would be a salesman devoting time to a new sales method. Intangible costs that produce or enhance tangible assets are wages for the construction of a building or legal fees for the defense of a trademark. Intangible costs which by themselves become intangible assets would be the costs incurred for developing a patent.
of undefined value.\textsuperscript{100} The test proposed in the panel decision in \textit{NCNB} would examine each intangible expense separately (i.e., market studies, feasibility studies) for their long-term benefits. The \textit{en banc}'s "all or nothing,"\textsuperscript{101} or aggregating approach would deny capitalization of all contributing costs because of the unascertainable value of the associated intangible asset, i.e., the "right" to operate a branch bank.

Planning and promotion expenses, such as those incurred in \textit{NCNB} and \textit{Briarcliff}, are more easily justified as capital expenditures when incurred by a new business. Of course, under the \textit{Richmond Television} rationale, the capitalization issue of whether a separate and distinct additional asset must be created would not be reached until the trade or business requirement was initially met. Nonetheless, the purchase of a new business is the acquired capital asset\textsuperscript{102} to which related expenses can be attributed. That the taxpayer develops the new business through his own efforts does not change the character of the expenditure incurred in acquiring the asset.\textsuperscript{103} However, if an established business is expanding, the search for an identifiable asset can be quite difficult. The expanding business is essentially developing additional goodwill when costs are incurred to gain new customers\textsuperscript{104} or to provide more adequate service for existing customers.\textsuperscript{105} Although the cost of purchased goodwill and other intangibles in the acquisition of an existing business are capital expenditures,\textsuperscript{106} costs of developing intangibles, including goodwill, are deductible as ordinary and necessary expenses of doing business.\textsuperscript{107}

If goodwill in the sense of "assurance of a market" or "new channels of distribution" is to be regarded as an "asset" as that term was used in \textit{Lincoln Savings and Loan}, the search for an asset in

\textsuperscript{100} Briarcliff Candy Corp. v. United States, 475 F.2d 775, 783 (2d Cir. 1973) (taxpayer incurred costs, such as sales calls and advertisements, in an effort to expand its sales territory).

\textsuperscript{101} NCBN Corp. v. United States, 684 F.2d 285, 294 (4th Cir. 1981) (Murnaghan, J., dissenting).

\textsuperscript{102} Vermont Transit Co. v. Commissioner, 218 F.2d 468 (2d Cir. 1955).

\textsuperscript{103} Francis v. Commissioner, 46 T.C.M. 706 (P-H) (1977).

\textsuperscript{104} Briarcliff Candy Corp. v. United States, 475 F.2d 775 (2d Cir. 1973). \textit{Contra}, Houston Natural Gas v. Commissioner, 90 F.2d 814, 817 (4th Cir. 1937) ("an intensive campaign at any time gives rise to capital expenditures").

\textsuperscript{105} Connecticut Light & Power Co. v. United States, 299 F.2d 259 (Ct. Cl. 1962) (costs of converting customer's appliances for use with different grade of gas were made to retain customer goodwill and thus deductible).

\textsuperscript{106} Treas. Reg. § 1.263(a)-2(h).

\textsuperscript{107} Note, \textit{Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill}, 81 Harv. L. Rev. 859 (1968). See, \textit{e.g.}, Welch v. Helvering, 290 U.S. 111 (1933) (to the extent the issue in \textit{Welch} is considered to be one between capitalization and current deductibility, the capitalization is justified on the fact the expenses for extinguishing debt to preserve credit and protect reputation were made in connection with the establishment of a new enterprise); Richmond Television Corp. v. United States, 345 F.2d 901, 904 (4th Cir. 1965) (the government conceded that expenses for training a staff of broadcasting employees would be deductible under § 162 if incurred while carrying on a trade or business). \textit{See also} Dunn & McCarthy v. Commissioner, 139 F.2d 242 (2d Cir. 1943); Carl Reimers Co. v. Commissioner, 211 F.2d 66 (2d Cir. 1954).
capitalization cases will become merely a test for the Commissioner's ingenuity in putting names to whatever benefits a taxpayer's activities have created.\(^{108}\)

The rationale frequently used for exempting certain intangible benefits or rights from capitalization is their lack of market value,\(^{109}\) as opposed to the objective value placed on contract rights or licenses. Distinguishing intangible benefits by their objective value and transferability is a fair approach. If capitalization is required for benefits such as the right to own a branch bank in a particular location, amortization or depreciation possibly will be denied because of the indefinite life of the asset.\(^{110}\) In that case, the business would never recover the underlying investment because the "right" could not be added to the cost of the branch bank, the branch not being a separate trade or business; rather, the right would simply collect dust as a useless asset on the taxpayer's books. Even the cost of purchased goodwill can be recovered in the form of a higher basis upon sale of the business. To be sure, an expanding business will have an intrinsic increase in value as a result of the intangible benefits. But the expanding business is likely to pay for many types of services that will provide benefits over future periods, but are nevertheless currently deductible.\(^{111}\) As noted in Colorado Springs, "[i]f an expenditure, concededly of temporal value may neither be expensed or capitalized, the adoption of technological advances is discouraged."\(^{112}\)

The rule in the NCNB majority decision, which focuses on the creation or enhancement of a separate and distinct additional asset, is beneficial to

109. The Tenth Circuit in Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974), in assessing the nature of expenses incurred for a credit card system, said: "The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. They are recurring. At the most they introduce a more efficient method of conducting an old business." Id.
110. See supra note 7.
111. See Treas. Reg. § 1.162-20(a)(2) (allows for deductibility of "good will" advertising "provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future.") See also Southland Royalty Co. v. United States, 582 F.2d 604 (Ct. Cl. 1978) (expenses for engineering analysis of extent of oil and gas reserves held deductible since no underlying tangible or intangible asset to which the survey costs may be added); Goodwyn Crockery Co. v. Commissioner, 37 T.C. 355, aff'd, 315 F.2d 110 (6th Cir. 1963) (cost of management survey held deductible although related to future year's business activities). Judge Tannenwald (concurring), in Primuth v. Commissioner, 54 T.C. 381-82 (1970), discussed the concept of a capital expenditure in holding a fee expended by a corporate executive to secure employment was deductible under § 162:

That concept has generally been confined to cases of acquisition of tangible assets or intangible assets, such as a license or goodwill of a going business, or preparation for engaging in a new field of endeavor. . . . By way of contrast, current deductibility has normally been permitted for advertising expenditures and for educational expenditures to improve one's skills utilized in existing employment, even though there were indications that some general benefit would in all probability last beyond the year of expenditure.
the taxpayer who elects amortization under section 195. Start-up expenditures that provide benefits beyond one year, similar to those incurred by the parent bank in NCNB, but which result in the acquisition or formation of a new business, could arguably be capitalized even in the absence of the Richmond Television rationale. Under section 195, the granting of amortization depends only on whether the cost would be currently deductible by an existing business. The taxpayer may spread these deductions over five years, as opposed to their being recoverable upon disposition of the business in the form of goodwill.

Conclusion

Conceivably, the true purpose of section 195, in regard to ordinary and necessary start-up costs, is to grant an election between deferral through amortization and current deductibility. Unless there is more positive justification than the Richmond rule for classifying start-up costs as capital until matched by operational revenue, construing section 195 as relief from the burdens of capitalization does not necessarily satisfy the inquisitive taxpayer. Indeed, investigatory expenditures incurred in the review of a prospective business are distinguishable and the effect of section 195 is extremely welcome in this area. Tax parity is denied, however, if section 195 removes from the realm of section 162 legitimate recurring start-up costs that are incurred for well-intentioned business purposes.

If the effect of section 195 is to deny a deduction for bona fide business expenses incurred by a newly formed business prior to operations solely because the expenses are the groundwork for future revenues, existing businesses will receive more favorable tax treatment. As the recent trend indicates, the courts are more inclined to disregard an accounting philosophy of matching expenses and revenues in search for an identifiable asset with which to justify capitalization. This rule of construction would in fact be beneficial to the new business subject to section 195 in that certain planning expenses can more easily be considered as deductible items if incurred by the expanding trade or business. However, the disregard for the matching concept is fundamentally at odds with the strict Richmond Television rationale for new businesses. One solution for achieving a balance in tax fairness is to perceive the recurring start-up cost in its generally understood sense, i.e., a deductible "business" expense, just as the expansion expenditures are classified according to their "capital" nature.

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113. See supra text accompanying notes 101-102.