RECONSIDERING THE TREATMENT OF INVESTIGATORY COSTS FOR TAXPAYERS WITH EXISTING BUSINESSES

*By Glenn Walberg**

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I. INTRODUCTION

Managers of a growing business rarely attach much significance to labeling the growth as an expansion of the existing business or a start of a new business. The tax law, however, finds such labels critical.[1] Thus, taxpayers and their advisors as well as the Internal Revenue Service (hereinafter the "Service") have devoted substantial resources to making those determinations and contesting the characterizations of others.[2] At first glance, the effort might appear to produce an inconsequential result: the parties might determine that certain business expansion costs are deductible immediately[3] whereas certain start-up expenditures are generally amortized over a period of months.[4] But the differences in tax treatment often concern taxpayers because they can affect substantial amounts of frequently incurred costs,[5] they have often been overshadowed by prospects of permanent capitalization,[6] and they require determinations for each period of business growth.[7]

Unfortunately, a taxpayer with a growing business faces considerable uncertainty in determining the proper treatment for its costs. The manner of treating costs is well established: a taxpayer generally can deduct costs attributable to a business expansion under § 162[8] and might amortize costs attributable to a start of a new business under § 195.[9] The uncertainty in treatment primarily arises from the highly factual inquiries required to determine whether a particular activity or pursuit

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1. *See, e.g.*, I.R.C. § 195(b)(1)(B) (2006 & Supp. 2009).

2. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 08-30-009 (July 25, 2008) (classifying amounts attributable to the surviving corporation in a merger for financial, legal, and other advice as deductible expansion expenses and amounts attributable to an acquisition subsidiary in the same merger for similar services as start-up expenditures).

3. *See, e.g.*, Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 775 (2d Cir. 1973).

4. *See* I.R.C. § 195(b)(1)(B).

5. *See* I.R.S. Priv. Ltr. Rul. 08-30-009.

6. *See* Burgess J.W. Raby & William L. Raby, *Start-up Costs*, 114 TAX NOTES 661 (2007) (describing a risk of forfeiting deductions for costs, particularly with respect to taxpayers claiming aggressive return positions).

7. *See, e.g.*, Brown v. Comm'r, 46 T.C.M. (CCH) 233, 237 (1983) ("While we agree with petitioner's characterization that these activities constituted a 'series of diverse business ventures' that share Mr. Brown's 'energy and expertise' as a 'common denominator' we are reluctant to hold that these varied activities constituted the carrying on of a single trade or business within the meaning of § 162. The question is one of definition.").

8. *See* I.R.C. § 162(a) (2006 & Supp. 2009).

9. *See* I.R.C. § 195(b)(1)(B). Start-up expenditures include costs attributable to active trades or businesses. *See* I.R.C. § 195(c)(1)(A)(ii). For clarity, this Article only references costs attributable to businesses.

expands or starts a business.[10] Although the Code frequently burdens taxpayers with such factual determinations, § 195 makes these uncertain characterizations particularly troubling insofar as its amortization remains elective[11] and the lack of an effective election subjects a taxpayer to permanent capitalization.[12] The elective nature of § 195 thus limits options to correct for any prior erroneous treatment of costs, which unduly stresses the importance of making a correct initial determination,[13] and creates a preference for taxpayers to accept amortization voluntarily for costs regardless of their character.[14]

The differences in tax treatment and implications of § 195 elections become especially problematic for a taxpayer investigating potential opportunities to grow an existing business. These problems arise because the reach of § 195 extends beyond pre-opening costs paid or incurred in connection with creating a business, including rent, salary, insurance, and other costs paid or incurred after a taxpayer makes a final decision to proceed until the doors open for business.[15] In particular, § 195 extends to encompass investigatory costs.[16] A taxpayer would pay or incur these investigatory costs in researching general markets and industries and specific opportunities prior to making a final decision about what opportunity to pursue.[17] Conceptually, § 195 treats costs attributable to investigating the start of a business as costs of that new business and considers costs attributable to investigating an expansion of a business as costs of that existing business. But that logic thereby requires that a taxpayer in an investigatory phase characterize its costs, with all attendant consequences, as amounts attributable either to an expanded or new business before the taxpayer has even decided what opportunity it might pursue. Because § 195 creates unacceptable options and results for investigatory costs of existing businesses, Congress should revisit their treatment to clarify and modify an uncertain area before additional controversies arise.

This Article addresses the treatment of investigatory costs paid or incurred by existing businesses. Part II describes the tax

10. I.R.C. § 195(c)(1)(A)(ii).

11. *See* I.R.C. § 195(b)(1), (d) (prescribing an election to deduct start-up expenditures).

12. *See* I.R.C. § 195(a) (denying a deduction for start-up expenditures).

13. *See* Raby et al., *supra* note 6 (describing § 195 as a "trap for the unwary").

14. *See id.*; I.R.C. § 195.

15. *See* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980).

16. *See* I.R.C. § 195(c)(1) (2006 & Supp. 2009) (defining start-up expenditures).

17. *See* H.R. REP. NO. 96-1278, at 9 (1980); S. REP. NO. 96-1036, at 10 (1980).

consequences of paying or incurring costs to expand or start a business with respect to § 195. The description highlights several issues that create uncertainty in characterizing and accounting for costs in expansion and start-up contexts. Part III explores how both the elective nature of § 195 and the implications of complying with a recently created "deemed election" entice taxpayers with existing businesses to treat their investigatory and pre-opening costs as start-up expenditures despite frequent uncertainty about their proper characterization. The Article accordingly recommends making amortization of start-up expenditures mandatory under § 195 to avoid a consequence of having such elections applied to expansion costs. Part IV explores additional problems that a taxpayer with an existing business encounters in characterizing costs while it remains in an investigatory phase. That Part explains why a taxpayer cannot accurately attribute its investigatory costs to efforts to expand or start a business where the taxpayer does not yet know how its business might grow. The Article concludes that, due to the need to account for such costs in filing a return for the year of the investigation, it seems desirable to treat those costs as deductible expenses of the existing business. Thus, the Article recommends eliminating investigatory costs of an existing business from the definition of start-up expenditures under § 195.

II. BACKGROUND OF § 195

A. *Tax Consequences of Expanding or Starting a Business*

Perhaps the best way to understand the tax significance of a business expansion is to consider it relative to its counterpart: the start of a new business. The start of a new business generally represents a new activity or pursuit for a taxpayer that differs from any business previously conducted by that taxpayer. In the most straightforward situation, a taxpayer that has conducted no prior business activity might start a business venture, such as the paradigm of a budding entrepreneur starting a business in a basement.[18] Once the taxpayer begins conducting that business, however, it might engage in additional activities—such as adding new products, seeking new markets, adopting new technologies, or using new operating procedures—

18. *See, e.g.*, Bailey v. Comm'r, No. 13014-05S, 2007 WL 987797, at *1 (Tax Ct. Apr. 13, 2007) (describing a model coffee and wine bar created in the taxpayer's basement in order to pitch the concept to investors).

that differ in some aspect from the taxpayer's original business activity.[19] Although a businessperson might reasonably view the additional activities as efforts to expand the original business, the tax law asks whether the additional activities are *different enough* to constitute a new business.[20] Thus, the tax law attaches significance to characterizations of business growth by generally treating costs attributable to the start of a new business (hereinafter "start-up costs"[21]) differently than it treats costs attributable to the expansion of an existing business.[22]

In the context of a new business, such as the business started in the entrepreneur's basement, a taxpayer generally cannot deduct any costs associated with that venture until the business actually begins.[23] Under what became known as the pre-opening expense doctrine, two rationales for this treatment emerged from case law.[24] The first rationale simply denied a deduction for all start-up costs where a taxpayer had not yet carried on the intended business. A court could deny the deduction by applying the literal language of § 162,[25] which permits a deduction only for those amounts paid or incurred in "carrying on" a business.[26] The court could reason that, where the business had not actually begun, it would have been impossible for the taxpayer to pay or incur costs in carrying on that business.[27] Therefore, a literal application of the Code

19. *See id.* at *4.

20. *See id.* at *4.

21. References to start-up costs in this Article include both investigatory and pre-opening costs attributable to the new business. *See supra* notes 1-7, 16-18, and accompanying text.

22. References to costs in this Article generally mean costs that an existing business could deduct as ordinary and necessary business expenses. *See* I.R.C. § 162(a) (2006 & Supp. 2009); *see also infra* Part II.B.3. For example, the references do not include capital expenditures. *See* I.R.C. § 263(a) (2006 & Supp. 2009). They also do not include costs specifically addressed by other Code provisions, such as research and experimental expenditures, which new and existing businesses generally treat consistently. *See* I.R.C. § 174(a) (2006).

23. *See* Glotov v. Comm'r, 93 T.C.M. (CCH) 1339, 1340 (2007); *see also* I.R.C. § 195(a) (2006 & Supp. 2009) (denying deductions for start-up expenditures).

24. *See* Toth v. Comm'r, 128 T.C. 1, 5 (2007) (noting the two rationales); *see also* Kukes v. Comm'r, 72 T.C.M. (CCH) 333, 336 (1996) (noting the same).

25. *See* Kantor v. Comm'r, 998 F.2d 1514, 1518 (9th Cir. 1993) (noting that the narrow language of § 162 limits deductions to costs paid or incurred in connection with a taxpayer's ongoing business).

26. I.R.C. § 162(a) (2006 & Supp. 2009) (allowing a deduction for "the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business").

27. *See* Wilson v. Comm'r, 71 F. App'x 623, 623 (9th Cir. 2003) (disallowing any deduction where a taxpayer was not carrying on a business); *see also* Aboussie v. United States, 779 F.2d 424, 428 (8th Cir. 1985) (relying on a taxpayer's failure to carry on a business at the time it incurred costs to deny a deduction for those costs); Richmond

would lead to a conclusion that a taxpayer lacks authority to deduct costs paid or incurred prior to the start of a new business.[28]

The alternative[29] and perhaps more principled[30] rationale for denying deductions under the pre-opening expense doctrine focused on the potential income distortion that would result from immediately deducting start-up costs. Courts applying this rationale noticed that taxpayers primarily realized the benefits derived from start-up costs after their businesses began.[31] In particular, courts found start-up costs analogous to capital expenditures[32] paid or incurred to acquire or create capital assets that would provide benefits into the future.[33] In a start-up context, an established business presumably could represent the relevant asset that would provide future benefits.[34] Because

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Television Corp. v. United States, 345 F.2d 901, 905 (4th Cir. 1965) (describing a taxpayer's failure to demonstrate that start-up costs satisfy the "carrying on" requirement of § 162), *vacated and remanded per curium on other grounds*, 382 U.S. 68 (4th Cir. 1965), *reaff'd on remand*, 354 F.2d 410 (4th Cir. 1965).

28. I.R.C. § 162(a) (2006 & Supp. 2009) (allowing a deduction for "the ordinary and necessary business expenses *paid or incurred during the taxable year in carrying on any trade or business*") (emphasis added).

29. Although occasionally described as an alternative rationale to a literal reading of § 162, *see, e.g., Richmond Television*, 345 F.2d at 907 (describing "another and related reason" for denying a deduction), the potential distortion of income rationale was necessary to deny taxpayers' claimed deductions for similar costs under § 212, which contains no trade or business requirement. *See, e.g.*, Johnsen v. Comm'r, 794 F.2d 1157, 1162 (6th Cir. 1986) (criticizing the Tax Court's rationale in Hoopengarner v. Comm'r, 80 T.C. 538, 543 (1983), for focusing too narrowly on the absence of a trade or business requirement under § 212 in permitting a deduction for start-up costs and for failing to consider the capital nature of such costs); Hardy v. Comm'r, 93 T.C. 684, 690 (1989) (following *Johnsen*'s rationale).

30. *See* John W. Lee, *Start-up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-on Tax Reform, and A Touch of Basics*, 6 VA. TAX REV. 1, 46-51 (1986).

31. *See, e.g.*, Fishman v. Comm'r, 837 F.2d 309, 312 (7th Cir. 1988) (characterizing start-up costs as amounts that yield benefits over the entire life of a business); *id.* at 313 (finding that start-up costs "were 'advance payments in contemplation of future benefits'") (quoting Sw. Hotel Co. v. United States, 115 F.2d 686, 688 (5th Cir. 1940)).

32. *See* I.R.C. § 263(a) (2006 & Supp. 2009) (denying a deduction for capital expenditures); INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 87 (1992) (describing how the realization of significant future benefits might require the capitalization of incurred costs).

33. *See Richmond Television*, 345 F.2d at 907 (describing start-up costs for staff training as being "in all regards the acquisition of a capital asset whose value to the taxpayer would continue for many years"); *Hardy*, 93 T.C. at 690 (describing start-up costs as "inherently capital because they are expenses of creating or acquiring a capital asset").

34. *See Johnsen*, 794 F.2d at 1162 ("An immediate deduction for expenses incurred before an enterprise has begun actual business operations is inappropriate because the expenses are part of the cost of establishing the enterprise."); Aboussie v. United States, 779 F.2d 424, 428 n.6 (8th Cir. 1985) (characterizing start-up costs as amounts incurred to establish a business).

capitalization generally seeks to match costs with their associated benefits,[35] the courts required capitalization of start-up costs to prevent distortions of taxpayers' incomes.[36] Capitalization principles, therefore, suggest that deductions for start-up costs should occur as a taxpayer realizes benefits from the activities that generated those costs (i.e., once the business begins) rather than when the costs were paid or incurred.[37]

Although the idea of avoiding income distortion gave a more principled rationale for denying immediate deductions for start-up costs, the Code contained no mechanism prior to 1980 that would have permitted a recovery of capitalized start-up costs once a business actually began.[38] As a result, prior to 1980, a taxpayer would have found that the pre-opening expense doctrine effectively precluded a deduction for start-up costs both before and after a business began. In other words, taxpayers had to capitalize their start-up costs permanently.[39]

In contrast, a taxpayer expanding its existing business faces no similar obstacles in deducting comparable costs. By conducting an established business, a taxpayer satisfies the Code's "carrying on" requirement, which one rationale of the pre-opening expense doctrine had used to prevent taxpayers from

35. *See INDOPCO*, 503 U.S. at 84 ("[T]he Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."); *see also* Lychuk v. Comm'r, 116 T.C. 374, 384 (2001) (describing the principal difference between a capital expenditure and business expense as the timing of cost recovery).

36. *See, e.g.,* Cent. Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984) (denying a deduction for investigatory and pre-opening costs incurred to open branch banks due the potential distortion of income that would result for amounts paid to "procure benefits that endure for the life of the branch"); *Fishman,* 837 F.2d at 312 ("[S]ome of the expenses of carrying on a trade or business could be incurred before the trade or business went into operation. [The denial of a deduction for such expenses] has everything to do with the basic principle of tax law that . . . income and expense must be matched temporally in order to minimize the inevitable misallocations of resources that a taxing system creates."); *Richmond Television,* 345 F.2d at 907 (describing an attempt to match income and expense in order to tax net income).

37. Lee, *supra* note 30, at 5.

38. *See* Jackson v. Comm'r, 86 T.C. 492, 517-18 (1986) (denying future amortization deductions for pre-opening advertising costs where a taxpayer could not demonstrate their ascertainable useful life); X-Pando Corp. v. Comm'r, 7 T.C. 48, 53-54 (1946) (denying amortization deductions for pre-opening costs capitalized to a business development account where a taxpayer could not establish a statutory basis for amortizing something akin to self-created goodwill); *cf. Fishman,* 837 F.2d at 314 (questioning whether a partnership could amortize start-up costs, in a pre-section 195 context, over the useful life of a shopping center created by the partnership); Blasius v. Comm'r, 90 T.C.M. (CCH) 274, 281 (2005) (describing § 195 as introducing amortization for investigatory and pre-opening costs that a taxpayer would otherwise not have recovered without disposing of a new business).

39. Lee, *supra* note 30, at 3-4.

claiming deductions relative to new businesses.[40] Moreover, the ongoing operation of an existing business minimizes the concerns about income distortion raised by the other rationale of the doctrine because expansion costs arguably benefit the current operation of a business.[41] Expansion costs can provide insignificant future benefits so a current deduction produces better matching.[42] Accordingly, courts have likened business expansion costs to other currently deductible costs that a taxpayer routinely incurs to protect, promote, and defend an existing business.[43] Therefore, a taxpayer expanding an existing business can deduct a cost that another taxpayer with a new business would have permanently capitalized under the pre-opening expense doctrine.[44]

In 1980, Congress enacted § 195 to specifically address the treatment of start-up costs.[45] Although Congress codified the pre-opening expense doctrine in § 195,[46] it also used § 195 to alleviate the problem of permanent capitalization insofar as that

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40. *Id.* at 3.

41. As noted above, this Article generally does not include capital expenditures in its references to costs. *See supra* note 22 and accompanying text. Thus, a taxpayer with an existing business might deduct costs for advertising, but not costs for a new building, even though the advertising and building both could facilitate a business expansion. *See* FMR Corp. v. Comm'r, 110 T.C. 402, 429 (1998) ("Under petitioner's reasoning, *any* expenditure incurred in the expansion of an existing business would be deductible. Obviously this is not a proper interpretation of the law."). Thus, this Article assumes that the costs of an expanding business otherwise qualify for deduction under § 162. *See generally* Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971) (describing a deductible item as being: (i) paid or incurred during the taxable year, (ii) for carrying on a trade or business, (iii) an expense, (iv) necessary for the trade or business, and (v) ordinary in the trade or business).

42. *See* Rev. Rul. 00-4, 2000-1 C.B. 331, 332 (acknowledging that, with respect to efforts to expand an existing business, "the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits").

43. *See* Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 783 (2d Cir. 1973) ("Every business entity, to remain viable, must continue to promote the sale of its product."); NCNB Corp. v. United States, 684 F.2d 285, 290 (4th Cir. 1982) (noting, in the context of a bank's activities to develop and operate a statewide branch banking network, "[i]t is a long recognized principle of tax law that expenditures for the protection of an existing investment, the continuation of an existing business, or the preservation of existing income from loss or diminution are ordinary and necessary business expenses within the meaning of IRC § 162.").

44. *Compare* Lee, *supra* note 30, at 3-4 (stating that, unlike "ordinary and necessary expenses of carrying on a trade or business," start-up costs for a new business have traditionally not been deductible), *with NCNB Corp.*, 684 F.2d at 290 (en banc) (noting that, in regards to a bank's activities to develop a statewide network, an expenditure "for the protection of an existing investment, the continuation of an existing business, or the preservation of existing income from loss or diminution are ordinary and necessary business expenses within the meaning of I.R.C. § 162").

45. *See* Lee, *supra* note 30, at 6.

46. *See* I.R.C. § 195(a) (2006 & Supp. 2009) (prohibiting deductions for start-up expenditures).

section permits taxpayers to amortize qualified start-up expenditures.[47] Through amortization, Congress generally sought to reduce controversies between the Service and taxpayers regarding the treatment of start-up costs.[48] Amortization was also thought to provide taxpayers starting new businesses with an incentive of cost recovery comparable to that enjoyed by taxpayers expanding their businesses.[49]

Controversies had arisen frequently because the prospect of having to capitalize start-up costs permanently under the pre-opening expense doctrine had placed undue emphasis on determining the dates when businesses began.[50] The pre-opening expense doctrine would not have precluded deductions once a business began because a taxpayer would thereafter pay or incur costs in carrying on that business.[51] Thus, the start of a business meant the difference between permanently capitalizing and immediately deducting costs.[52] The prospect of avoiding permanent capitalization encouraged taxpayers to argue that their businesses began as soon as possible so they could begin deducting their costs.[53] Controversies arose as taxpayers—seeking to deduct amounts that, prior to the enactment of § 195, would have been otherwise non-recoverable—asserted that their new businesses began at earlier dates than the Service would accept.[54] Section 195 offered amortization for start-up expenditures to reduce controversies by minimizing both the risk of permanent capitalization and the impulse of taxpayers to

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47. *See* I.R.C. § 195(b)(1) (providing an election to deduct start-up expenditures). *Compare* American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902(a)(1), § 195(b)(1), 118 Stat. 1418, 1651 (2004) (allowing a taxpayer to immediately deduct up to $5000 of start-up expenditures and amortize any remainder over a 180-month period through a 2004 amendment), *with* I.R.C. § 195 (1982), *amended by* I.R.C. § 195(b)(1) (2006) (stating that (prior to amendment) a taxpayer would have amortized start-up expenses over a period of sixty months (or more)).

48. *See* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980).

49. *See* H.R. REP. NO. 96-1278, at 10; S. REP. NO. 96-1036, at 11.

50. *See, e.g.,* Richmond Television Corp. v. United States, 345 F.2d 901, 905 (4th Cir. 1965) (finding that, in regards to preparatory expenses, "[t]he issue therefore is at what point of time did its business begin, and whether at this doubtful, prefatory stage it was carrying on a business"), *vacated and remanded per curium on other grounds*, 382 U.S. 68 (1965), *reaff'd on remand,* 354 F.2d 410 (4th Cir. 1965).

51. *See id.* at 904.

52. *See id.* at 905.

53. *See id.* at 904, 907 (stating that, to qualify for the deduction, "expenses must be . . . incurred in carrying on a trade or business," which does not begin "until such time as the business has begun to function as a going concern").

54. *See, e.g., id.* at 907 (finding that a television broadcasting business did not begin prior to securing a license and beginning to broadcast).

pursue aggressive positions in identifying dates when their businesses began.[55]

Section 195 established comparable treatments for costs paid or incurred by expanding and new businesses through its definition of start-up expenditures as well as its amortization provision.[56] The statute generally defines start-up expenditures as those amounts that (i) a taxpayer paid or incurred to create or to investigate the "creation or acquisition of an active business" and (ii) a taxpayer with an existing business could deduct.[57] Thus § 195 derives comparability by linking start-up expenditures to the ordinary and necessary business expenses[58] of an expanding business, regardless of whether they are investigatory or pre-opening in nature.[59] As a result, § 195 does not make more costs eligible for amortization than are deductible by an expanding business, but it ensures that costs considered deductible by an expanding business are considered amortizable by a new business too.[60] At the same time, amortization helped

55. *Compare id.* at 907 (noting the importance of the timing of when business begins), *with* Lee, *supra* note 30, at 5-6 (stating that the amortization feature of § 195 was implemented to counteract both the inequities present in the then-current system and the controversy and confusion caused by the inequities).

56. *See* I.R.C. § 195(b)-(c) (2006 & Supp. 2009).

57. *See* I.R.C. § 195(c)(1); *see also* I.R.C. § 163(a) (2006) (covering interest payments); I.R.C. § 164 (2006) (covering taxes); I.R.C. § 174 (2006) (covering research and experimental expenditures). *But see* I.R.C. § 195(c)(1)(B) (excluding amounts deductible under § 163(a) (interest payments), § 164 (taxes), or § 174 (research and experimental expenditures) from the definition of start-up expenditures).

58. *See generally* I.R.C. § 162(a) (2006 & Supp. 2009) (allowing a deduction for ordinary and necessary business expenses paid or incurred in carrying on a trade or business); *see also* T.D. 9107, 2004-1 C.B. 447, 454-55 (explaining the correlation between § 195 and §§ 162 and 263).

59. *See* I.R.C. § 195(c)(1); *see also* I.R.S. Priv. Ltr. Rul. 99-01-004 (Sept. 28, 1998) (acknowledging the pre-opening expense doctrine in that "the purpose of section 195(c)(1)(B) is to limit amortization to those expenditures that otherwise would not be deductible solely because the taxpayer did not meet the 'carrying on' requirement of section 162 (i.e., because the expenses were incurred prior to the commencement of business operations)"). Prior to the amendment of 1984, § 195 had defined start-up expenditures, in part, as amounts that a taxpayer could deduct "in connection with the expansion of an existing trade or business." I.R.C. § 195(b)(2) (1982), *amended by* I.R.C. § 195(c)(1)(B) (Supp. I 1984). The amendment replaced the quoted language with "in connection with the operation of an existing active trade or business." Congress apparently intended to use the term "operation" to define start-up expenditures by reference to costs paid or incurred either to operate or expand an existing business. *See* STAFF OF THE J. COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, H.R. Doc. No. 4170, at 295-96 (2d Sess. 1984).

60. *See* FMR Corp. v. Comm'r, 110 T.C. 402, 429 n.20 (1998) (noting that, by referencing investigatory costs that are deductible in nature, the legislative history to § 195 creates "the [inescapable] implication . . . that there are other investigatory costs which are not deductible, i.e. are to be capitalized") (citing NCNB Corp. v. United States, 684 F.2d 285, 295 (4th Cir. 1982)); *see also* Duecaster v. Comm'r, 60 T.C.M. (CCH) 917,

lessen an apparent pre-section 195 advantage that a taxpayer with an expanding business had through its ability to deduct certain costs that another taxpayer starting a new business would otherwise have been required to capitalize permanently under the pre-opening expense doctrine.[61]

The comparability produced by § 195 underscores the significance of determining the context in which a taxpayer pays or incurs costs. Costs paid or incurred in connection with any new business, even a new business relative to a taxpayer's existing business(es),[62] might constitute amortizable start-up expenditures.[63] In contrast, the same costs paid or incurred in connection with an expanding business might constitute deductible business expenses.[64] Thus any taxpayer with an existing business, regardless of the size and scope of current operations, must consider whether the costs of growth activities reflect attempts to start a new business—such that the costs are potentially amortizable under § 195—or to expand the existing business—such that the costs are deductible under § 162.[65]

For a taxpayer with start-up expenditures, § 195 provides an election to deduct those expenditures, primarily through amortization, once the new business begins.[66] This amortization

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920 (1990) ("Nothing in the statute or legislative history suggests that section 195 was intended to create a deduction, by way of amortization, in respect of an item which would not, in any event, have been deductible under prior law.").

61. *See* H.R. REP. NO. 96-1278, at 10 (1980) (expressing a belief that amortization would encourage new business formations); *see also* S. REP. NO. 96-1036, at 11 (1980).

62. *See* Butler v. Comm'r, 36 T.C. 1097, 1107 (1961) (concluding that "it is well settled that a taxpayer may engage in more than one trade or business (profession) for income tax purposes").

63. *See* I.R.C. § 195 (2006 & Supp. 2009).

64. *See* I.R.C. § 162 (2006 & Supp. 2009).

65. *Cf.* Larsen v. Comm'r, 89 T.C. 1229, 1278 (1987) ("We believe it strains credulity to think that a taxpayer who is engaged in one business and who commences an entirely new business or activity for income production totally unrelated to, and unconnected with, the taxpayer's initial activity should have a privilege granted to the former business extended to the latter."), *aff'd in part and rev'd in part on other grounds*, 909 F.2d 1360 (9th Cir. 1990).

66. *See* I.R.C. § 195(b)(1)(A) (2006 & Supp. 2009). For costs paid or incurred before October 23, 2004, a taxpayer could have amortized start-up expenditures over a period of sixty months (or more). *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902(a)(1), § 195(b)(1), 118 Stat. 1418, 1651 (2004); *see also* I.R.C. § 195(b)(1) (1982), *amended by* I.R.C. § 195(b)(1) (2000 & Supp. 2004). In 2004, Congress amended § 195 to allow a taxpayer generally to deduct $5,000 of start-up expenditures immediately and amortize any remainder over a 180-month period. *See* I.R.C. § 195(b)(1)(A)(ii), (B) (2000 & Supp. 2004). The $5,000 amount, however, is reduced dollar-for-dollar to the extent a taxpayer's total start-up expenditures exceed $50,000. *See* I.R.C. § 195(b)(1)(A)(ii), (B). Congress believed the amendment would encourage the formation of new businesses with insignificant start-up expenditures and would establish a more consistent amortization period for intangibles. *See* S. REP. NO. 108-192, at 197 (2003). For convenience, this Article refers to all cost recovery under § 195 as amortization, unless otherwise noted.

effectively permits a taxpayer to recover start-up expenditures over the first one hundred eighty months (i.e., fifteen years) of business operations[67]—which was recently lengthened from sixty months (i.e., five years)[68]—even though such costs were not immediately deductible when paid or incurred.[69] Amortization under § 195 thus provides less favorable treatment for start-up expenditures than an immediate deduction under § 162 for business expansion expenses.[70] But § 195 offers more relief from and achieves better matching than permanent capitalization under the pre-opening expense doctrine.[71]

B. *Confusion in the Practical Application of § 195*

The ostensibly simple treatment provided by § 195 for start-up expenditures, particularly relative to its intended goal of reducing controversies, masks three troubling aspects of its practical application. Specifically, a taxpayer might struggle to determine whether various activities or pursuits constitute a new business, when any new business begins, and what start-up costs an expanding business could have deducted. Although this Article does not attempt to answer these questions, it explores them briefly to describe the context in which a taxpayer with an existing business must determine the tax treatment for its investigatory costs.

1. Is an Activity or Pursuit a New Business?

Unless it has conducted no prior business activity, a taxpayer is likely ill equipped to determine whether an activity or pursuit has resulted in the creation or acquisition of a new business. In the above-referenced example of a taxpayer's initial entrepreneurial venture in a basement, the taxpayer should understand that there is no existing business to expand. Thus, activities associated with that venture necessarily represent the start of a new business for that taxpayer.[72] But where a taxpayer has an existing business, the taxpayer could only characterize its activities or pursuits after considering their

67. The taxpayer might qualify for a loss deduction under § 165 for unamortized start-up expenditures upon a complete disposition of the new business prior to the end of the 180-month period. I.R.C. § 195(b)(1)(B), (2).

68. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902(a)(1), § 195(b)(1), 118 Stat. 1418, 1651 (2004).

69. *See* I.R.C. § 195(b)(1)(B).

70. *See id.*

71. *See supra* text accompanying notes 55-60.

72. *See* Bailey v. Comm'r, No. 13014-05S, 2007 WL 987797, at *4-5 (Tax Ct. Apr. 3, 2007).

comparable and distinguishable features relative to the existing business.[73]

For a taxpayer with an existing business, the characterization of a new activity or pursuit as a business start-up or a business expansion depends on how closely the new activity or pursuit resembles the existing business.[74] The Service has stated:

> If two separate activities or pursuits are related in such a fashion that the average trade or business in a particular field of endeavor that includes one of the activities would be likely to include the other, and could be included as a matter of course, then it would be reasonable to conclude that the other pursuit or activity is not a new and additional trade or business. If, however, substantial amounts of new skills and expertise are required to enable the existing trade or business to include the other activity or pursuit, then it would be reasonable to conclude that the other activity is a new and trade or business for purposes of section 162 of the Code.[75]

Even though the Service implies that it assigns new business characterizations by looking at "average" businesses in relevant fields, conclusions about the relatedness of activities or pursuits have often simply depended on what features the government chose to emphasize.[76] For example, the Service has indicated that various means used to enlarge an existing customer base can represent the expansion of an existing business, including "adding a new product, opening new stores, outlets or branches, or by changing [a] marketing strategy."[77] At other times, the Service has used a two-part approach of asking if the taxpayer was organized to conduct and has been engaged in

73. *See id.*

74. *See* Krebs v. Comm'r, 63 T.C.M. (CCH) 2413, 2421 (1992) ("We reject the notion of a generic entrepreneur with all enterprises being a part of an ongoing business.").

75. I.R.S. Priv. Ltr. Rul. 93-10-001 (Nov. 4, 1992); *see also* I.R.S. Gen. Couns. Mem. 35,116 (Nov. 14, 1972).

76. *See, e.g.,* Duffy v. United States, 690 F.2d 889, 894 (Ct. Cl. 1982) (per curium) (rejecting the government's new business characterization whereby the government attempted to distinguish between a business of constructing hotels for operation by others and a business of constructing hotels for operation by a taxpayer).

77. I.R.S. Tech. Adv. Mem. 93-31-001 (Apr. 23, 1993) (citing NCNB Corp. v. United States, 684 F.2d 285, 290 (4th Cir. 1982)); *see also* Malmstedt v. Comm'r, 578 F.2d 520, 525 (4th Cir. 1978); Colo. Springs Nat'l Bank v. United States, 505 F.2d 1185, 1190 (10th Cir. 1974); Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (2d Cir. 1973).

the new activity or pursuit and, if not, considering whether the new activity or pursuit is within the "compass" of the existing business.[78] The Service apparently measures such compass with respect to "the limits of the typical . . . enterprise" within an industry.[79]

Unfortunately, these measures give little indication about how a taxpayer should identify a new business. For example, in considering the deductibility of investigatory costs, the Tax Court has broadly questioned whether a new activity or pursuit was "sufficiently different" from an existing business to support a new business characterization.[80] In that regard, the court concluded that the publication of a book examining the history of political corruption in the United States represented a new business for a taxpayer that had already published a book providing a historical perspective of contemporary music.[81] The court chose to emphasize the close relationship between the musically-orientated book and another role of the taxpayer in managing and promoting rock and pop performers over the similarity between the taxpayer's two book-publishing ventures.[82]

A business expansion characterization seems most supportable where a taxpayer conducts the exact same business in a new geographic location. The compass of a business is generally not site specific.[83] So an extension of ongoing activities to a new location reasonably appears to represent an expansion of the existing business.[84] Although a pure geographic extension

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78. I.R.S. Tech. Adv. Mem. 93-10-001 (Nov. 4, 1992) (finding that a rendering of consulting services to third-party hospitality-related companies differed from a taxpayer's activities in providing meals and lodging in the taxpayer's own hospitality business and that the consulting services were not within the hospitality industry's compass); *see also* I.R.S. Gen. Couns. Mem. 35,116 (Nov. 14, 1972) (concluding that differences in expertise and management used in credit card operations, as well as the limited affiliation of banking institutions with major credit card systems prior to 1967, more reasonably supports treating a new credit card system as a new business rather than as a cultivated sector within the taxpayer's commercial banking field).

79. I.R.S. Gen. Couns. Mem. 35,116 (Nov. 14, 1972) (citing York v. Comm'r, 261 F.2d 421, 422 (4th Cir. 1958)); *cf.* Haskins v. Comm'r, 45 T.C.M. (CCH) 359, 361 n.5 (1982) (questioning whether a new project had "sufficient nexus" to prior business activities to support a business expansion characterization).

80. Krebs v. Comm'r, 63 T.C.M. (CCH) 2413, 2421 (1992).

81. *See id.* at 2420-21.

82. *See id.*

83. *See* I.R.S. Tech. Adv. Mem. 93-10-001 (Nov. 4, 1992).

84. *See, e.g.*, Rev. Rul. 56-181, 1956-1 C.B. 96 (allowing a deduction for advertising costs incurred to establish new sales territories for a manufacturer's products); I.R.S. Tech. Adv. Mem. 82-04-061 (Oct. 28, 1981) (refusing to apply a new business characterization to a taxpayer's first manufacturing facility located in the eastern part of the United States that manufactured the same products that the taxpayer produced elsewhere, despite the facility's use of computerized and automated devices); I.R.S. Tech.

arguably provides the cleanest example of an expanding business,[85] it might give little comfort whenever taxpayers cannot claim that their new operations are exactly the same. Any operational changes at the new location might constitute a "sufficiently different" factor that could result in an activity or pursuit being characterized as a new business.[86]

Thus, a more interesting situation frequently arises in which a taxpayer must decide whether the sale of identical products in a new way, such as through different distribution channels, represents a new business. For example, the seminal business expansion case *Briarcliff Candy Corp. v. Commissioner*[87] examined a refocusing of sales efforts from a retail market to a wholesale market. In that case, the taxpayer undertook a program to enfranchise independent suburban retail outlets for its products in reaction to a demographic shift of its customer base from the urban locations of its retail stores to suburban areas.[88] Although twenty percent of the taxpayer's sales had been to wholesale customers prior to this undertaking, the taxpayer established a separate "franchise" division and commenced an extensive advertising campaign to enlist new retail outlets as part of this program.[89] The Second Circuit concluded that the taxpayer's promotional costs represented deductible business expenses incurred to protect, continue, and preserve an existing business.[90] In reaching that conclusion, the court observed that the taxpayer continued to sell the same products under this program and that the taxpayer had a long established policy of making sales in retail and wholesale markets.[91] The court found the new division and promotional campaign used to stimulate sales of existing products clearly

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Adv. Mem. 84-23-005 (Feb. 8, 1984) (characterizing an opening of new stores, which sold products identical to those sold by a taxpayer's existing stores, as a business expansion).

85. *See* I.R.S. Tech. Adv. Mem. 81-41-033 (June 30, 1981) (Concluding that the creation of new branches of an existing banking business represented a business expansion because the "business activity . . . remained the same . . . . It involved extending credit to customers and receiving deposits. That activity was conducted in the same manner at the main office and at the branch facilities. The taxpayer only geographically added to the locations at which it operated its pre-existing business.").

86. *See, e.g.*, Francis v. Comm'r, 36 T.C.M. (CCH) 704, 707 (1977) (dictum) (characterizing the development and construction of a rental apartment complex as a new business for a taxpayer because it was not "an integral part or extension of an unrelated and geographically removed rental property" operated by the taxpayer).

87. Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 777 (2d Cir. 1973).

88. *See id.* at 777.

89. *See id.*

90. *See id.* at 787.

91. *See id.* at 781.

distinguishable from efforts to sell new or different products;[92] accordingly, the court attributed the costs to the taxpayer's existing business.

Subsequent guidance suggests that the Service considers the taxpayer's prior (albeit somewhat limited) experience with wholesale distribution in *Briarcliff Candy* as the primary basis for the court's business expansion characterization.[93] For example, in response to a request for technical advice, the IRS National Office considered whether § 195 applied to a taxpayer—as a traditional manufacturer and wholesale distributor of products—that established a new division to sell the same products through wholly-owned retail stores.[94] In determining whether the retail pursuit represented a new business for the taxpayer, the Service noted "it is appropriate to look for a change in the nature of the activities engaged in by the entity."[95] Applying this standard, the Service summarily found that the activities of a retail operation were "substantially different" than those of manufacturing and wholesaling operations.[96] Accordingly, the Service concluded that the costs of the first retail store were properly classified as start-up expenditures under § 195.[97] The Service also concluded that the costs attributable to opening additional retail stores, which the taxpayer established under consistent operating procedures, qualified as deductible business expansion expenses.[98] Therefore, the Service appears to identify a new business by

92. *See id.* at 782-83 ("Every new idea and every change of method in making sales, even in promoting special sales or developing new sales territory, do not require that the expenses connected with the operation be non-deductible under § 162."); *see also* NCNB Corp. v. United States, 684 F.2d 285, 292 (4th Cir. 1982) (finding the investigation of new branch locations constituted expansion of a taxpayer's existing banking business).

93. I.R.S. Priv. Ltr. Rul. 93-31-001 (Apr. 23, 1993); *see also* Colo. Springs Nat'l Bank v. United States, 505 F.2d 1185, 1190-91 (10th Cir. 1974) (citing *Briarcliff* as a "more pertinent decision").

94. *See* I.R.S. Priv. Ltr. Rul. 93-31-001 (Apr. 23, 1993).

95. *Id.* at *7 (citing Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228-29 (1985)); *see also* Radio Station WBIR v. Comm'r, 31 T.C. 803, 813 (1959).

96. *See* I.R.S. Priv. Ltr. Rul. 93-31-001 (Apr. 23, 1993).

97. *See id*; *but see* Equitable Life Ins. Co. v. Comm'r, 36 T.C.M. (CCH) 1184, 1189 (1977) (concluding that the business of a wholly owned subsidiary corporation included a private sale of variable annuity contracts to its parent corporation as well as public sales of such contracts because its business was "simply *sales* of such contracts" (emphasis added)); *cf.* I.R.S Field Serv. Adv. Memo. 96-576 (Sept. 4, 1996), *available at* 1996 FSA LEXIS 576 (noting that a new division's sale of "somewhat different" products—notably upscale products under a new trademark, which arguably represented an attempt to differentiate such products—and "separation somewhat" from the operations of the taxpayer's existing division—through different sales and service support in the field—was not enough to conclude that the taxpayer entered into a new business).

98. *See* I.R.S Priv. Ltr. Rul. 93-31-001 (Apr. 23, 1993).

emphasizing those activities a taxpayer performs rather than the products, services, and markets the taxpayer pursues.[99]

A focus on the operational nature of a new activity or pursuit can lead to problems in defining the compass of a taxpayer's existing business. These problems surfaced in the so-called "credit card cases," wherein several courts rejected the Service's attempt to characterize banks' implementations of credit card systems as developments of new areas or lines of business apart from their existing banking businesses.[100] The courts essentially were asked to decide whether a bank is expected to offer credit cards as part of its business.[101] By comparing the offerings of credit cards to the functions historically performed by banks in extending lines of credit and making loans on accounts receivable, the courts concluded that credit cards simply used a new method and technological advancements to conduct a traditional lending business.[102] Those conclusions might seem obvious today, but the courts' approach of having to evaluate functions, methods, and technologies as they emerge becomes unwieldy for a taxpayer trying to define the compass of a business. In particular, the compass of a business is difficult to define where a taxpayer traditionally has operated in a rapidly changing industry with diverse competitors.[103] Consider, for example, defining an expected compass for a telecommunications business in light of converging mediums, advancing technologies,

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99. *See id.*

100. *See* Colo. Springs Nat'l Bank v. United States, 505 F.2d 1185, 1190-91 (10th Cir. 1974); First Sec. Bank of Idaho v. Comm'r, 592 F.2d 1050, 1052 (9th Cir. 1979); Iowa-Des Moines Nat'l Bank v. Comm'r, 592 F.2d 433, 434 n.1 (8th Cir. 1979); First Nat'l Bank of S.C. v. United States, 413 F. Supp. 1107, 1110 (D.S.C. 1976), *aff'd per curiam*, 558 F.2d 721 (4th Cir. 1977).

101. *See Colo. Springs Nat'l Bank*, 505 F.2d at 1188; *First Sec. Bank of Idaho*, 592 F.2d at 1052; *Iowa-Des Moines Nat'l Bank*, 592 F.2d at 434; *First Nat'l Bank of S.C.*, 413 F. Supp. at 1108.

102. *See Colo. Springs Nat'l Bank*, 505 F.2d at 1191 ("[W]e have an established bank which adopted a new method, use of cards and computers, to conduct an old business, financing of consumer transactions."); *Iowa-Des Moines Nat'l Bank*, 592 F.2d at 436 (finding an extension of the banking business); *First Nat'l Bank of S.C.*, 413 F. Supp. at 1110 ("The conclusion is inescapable that banks such as this taxpayer which enter the credit card field are simply expanding the scope and profitability of their existing business and are not establishing or attempting to establish a new business."); First Sec. Bank of Idaho v. Comm'r, 63 T.C. 644, 649 (1975) (concurring with the reasoning in *Colo. Springs Nat'l Bank*), *aff'd*, 592 F.2d 1050 (9th Cir. 1979); *cf.* I.R.S. Tech. Adv. Mem. 80-36-008 (May 29, 1980) (characterizing an electronic fund transfer service as merely a new method of conducting a business that had previously used a paper recording system).

103. *See* Ritsuko Ando, *Tech Execs See Convergence Lifting Broadband Demand*, DOW JONES FACTIVA, June 20, 2007, http://www.reuters.com/article/technologyNews/idUSN1846685020070621.

and encroaching competitors; what exactly are the parameters for the business of a cellular phone company?[104]

Even if taxpayers avoid unwittingly characterizing their activities as new,[105] any operational change in providing the same goods or services might result in a new business characterization. For example, the United States Claims Court in *Cleveland Electric Illuminating Co. v. United States* considered whether the generation of electricity through a nuclear-powered plant represented a new business for an electric utility that previously used only coal-powered plants.[106] Although the nuclear plant generated the same end product as the utility had generated in its existing coal facilities (electricity), the court characterized the nuclear operations as a new business in dictum.[107] To support this characterization, the court highlighted the greater degree of employee training required to operate a nuclear plant safely; the different means of producing heat, which in turn creates steam to drive turbines, in the nuclear and coal plants; and the additional support systems required in nuclear-powered plants.[108] Those factors led the court to conclude that, by acquiring a nuclear-powered plant to complement existing coal-powered plants, the utility entered a new business.[109] Thus, a change in the manner of conducing business operations, arguably to an extent beyond merely keeping up with technological advances,[110] can represent a new business even when a taxpayer incorporates the change while offering the same product to its customers. Under this

104. *See id.* (describing all-in-one gadgets that combine telephone, music, and video capabilities, advanced internet capabilities for carrying high bandwidth services, and competition from cable television providers with bundled video, phone, and internet services).

105. *See, e.g.*, I.R.S. Tech. Adv. Mem. 95-44-001 (Nov. 3, 1995) (attributing characterizations about a "radical redesign" and "fundamental change in the business processes" to statements made by the taxpayer).

106. Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228-29 (1985).

107. *See id*; *but see* I.R.S. Tech. Adv. Mem. 75-09-099 (Sept. 9, 1975) (describing a taxpayer's conduct of an existing business as the production of electricity, regardless of whether the production facility used nuclear or conventional fuels). The court's primary reason for requiring the capitalization of the employee training costs associated with the nuclear-powered plant was that the utility acquired the turnkey operations of the nuclear facility, including a trained workforce. *Cleveland Elec.*, 7 Cl. Ct. at 227. The court concluded that costs associated with acquiring tangible and intangible assets of a going concern represent capital expenditures. *Id.*

108. *Cleveland Elec.*, 7 Cl. Ct. at 229.

109. *Id.*

110. *Cf. id.* at 234 (concluding that the utility's construction of a larger, more modern coal-powered plant did not represent a new business to the utility because the larger size and the incorporation of modern features, which were not available when the other coal plants were built, did not constitute differences in kind).

reasoning, one might even ask whether the introduction of computers to a law office, with the accompanying training and support staff, represents a new business in the context of practicing law.

These descriptions of situations, where a need to distinguish between new and expanding businesses has arisen, sufficiently illustrate that such characterizations are usually difficult to make. Due to vague and inconsistent authority and guidance, taxpayers unfortunately cannot attribute much confidence to their fact-specific characterizations about particular activities and pursuits. Nevertheless, for a taxpayer with an existing business, the characterization of any new activity or pursuit represents a threshold requirement for determining whether particular investigatory costs are deductible under § 162 or are amortizable under § 195.[111]

2. Has a Business Started?

Solely from the perspective of § 195, the start of a business represents a significant event because it establishes the time after which a taxpayer no longer pays or incurs start-up costs and when the taxpayer can begin amortizing start-up expenditures.[112] Although the statute provides that a taxpayer can begin amortizing its expenditures when an active business begins,[113] how a taxpayer identifies that event is not always clear. The statue simply equates the date on which an acquired business begins with the date of its acquisition.[114] The date on which a created business begins, however, is often more difficult to assess. Unlike an acquisition, the creation of a business can lack a single identifiable event that clearly signifies its beginning.[115] Accordingly, § 195 does not directly address the

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111. I.R.C. § 162 (2006 & Supp. 2009); I.R.C. § 195 (2006 & Supp. 2009).

112. *See* I.R.C. § 195(b)(1)(B) (2006 & Supp. 2009) (providing an amortization period that starts with the month during which an active trade or business begins); *see also* I.R.C. § 195(b)(1)(A)(i)-(ii) (allowing for a deduction for start-up expenditures, not to exceed $5,000, for the taxable year during which an active trade or business begins).

113. I.R.C. § 195(b).

114. *See* § 195(c)(2)(B) (2006 & Supp. 2009); *see also* H.R. REP. NO. 96-1278, at 11-12 (1980) (considering economic substance in determining the month of acquisition); S. REP. NO. 96-1036, at 14 (1980). Note that a taxpayer must acquire an *active* business to have the business begin on acquisition (e.g., a taxpayer cannot acquire a pre-operational "business" to begin amortization under § 195) and presumably the acquired business must operate within the compass of the business that the taxpayer intends to enter (e.g., a taxpayer could not acquire an active business to secure technology needed for the taxpayer's intended operations in an unrelated field). I.R.C. § 195(b)(1)(A).

115. *See* I.R.C. § 195(c)(2)(B).

question, which has persisted since the pre-opening expense doctrine,[116] of when a created business begins.[117]

Taxpayers and the Service often can point to many factors that could suggest when created businesses begin for purposes of § 195. The Fourth Circuit articulated the predominant standard[118] for making a determination in *Richmond Television Corp. v. United States*:[119] a business begins when it "has begun to function as a going concern and performed those activities for which it was organized."[120] Although the application of this standard arguably varies by industry,[121] factors taken into account in its application could include having necessary assets in place, producing revenue, holding oneself out as being in business, and/or acting in accordance with a defined business purpose.[122]

The variety of factors that could impact applications of the *Richmond Television* standard fosters uncertainty about when created businesses begin. For example, the need to function as a going concern has been interpreted, at least in a manufacturing context, as requiring a taxpayer to have necessary operational assets in place as well as to have put those assets to productive use.[123] Although the Service presumably favors a productive use of such assets that is revenue generating,[124] a business can

116. *See supra* note 54 and accompanying text.

117. Although Congress granted the Treasury Department specific authority to prescribe regulations for determining when a created active trade or business begins, *see* I.R.C. § 195(c)(2)(A) (2006 & Supp. 2009), the Secretary deferred to case law to guide that determination. *See also* I.R.S. Priv. Let. Rul. 90-47-032 (Aug. 27, 1990).

118. A minority of courts have interpreted § 162 as permitting deductions for recurring costs as distinguished from start-up costs. *See, e.g.*, United States v. Manor Care, Inc., 490 F. Supp. 355, 359-62 (D. Md. 1980); Blitzer v. United States, 684 F.2d 874, 879-80 (Ct. Cl. 1982); I.R.C. § 162 (2006 & Supp. 2009).

119. Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965).

120. *Id.* at 907.

121. *See* TODD F. MAYNES ET AL., START-UP EXPENDITURES A-10 to -17 (T.M. Portfolio (BNA)) (534-3d 2008) (exploring the *Richmond Television* standard in the context of production, leasing, retailing, distribution, service, and other businesses).

122. *Id.*

123. *See* I.R.S. Priv. Ltr. Rul. 90-47-032 (Aug. 27, 1990) (concluding that a business began when a manufacturing process was ready to produce marketable products).

124. *See id.* (noting that the "going concern" standard of *Richmond Television* includes a requirement of generating revenue, such that a manufacturing entity begins its business when it "is ready to receive revenue for the sale of" its products); I.R.S. Tech. Adv. Mem. 90-27-002 (Mar. 6, 1990) (concluding that a business did not begin until a taxpayer marketed literary works); *cf.* Charlton v. Comm'r, 114 T.C. 333, 338 (2000) (concluding that a taxpayer's renovations of cabins did not constitute an active rental trade or business where the cabins were neither rented nor offered for rent).

generally function as a going concern before having any sales.[125] Taxpayers accordingly must determine tax consequences by pondering what assets are necessary to a business and how they are used.[126] The aspect of functioning as a going concern also ties into the question about whether a taxpayer has performed those activities for which it was organized, which in turn can depend on how the taxpayer defines its purpose. For example, Taxpayer A, which was expressly organized to develop, manufacture, and sell a product, arguably could begin its business by commencing with development activities (despite a lack of manufacturing and sales activities).[127] Taxpayer B, which was expressly organized to manufacture and sell a to-be-developed product, might not begin its business on the other hand until it can commence production (i.e., after Taxpayer B completes development).[128] Despite undertaking the same activities, Taxpayer A's business might begin before Taxpayer B's business due to the fact that Taxpayer A defined its business to include development whereas Taxpayer B did not.[129] Thus, the task of determining when a taxpayer's activities have sufficiently advanced to "establish the nature of its business operations"[130] can become quite difficult, particularly where an underlying business concept continues to evolve.[131]

As noted above, the start of a business also establishes a taxpayer's ability to claim deductions under § 162 for costs paid or incurred thereafter.[132] The Code permits deductions because, as originally explained by the pre-opening expense doctrine,[133] a taxpayer would meet the carrying on requirement once the business starts. The start of business thus signifies a point of

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125. Cabintaxi Corp. v. Comm'r, 63 F.3d 614, 620-21 (7th Cir. 1995) (finding that a taxpayer began its business with bona fide, yet completely unsuccessful efforts to sell a product).

126. *See* I.R.S. Priv. Ltr. Rul. 90-47-032 (Aug. 27, 1990).

127. *See* Lamont v. United States, No. 94-44T, 1997 WL 881204, at *6 (Fed. Cl. Oct. 17, 1997) (finding that a corporation, organized to develop software and to sell the software and services, began its business with software development because it was "precisely the purpose for which the corporation was organized").

128. *See* I.R.S. Priv. Ltr. Rul. 90-47-032 (Aug. 27, 1990) (concluding that a business began when a manufacturing process was ready to produce marketable products).

129. *See id.*

130. S. REP. NO. 96-1036, at 14 (1980).

131. *See* I.R.S. Priv. Ltr. Rul. 93-10-001 (Nov. 4, 1992) (concluding that, despite extensive development and marketing activities, a business of developing a mechanical service assessment system did not begin because the system continued to evolve in response to technological advancements and customer suggestions and the customers had not clearly identified the information and analysis they desired from such a system).

132. *Id.*

133. *See supra* notes 23-28 and accompanying text.

transition from including paid or incurred costs in amortizable start-up expenditures to deducting otherwise eligible costs under § 162.[134] Accordingly, investigatory costs that would have been treated as start-up expenditures could become deductible if a taxpayer starts the business to which they relate before paying or incurring the costs.[135]

In contrast, a taxpayer with an existing business does not care when it completes an expansion because its costs are deductible before, during, and after the expansion.[136] This disparity creates an opportunity for taxpayers to minimize the rigors and long amortization period of § 195 by conducting enough activities to start a business and then expanding that business afterward.[137] For example, a taxpayer might acquire a small operation in order to establish the start of its new business and thereafter deduct costs paid or incurred to investigate or otherwise expand that business through certain acquisitions[138] or development activities. Taxpayers in those situations (or their advisors) would find, most likely as an afterthought, some aspect of the acquired operation that could support a business expansion characterization to claim deductions for many investigatory costs.[139]

Therefore, a difficult factual determination about when a business begins triggers both the start of amortization for start-up expenditures under § 195 and establishes the earliest date when a taxpayer may begin deducting costs under § 162.[140] This determination is required from a taxpayer with no other business as well as from a taxpayer with an existing business that starts another.[141] So a taxpayer investigating a new opportunity faces

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134. *See* I.R.S. Field Serv. Adv. Memo. 99-18-013 (May 7, 1999), *available at* 1999 FSA LEXIS 013 (considering the potential application of § 195 moot after concluding that certain costs, such as training costs, were otherwise deductible under § 162). For a taxpayer that has failed to elect amortization under § 195 properly, the start of a business would further mean that the taxpayer would no longer need to capitalize its costs permanently. *Id.*

135. *See* I.R.C. § 195 (2006 & Supp. 2009) (stating when investigatory costs can be allowed as deductions).

136. *See* I.R.C. § 162 (2006 & Supp. 2009) (explaining how expense deductions are handled for taxpayers carrying on any trade or business).

137. *See generally* I.R.C. § 195.

138. *Cf.* Treas. Reg. § 1.263(a)-5(a) to (e)(1) (2004) (excepting certain costs paid or incurred to investigate or otherwise pursue so-called covered transactions from the capitalization requirements of § 263).

139. *See id.*

140. *See* I.R.S. Gen. Couns. Mem. 35,116 (Nov. 14, 1972).

141. *See* I.R.S. Tech. Adv. Mem. 93-31-001 (Apr. 23, 1993); *cf.* Cabintaxi Corp. v. Comm'r, 63 F.3d 614, 619 (7th Cir. 1995) ("But a firm that had income from one trade or business could, were it not for the rule that prevents the deduction of expenses incurred

difficult tasks, in determining how to treat any investigatory costs, of deciding whether the investigation could lead to a new business and, if so, whether the particular business to which the investigation relates has started.[142]

3. Could an Expanding Business Deduct the Costs?

Section 195 innocently defines start-up expenditures, in part, as costs that a taxpayer could otherwise deduct in connection with the operation of an existing business.[143] Because only costs associated with operating or expanding an existing business are deductible,[144] § 195 effectively equates the deductible costs of an expanding business with the start-up expenditures of a new business. Unfortunately, the start-up expenditure definition relies on a taxpayer's ability to determine what costs are deductible in a business expansion.[145] Such reliance has historically seemed misplaced.[146]

With § 162 serving as the reference point for § 195, a taxpayer starting a new business must struggle with general capitalization principles to identify any costs as start-up expenditures.[147] Historically, taxpayers and the Service have found it difficult to distinguish deductible expenses from capital expenditures in the context of an existing business, especially with respect to investigatory costs.[148] Moreover, a heightened awareness and aggressiveness of taxpayers with respect to capitalization issues, following *INDOPCO, Inc. v. Commissioner*,[149] led to considerable controversy in exploring the

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before the beginning of operations of the business to which the expenses pertain, deduct those expenses from that income, thus in effect postponing the realization for tax purposes of the income generated by the existing business.").

142. *See* I.R.S. Tech. Adv. Mem. 93-31-001 (Apr. 23, 1993).

143. *See* I.R.C. § 195(c)(1)(B) (2006 & Supp. 2009); *see also* Lee, *supra* note 30, at 105 ("This situation represents still another case of tacked-on reform producing the antithesis of simplification, i.e., unpredictability.").

144. *See supra* note 59 and accompanying text.

145. *See* Lee, *supra* note 30, at 105.

146. *See id.*

147. *See id.*

148. *Compare, e.g.*, NCNB Corp. v. United States, 684 F.2d 285, 285 (4th Cir. 1982) (allowing a deduction for investigatory costs incurred to expand an existing banking business through new branch locations), *with* Cent. Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1181 (5th Cir. 1984) (requiring capitalization for investigatory and pre-opening costs incurred to expand an existing banking business through a new branch location), *and* Ellis Banking Corp. v. Comm'r, 688 F.2d 1376, 1376 (11th Cir. 1982) (requiring capitalization for investigatory costs incurred in connection with an acquisition of a bank's stock whereby the acquisition was intended to facilitate an expansion into a new geographic market).

149. INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 79 (1992).

scope of deductible expenses for expanding businesses.[150] Unfortunately, a vague standard of requiring capitalization for costs that provide significant future benefits, as reiterated by the Court,[151] made it unclear what costs an existing business could deduct. That vagueness necessarily affected the identification of start-up expenditures under § 195.[152]

Final capitalization regulations recently published for intangibles[153] and transaction costs,[154] as well as proposed regulations for tangible property,[155] help clarify what costs of an expanding business are not deductible and thereby more readily establish costs ineligible for treatment as start-up expenditures under § 195. The final regulations generally operate by enumerating costs for which capitalization is required.[156] That approach arguably relieves the burden of applying ambiguous capitalization principles, such as *INDOPCO*'s significant future benefits standard, in determining deductibility.[157] Although the regulations were not intended to directly affect the application of § 195,[158] they create an indirect benefit by describing costs that a taxpayer with an expanding business must capitalize (i.e., costs that cannot qualify as start-up expenditures).[159]

To the extent recent capitalization regulations effectively address particular costs, taxpayers with new and expanding businesses enjoy greater certainty in identifying those costs eligible for deduction under § 162 and amortization under

150. *See, e.g.*, Wells Fargo & Co. v. Comm'r, 224 F.3d 874, 876-80 (8th Cir. 2000) (considering the deductibility of investigatory costs incurred by a target corporation); H.E. Butt Grocery Co. v. United States, 108 F. Supp. 2d 709, 709-10 (W.D. Tex. 2000) (addressing the deductibility of investigatory costs associated with a business expansion into Mexico); FMR Corp. v. Comm'r, 110 T.C. 402, 414 (1998) (considering the deductibility of costs incurred to expand through the creation of new mutual funds).

151. *See INDOPCO*, 503 U.S. at 87.

152. *See generally id.* at 87-90.

153. *See* Treas. Reg. § 1.263(a)-4 (2003).

154. *See id.* at 1.263(a)-5.

155. *See* Prop. Treas. Reg. § 1.263(a)-2, 73 Fed. Reg. 12,838 (Mar. 10, 2008).

156. *See* T.D. 9107, 2004-1 C.B. 447 ("[A]n amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure.").

157. *See id.* at 436-38.

158. *See* Guidance Regarding Deduction & Capitalization of Expenditures, 67 Fed. Reg. 77,701, 77,706 (Dec. 19, 2002) ("The proposed regulations do not affect the treatment of start-up expenditures under section 195.").

159. *See* T.D. 9107, 2004-1 C.B. 447, 451 (describing a concern expressed by commentators about taxpayers with expanding businesses having to capitalize costs incurred to investigate prospective contractual arrangements); *id.* at 454-55 (explaining the correlation between § 195 and §§ 162 and 263 with respect to transaction costs).

§ 195.[160] Unfortunately, the regulations still require a highly factual inquiry insofar as the eligibility of an investigatory cost for deduction or amortization could depend, for example, on what and when a taxpayer investigates[161] and how the taxpayer structures a transaction.[162] Consequently, capitalization remains an important, yet often imprecise, consideration in determining the treatment of investigatory costs for new and expanding businesses.

4. Summary

The above discussion briefly highlights several obstacles taxpayers encounter in applying simple concepts to actual business transactions. Although enacted under an admirable purpose of encouraging business formations,[163] § 195 effectively conditions amortization on the favorable resolution of intensive factual issues. Those issues include deciding whether a taxpayer has undertaken a new business, when the taxpayer began to conduct the business, and whether an existing business could have deducted comparable costs.[164] Because of the codification of the pre-opening expense doctrine, however, any taxpayer with a growing business must consider these issues too.[165] In particular, a taxpayer who seeks to deduct costs under § 162 must be able to substantiate that it expanded an existing business so its costs remain outside the scope of § 195 and that

160. *But see* Ethan Yale, *The Final* INDOPCO *Regulations*, 105 TAX NOTES 435, 476-77 (2004) (noting ambiguity created by a requirement to capitalize inherently facilitative costs paid or incurred to investigate an acquisition, which might inappropriately extend capitalization to amounts intended to qualify as start-up expenditures, and by "illogical" results flowing from the interaction of the capitalization regulations and § 195).

161. *Compare* Treas. Reg. § 1.263(a)-4(e)(1)(i) (2009) (describing capitalizable costs paid or incurred to facilitate an acquisition or creation of an intangible as including investigatory costs), *with* Treas. Reg. § 1.263(a)-4(e)(1)(iii) (2009) (excluding certain investigatory costs attributable to creating a contract from the capitalizable costs paid or incurred to facilitate its creation), *and* Prop. Treas. Reg. § 1.263(a)-2(d)(3)(ii)(C), 73 Fed. Reg. 12,838 (Mar. 10, 2008) (excluding certain investigatory costs attributable to acquiring real property from the capitalizable costs paid or incurred to facilitate its acquisition).

162. *Compare* Treas. Reg. § 1.263(a)-5(b)(1) (2009) (describing capitalizable costs paid or incurred to facilitate a transaction as including investigatory costs), *with* Treas. Reg. § 1.263(a)-5(e)(1) (2003) (excluding investigatory costs attributable to a so-called covered transaction from the capitalizable costs paid or incurred to facilitate the transaction).

163. *See* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980); *see also* S. REP. NO. 108-192, at 197 (2003) (explaining that the ability to immediately deduct the first $5,000 of start-up expenditures might encourage new business formations).

164. *See* I.R.C. § 195(c)(1) (2006 & Supp. 2009).

165. *See supra* note 65 and accompanying text.

the costs otherwise qualify as deductible business expenses.[166] As a result, taxpayers with existing businesses continue to face considerable uncertainty about how to treat their investigatory costs properly for tax purposes.[167]

III. UNCERTAINTY COMPOUNDED BY § 195 ELECTIONS

The elective nature of amortization under § 195 has compounded problems in dealing with investigatory costs for taxpayers with new businesses as well as for taxpayers with expanding businesses. Essentially, § 195 often forces taxpayers to decide whether to elect amortization for costs that the taxpayers are uncertain even qualify as start-up expenditures.[168] Although the process of filing an election statement had been the original source of many taxpayers' concerns, the recent establishment of deemed elections under § 195 makes the process easier but still leaves taxpayers to confront similar issues.[169]

A. *The Prior Election Statements under § 195*

For start-up expenditures paid or incurred before September 9, 2008,[170] taxpayers have generally been required to file election statements in order to claim amortization deductions under § 195. Although proper compliance with tax elections often eludes taxpayers, nuances with § 195 elections had potentially serious consequences for taxpayers seeking to amortize start-up expenditures.[171] Those consequences in turn might have unduly influenced a taxpayer's decision to characterize growth as the start of a new business as opposed to an expansion of an existing business.

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166. *See supra* notes 72-75 and accompanying text.

167. *See supra* notes 137-38 and accompanying text.

168. *See supra* notes 74-75 and accompanying text.

169. *See* Elections Regarding Start-Up Expenditures, Corporation Organizational Expenditures, and Partnership Organizational Expenses, 73 Fed. Reg. 38,910, 38,911 (July 8, 2008) (to be codified at 26 C.F.R. pt. 1) ("[A] taxpayer is no longer required to attach a statement to a return . . . for the election under section 195(b) to be effective."); *accord* I.R.C. § 195(b).

170. *See* Temp. Treas. Reg. § 1.195-1T(d) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

171. *See* Hefti v. Comm'r, 54 T.C.M. (CCH) 1555, 1570 n.31 (1988) ("Obviously, petitioners would not have made such an election where they deducted the full amount as an expense in the year of expenditure."); *see also* Walsh v. Comm'r, 55 T.C.M. (CCH) 994, 996 (1988) (recognizing that taxpayers failed to file an election statement under a mistaken belief that their costs were deductible, but denying their claims for any cost recovery due, in part, to their failure to make the election), *aff'd*, 884 F.2d 1393 (6th Cir. 1989).

The prior election procedures appeared fairly mild. A taxpayer had to prepare a statement that identified: (i) the relevant business to which an election related, (ii) the start-up expenditures associated with that business, (iii) the number of months in an applicable amortization period, and (iv) the month during which the business began (i.e., the first month of the amortization period).[172] The taxpayer then had to attach the election statement to a tax return filed no later than the extended due date for the taxable year during which the business began.[173] Ignoring the considerable tasks of determining what new businesses were started[174] and what costs qualified as start-up expenditures,[175] taxpayers usually could satisfy these procedural requirements easily,[176] with the possible exception of declaring when those businesses began.[177]

The date on which a business begins thus plays a substantive role in signifying when amortization can begin and business expenses thereafter become deductible.[178] It also played a procedural role, as noted above, in establishing the latest date for filing an election statement.[179] The filing deadline, however, bore an important substantive consequence. If a taxpayer failed to make a timely election, § 195 would have barred any future amortization of the start-up expenditures;[180] in other words, an untimely election resulted in the permanent capitalization of

172. *See* Treas. Reg. § 1.195-1(c) (1998). Note that Congress amended § 195 to provide a uniform 180-month amortization period for start-up expenditures paid or incurred after October 22, 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902(a)(1), § 195(b)(1), 118 Stat. 1418, 1651 (2004). Because the Treasury Department did not modify the procedural requirements to reflect that statutory amendment prior to establishing deemed elections in 2008, taxpayers presumably would continue declaring a 180-month amortization period on an election statement in order to comply with the former requirements. *Id.*

173. *See* I.R.C. § 195(d)(1) (2006 & Supp. 2009); *see also* Treas. Reg. § 1.195-1(b) (1998).

174. *See supra* Part II.B.1.

175. *See supra* Part II.B.3.

176. *Cf.* T.D. 8797, 1999-1 C.B. 362, 363 ("The statement is simple to complete and the time to prepare the statement is minimal.").

177. *See supra* Part II.B.2.

178. *See supra* note 134 and accompanying text.

179. *See* I.R.S. Priv. Ltr. Rul. 87-27-049 (Apr. 7, 1987) (expressing an inability to grant a taxpayer's request for an extension of time to file an election statement under § 195—where the taxpayer's accountant had mistakenly filed its return late—due to a statutorily prescribed filing deadline).

180. *See* Krebs v. Comm'r, 63 T.C.M. (CCH) 2413, 2421 (1992); Pino v. Comm'r, 52 T.C.M. (CCH) 1388, 1392 (1987); *but see* Hefti v. Comm'r, 54 T.C.M. (CCH) 1555, 1570 n.31 (1988) (noting that the Service allowed amortization under § 195 despite a taxpayer's failure to make an appropriate election).

costs.[181] This consequence reflected the codification of the pre-opening expense doctrine in § 195[182] and raised the stakes for properly determining when a business began.

Taxpayers accordingly have struggled to satisfy the timely-filing requirement of § 195. Prior to 1998, a taxpayer had been required to attach an election statement to a timely-filed return for the particular year during which it began an amortization period.[183] In other words, a valid election depended on the taxpayer correctly identifying the single taxable year for which it had to file the statement.[184] That requirement created considerable risk for a taxpayer given the debatable nature of any conclusions about when a business begins.[185] In particular, if the Service were to propose an adjustment during an examination to reflect the fact that a business began before or after the year for which a statement was filed, then a taxpayer could lose all amortization deductions for its start-up expenditures.[186] Regulations published in 1998 granted partial relief by allowing a taxpayer to file an election statement prior to the taxable year during which a business actually began.[187] Such a prospective election would become effective for the month during which the business eventually began.[188] A taxpayer with foresight could thereby make an early election in order to minimize the risk of having to capitalize start-up expenditures permanently as the sole result of filing too late.[189]

A taxpayer with an existing business, however, would need to possess considerable foresight to make a prospective election.[190] The regulations allowed a taxpayer to make a prospective election with incomplete information; a taxpayer only needed to describe its start-up expenditures and the month

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181. *Cf. In re* De Lisser, No. 387-36178-SAF-13, 1990 WL 105824, at *5 (Bank. N.D. Tex. May 11, 1990) (denying a loss deduction for capitalized start-up expenditures upon the disposition of a purported business where a taxpayer failed to make a timely amortization election).

182. *See* I.R.C. § 195(a) (2006 & Supp. 2009).

183. *See* I.R.S. Ann. 81-43, 1981-11 I.R.B. 52.

184. *Id.*

185. A taxpayer could have hedged its position by filing an election statement for every possible taxable year during which its business could have begun. *See* Election To Amortize Start-Up Expenditures, 63 Fed. Reg. 1933 (Jan. 13, 1998).

186. *Id.*

187. *See* I.R.C. § 195(d)(1).

188. *See* Treas. Reg. § 1.195-1(b) (1998).

189. Treas. Reg. § 1.195-1(b) (1998).

190. In contrast, a taxpayer with no other business activities could have more safely assumed that all costs were attributable to an anticipated business and could have benefited by filing a prospective election statement for qualified start-up expenditures. *See* I.R.C. § 195(c).

during which its business began to the extent the information was known.[191] The regulations even allowed a taxpayer to add start-up costs—originally omitted from a prospectively filed statement—to its amortizable expenditures as long as the taxpayer had not treated those costs in an inconsistent manner on a previously filed return.[192] But the regulations appeared to assume that a taxpayer could associate start-up expenditures with a particular business because the taxpayer still had to describe that business in detail in a prospective statement. Therefore, to file a prospective election statement under § 195, a taxpayer with an existing business would have needed foresight about whether an activity or pursuit would expand the existing business or start a new one. Such foresight presumably would have been lacking for any taxpayer in an investigatory phase who would still not know how their business might grow.[193]

The election requirements unfortunately caused problems in business expansion and start-up contexts by placing more emphasis on procedural compliance than on avoiding income distortion. As described above, a procedural misstep could have led to permanent capitalization. Thus, if a taxpayer initially deducted certain costs in a good faith belief that it incurred those costs to expand an existing business, then a subsequent determination that the taxpayer actually started a new business would have precluded any amortization by virtue of the taxpayer's failure to make a timely election.[194] Moreover, even where a taxpayer had made an election, but deducted some costs under a mistaken belief that they were incurred *after* a business began, adjustments would have been required to negate the prior deductions but the taxpayer could not have included those costs with its amortizable start-up expenditures due to their prior inconsistent treatment.[195] In either situation, the taxpayer's income ideally should have reflected those costs as the taxpayer began to realize their benefits (i.e., after the new business

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191. *See* Treas Reg. § 1.195-1(c) (1998).

192. *See id.*

193. *See* Arthur Fleischer, Jr., *The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment*, 14 TAX L. REV. 567, 567 n.4, 580 (1959) ("Investigations for new businesses or investments require an outlay of time, effort and expense.").

194. *See* Hefti v. Comm'r, 54 T.C.M. (CCH) 1555, 1570 n.31 (1988) ("Obviously, petitioners would not have made such an election where they deducted the full amount as an expense in the year of expenditure."); Walsh v. Comm'r, 55 T.C.M. (CCH) 994, 996 (1988) (recognizing that taxpayers failed to file an election statement under a mistaken belief that their costs were deductible, but denying their claims for any cost recovery due, in part, to their failure to make the election), *aff'd*, 884 F.2d 1393 (6th Cir. 1989).

195. *See* Treas. Reg. § 1.195-1(c) (1998).

began).[196] However, no cost recovery would have been permitted under the codified pre-opening expense doctrine in § 195, which applied whenever a taxpayer failed to satisfy the election's procedural requirements.[197] Therefore, in addition to appearing harsh, the permanent capitalization of such costs due to a procedural infraction created a potential distortion of a taxpayer's income.

Taxpayers often exhibited two responses to this potential risk of having to capitalize costs permanently for violations of the election requirements of § 195. First, some taxpayers cautiously treated all costs as start-up expenditures even if those costs could qualify as business expansion expenses.[198] A taxpayer might choose amortization over an immediate deduction given that the Service would most likely accept the amortization whereas, by challenging an immediate deduction, the Service could require the permanent capitalization of such costs.[199] Accordingly, taxpayers would intentionally make amortization elections for too many costs even though such elections arguably involved disregarding the proper characterization of certain costs as deductible expenses.[200] Second, other taxpayers aggressively contested any attempt by the Service to characterize their previously deducted costs as start-up expenditures.[201] For a taxpayer with no election statement in place, cost recovery was only possible insofar as the taxpayer denied that it started a new business and continued to insist that the costs were fully deductible in the year paid or incurred.[202] Unfortunately, this

196. *See supra* text accompanying notes 29-36.

197. *See* I.R.C. § 195(b)(1)(A)(i).

198. *See* I.R.S. Field Serv. Adv. Mem. 95-589 (May 18, 1995), *available at* 1995 FSA LEXIS 589 (noting that the inability to retroactively make an election drives the taxpayer to properly characterize expenses from the start).

199. Walsh v. Comm'r, 55 T.C.M. (CCH) 994, 996 (1988) (recognizing that taxpayers failed to file an election statement under a mistaken belief that their costs were deductible, but denying their claims for any cost recovery due, in part, to their failure to make the election).

200. *See* Toth v. Comm'r, 128 T.C. 1 (2007) (holding that expenses attributable to horse boarding and training activities did not need to be capitalized as startup expenditures, but rather, were deductible as expenses of non-business income production).

201. *Id.* at 1 (challenging the characterization of expenses as those associated with starting a business successfully).

202. Although motivations for pursuing tax controversies are not always clear, it seems reasonable to conclude that a taxpayer's failure to make an election under § 195—which would make it appear impossible to reach a compromise with the government to amortize the costs at issue—fosters controversy because the taxpayer, facing permanent capitalization, has nothing to lose by arguing for a current deduction. *See* Specialty Rests. Corp. v. Comm'r, 63 T.C.M. (CCH) 2759, 2761 (1992) (noting that a taxpayer's failure to make an election under § 195 took amortization off the table and left the court

posturing by a taxpayer during an examination contradicted the intended goal of using § 195 to minimize controversy. Thus, the election and election procedures encouraged inappropriate elections by taxpayers contemplating the filing of returns.[203] They also fostered controversy between the Service and taxpayers who had deducted costs on previously filed returns.[204]

B. *The New Deemed Elections under § 195*

In 2008, the Treasury Department significantly revised the manner of accounting for start-up expenditures by generally deeming a taxpayer to have made an irrevocable amortization election for the taxable year during which a new business began.[205] This revision effectively eliminated the prior requirement to file a separate election statement in order to qualify for amortization[206] with respect to start-up expenditures paid or incurred after September 8, 2008.[207]

The deemed elections under § 195 constitute a more significant change than a mere procedural modification. The Treasury Department modestly explained the change as occurring under initiatives for filing electronic returns, in acknowledgment that a "vast majority" of taxpayers elect to amortize start-up expenditures, and through efforts to reduce administrative burdens of making elections.[208] The deemed elections, however, appear to have more significantly reduced the possibility of having a missing or late election statement function as a barrier to cost recovery.[209] In particular, the regulations appear to contemplate that a taxpayer, which had not made a proper election to amortize start-up expenditures, could avoid permanent capitalization either by filing an amended return to

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with the task of deciding whether the costs were recoverable solely within the confines of § 162).

203. *Toth*, 128 T.C. at 1 (winning challenge against IRS to deduct expenses that could have been perceived as new business expenses).

204. *See id.*

205. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

206. *See* T.D. 9411, 2008-34 I.R.B. 398.

207. *See* Temp. Treas. Reg. § 1.195-1T(d). Taxpayers can choose to apply a deemed election to any start-up expenditures paid or incurred after October 22, 2004, as long as the year during which the business began remains open. Taxpayers would still need to file election statements to amortize other costs. *See id.*

208. *See* T.D. 9411, 2008-34 I.R.B. 398, 398.

209. *See id.* at 399 ("[A] taxpayer is no longer required to attach a statement to the return . . . for the election under section 195(b) to be effective.").

correct a prior reporting error[210] or by changing a method of accounting to treat the expenditures in a manner that conforms to a deemed election.[211] Other than permitting taxpayers to opt-out of amortization and choose permanent capitalization for start-up expenditures,[212] the deemed elections make § 195 superficially function as the equivalent to a non-elective provision.

1. Benefits of Deemed Elections for Taxpayers Starting Their First Businesses

The regulations take a positive step toward minimizing the risk of permanent capitalization for many taxpayers.[213] Short of a Congressional amendment to § 195 that might impose mandatory amortization for start-up expenditures, the regulations use reasonable means to minimize controversy that might arise from nonexistent or improper elections. The deemed election recognizes that Congress gave taxpayers with new businesses a choice between amortization deductions and permanent capitalization for their start-up expenditures and that stringent election procedures could readily defeat the overwhelming preference for amortization.[214] The all-or-nothing consequences flowing from the prior election statements had created needless administrative burdens, with significant substantive consequences, for taxpayers that routinely sought the benefits of elective amortization.[215] The deemed elections thus appropriately shift the default treatment for start-up expenditures away from permanent capitalization.[216]

As a policy matter, the reduced risk of permanent capitalization provides the strongest justification for a deemed amortization election insofar as it results in a more clear

210. If a taxpayer had not treated its start-up expenditures in a consistent, albeit erroneous, manner for two or more years, then the regulations would not consider the taxpayer to have adopted a method of accounting for such expenditures. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398). The taxpayer might then correct the error by filing an amended return. Treas. Reg. § 1.446-1(e)(2)(ii)(b) (2009).

211. *See* Temp. Treas. Reg. § 1.195-1T(b). An adjustment resulting from an accounting method change would ensure cost recovery for any start-up expenditure amortization properly attributable to prior, even closed, years. *See generally* I.R.C. § 481(a) (2006) (a change in the method of accounting from the preceding taxable year shall result in adjustments in order to prevent amounts from being duplicated or omitted).

212. *See* Temp. Treas. Reg. § 1.195-1T(b).

213. *See id.*

214. *See* I.R.C. § 195 (2006); T.D. 9411, 2008-34 I.R.B. 398.

215. *See* T.D. 9411, 2008-34 I.R.B. 398.

216. Martin J. McMahon, Jr., Ira B. Shepard & Daniel L. Simmons, *Recent Developments in Federal Income Taxation*, 9 FLA. TAX REV. 275, 304-05 (2009).

reflection of a taxpayer's income. The better-reasoned explanation, under the pre-opening expense doctrine, for denying an immediate deduction for start-up costs reflected a goal of avoiding the distortion of income that would otherwise occur if a taxpayer could deduct costs before the period during which the taxpayer started its business and first realized the benefits of those costs.[217] Start-up costs, which might provide insignificant immediate benefits to a taxpayer, primarily produce benefits once a business begins and thus are properly attributable to future periods.[218] Accordingly, a taxpayer would more clearly reflect its income by accounting for start-up costs in those future periods, which is readily accomplished with a deemed election.[219]

The permanent capitalization of start-up expenditures would threaten to distort a taxpayer's income more than an immediate deduction, which had been the focus of the pre-opening expense doctrine. Permanent capitalization would prevent a taxpayer from ever accounting for start-up expenditures in determining taxable income attributable to the operation of a business.[220] If the tax system had to choose between two alternatives that would distort a taxpayer's income, whereby one would create distortion by permitting the taxpayer to deduct costs immediately that admittedly will benefit business operations in future periods,[221] and another would create distortion by denying any deduction for those costs despite their assumed benefit for the business,[222] then the tax system should allow the immediate deduction because it would at least account—in some fashion—for costs paid or incurred to generate income.[223] A strong preference should therefore exist for making sure taxpayers account for start-up costs in determining income.[224] Such

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217. *See supra* notes 29-36 and accompanying text.

218. *See* Cent. Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984) (denying a deduction for start-up costs attributable to a branch bank due to the potential distortion of income that would result from a deduction of amounts paid to "procure benefits that endure for the life of the branch").

219. *Id.*

220. *See id.*

221. *See id.* at 1185.

222. *See* Colo. Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) ("[At most, t]he start-up expenditures here challenged . . . introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation.").

223. *See* Lee, *supra* note 30, at 26 ("[A] current deduction of temporally limited expenditures does produce less distortion of income than capitalization without amortization.").

224. *See* Centr. Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984).

preference is not accomplished with the permanent capitalization of start-up expenditures.

To the extent that deemed elections preclude permanent capitalization, they would allow taxpayers to reflect income more clearly for new businesses. Section 195 should never have conditioned the ability to reflect income clearly on a taxpayer's satisfactory compliance with election procedures. The deemed elections accordingly help restore the integrity of the tax system and elevate the importance of accurately determining taxable income.[225] Most notably, the deemed elections promote corrective efforts, through amended returns or method change applications, for improperly treated start-up expenditures rather than impose a complete bar on cost recovery.[226]

2. Pitfalls of Deemed Elections for Taxpayers with Existing Businesses

The consequences of deemed elections appear less certain for taxpayers with existing businesses. A taxpayer that starts a new business relative to an existing business conceivably should benefit from a deemed election, as discussed above, such that the taxpayer could amortize its start-up expenditures without complying with formal election procedures.[227] But, as discussed previously, taxpayers often struggle to characterize business growth as the start of a new business or the expansion of an existing business. So a taxpayer might not know if a deemed election should apply. Although the deemed election facially should not impact an expanding business that lacks any start-up expenditures, taxpayers in marginal (i.e., borderline) situations need to consider how deemed elections might affect positions taken on their tax returns.

a. Establishing Initial Tax Return Positions

At first glance, the deemed elections would seem to reduce the risk associated with taking business expansion positions for taxpayers in marginal situations. The prior requirement to file an election statement subjected a taxpayer who took a business expansion position on an original return to a risk that he might need to capitalize costs permanently if the Service, on exam, were to characterize those costs as start-up expenditures for which the taxpayer had never filed an election statement.[228] The

225. *See id.*
226. Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).
227. *See supra* Part II.B.1.
228. *See* Krebs v. Comm'r, 63 T.C.M. (CCH) 2413, 2421 (1992).

taxpayer's initial choice either to pursue an immediate deduction or to accept amortization for those costs could have resulted from a comparison of relative present values of the tax benefits of the alternative positions—irrespective of their relative merits—as long as each position would allow the taxpayer to avoid accuracy-related penalties. If an insignificant difference existed in relative present values, then one might anticipate the taxpayer would elect amortization to avoid the risk of permanent capitalization. In contrast, the elimination of the filing requirement appears, at least superficially, to have negated the risk of permanent capitalization. Thus a taxpayer in a marginal situation might reasonably expect to retain the ability to amortize start-up expenditures pursuant to a deemed election even though the taxpayer would deduct the costs under consideration on its original return.

From a practical standpoint, the deemed elections arguably could reduce administrative burdens in addressing start-up expenditures in marginal situations. Taxpayers have always been able to deduct business expansion costs without an election. Thus, the prior requirement to file an election statement and prospect of permanent capitalization encouraged taxpayers in marginal situations to amortize costs under § 195 on an originally filed return (in order to preserve the ability to amortize such costs under the properly filed election statement) and then to file an amended return or refund claim to argue for the deductibility of those same costs under § 162 as business expansion expenses.[229] The election statement requirement therefore encouraged taxpayers in marginal situations to take positions on original returns that they intended to challenge. Those taxpayers would accordingly file and the Service would then process additional returns and refund claims, and the Service would become more likely to challenge or at least question the taxpayers' positions. That process fostered controversy.[230] A deemed election, in contrast, might seem to

229. *See, e.g.*, I.R.S. Tech. Adv. Mem. 05-48-022 (Aug. 23, 2005) (describing a taxpayer's informal refund claim that asserted a deduction for business expansion expenses with respect to amounts characterized as start-up expenditures on an originally filed income tax return).

230. Against the backdrop of Congress' hope to reduce controversy and litigation by enacting § 195, *see* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980). Judge Cohen, in a dissent to *Hoopengarner v. Comm'r*, 80 T.C. 538, 550 (1983), *aff'd*, 745 F.2d 66 (9th Cir. 1984), warned against "chaos among those attempting to decide cases on principle rather than on the level of imagination utilized by the taxpayer. In my opinion, the approach of the majority will create new 'incongruities in this area of the law,' which can only constitute a renewed inducement to controversy and an impediment to settlement of litigation." *Id.*

provide a taxpayer with some comfort that it could take a position on a single return without risking a draconian penalty of permanent capitalization for taking a business expansion position that is eventually considered improper.[231] The deemed election would thereby seem to eliminate the need to employ protective tactics if a taxpayer intends to characterize growth as a business expansion.

Unfortunately, a perceived reduction in the risk of permanent capitalization, coupled with the recent lengthening of the amortization period for start-up expenditures from 60 to 180 months,[232] could increase the aggressiveness of taxpayers with respect to taking business expansion positions on original returns. Any assurance provided to a taxpayer that it could still amortize start-up expenditures under a deemed election when its primary business expansion position fails might eliminate the Treasury Department's hope that taxpayers, when in doubt about how to treat their costs, would choose amortization to avoid future controversies.[233] More specifically, a deemed election functioning as a safety net could prompt taxpayers to deduct more costs as business expansion expenses.[234] For this reason, albeit contrary to the stated purposes for deemed elections, it would seem desirable to require a taxpayer to file a statement with a return that describes the business that is expanded or started by a taxpayer and the costs deducted or amortized in connection with that business[235] as a deterrence mechanism for aggressive return positions.[236] Such a statement would at least

231. The Second Circuit Court of Appeals has commented: "The Commissioner in the present case resorted to such nebulous phrases as 'an intensive campaign to get new customers' and 'an ambitious new distribution program' to define what a capital asset was in the circumstances of the case. But practically all businesses are constantly seeking new customers and pursuing a distribution program. When are the wages and salaries of its employees who take care of these things capital expenditures and non-deductible and when are they current expenses and deductible under § 162? The taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are." Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 785 (2d Cir. 1973).

232. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 902(a)(1), § 195(b)(1), 118 Stat. 1418, 1651 (2004) (amending I.R.C. § 195(b)).

233. *See Hearing on H.R. 5729 Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 96th Cong., 2d Sess. 14 (1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy).

234. *Id.*

235. To the extent that taxpayers can re-characterize costs, which the taxpayers originally deducted as business expansion expenses, such re-characterizations might be limited to those costs described on statements filed with original returns.

236. The government encourages large taxpayers to have this issue examined before filing the relevant income tax return. *See* Rev. Proc. 2009-14, 09-3 I.R.B. 324 (describing the procedural framework for pre-filing examinations). Taxpayers subject to the

apprise the Service of a taxpayer's position and costs—which otherwise are concealed among other deductible items on a return—and better enable the Service to challenge a questionable characterization.

The deemed election, however, might leave a false impression that a taxpayer can seek recourse through amortization whenever a business expansion position fails. Although neither the recently promulgated regulations nor their preamble directly address the vitality of a deemed election in light of a contrary business expansion position taken on an original return, the regulations indicate that taxpayers could re-characterize amounts originally deducted under § 162 as start-up expenditures amortizable under a deemed election.[237] The opportunity to re-characterize items as start-up expenditures would thus leave an impression that an amortization-fallback position exists for taxpayers unable to sustain deductions under § 162 for business expansion costs.[238]

The regulations, however, illustrate a subsequent re-characterization only with respect to adding erroneously deducted costs to those start-up expenditures already being properly amortized under a deemed election.[239] The regulations

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jurisdiction of the Large and Mid-Size Business Division can use pre-filing procedures to identify investigatory costs in start-up contexts under the rationale that such identifications would result from applying well-settled law to the taxpayers' facts. *Id.*; *see also* Rev. Proc. 01-22, 2001-1 C.B. 745 (describing an identification of investigatory costs qualifying as start-up expenditures under § 195 as an eligible issue under a former pre-filing examination program). The pre-filing examinations, however, appear to have limited appeal to taxpayers with this issue. *See, e.g.*, I.R.S. Ann. 05-42, 2005-1 C.B. 1257 (disclosing the pre-filing agreement program's operations during 2004, which resulted in no closed cases related to the identification of investigatory costs); I.R.S. Ann. 04-59, 2004-2 C.B. 94 (disclosing the pre-filing agreement program's operations during 2003, which resulted in two completed pre-filing agreement related to costs deductible under § 162, costs amortizable under §§ 167, 195, or 709, and costs capitalizable under § 263); I.R.S. Ann. 03-43, 2003-1 C.B. 1139 (disclosing the pre-filing agreement program's operations during 2002, which resulted in one completed pre-filing agreement related to investigatory costs deductible under § 162, amortizable under § 195, and capitalizable under § 263); I.R.S. Ann. 02-54, 2002-1 C.B. 1190 (disclosing the pre-filing agreement program's operations during 2001, which resulted in no closed cases from the 2000 pilot program and no applications in 2001 related to the identification of investigatory costs); I.R.S. Ann. 01-38, 2001-1 C.B. 1138 (disclosing the pre-filing agreement pilot program's operations during 2000, which resulted in one completed pre-filing agreement related to investigatory costs deductible under § 162 and capitalizable under § 263).

237. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398) (describing certain re-characterizations as changes in methods of accounting).

238. *See id.*

239. *See* Temp. Treas. Reg. § 1.195-1T(c). The regulations notably reference changing a method of accounting for *additional* start-up expenditures in the example such that the taxpayer would have one accounting method applicable to properly amortized start-up expenditures and another accounting method applicable to re-characterized start-up expenditures. *See id.* By equating the relevant item with the additional start-up

do not clarify whether a taxpayer could re-characterize and amortize costs, which had been erroneously deducted as expenses of a particular business in a prior year, without having properly amortized any start-up costs attributable to that business in at least one prior year (i.e., a new business for which a taxpayer has not previously claimed or amortized start-up expenditures).[240]

The prior stance of the Treasury Department on protective elections and the legislative history to § 195 suggest that a taxpayer could not rely on a deemed election to amortize costs, which the taxpayer had erroneously deducted as business expansion costs in an earlier year. In 1998, the Treasury Department effectively foreclosed the impulse of some taxpayers to file income tax returns papered with protective election statements while deducting their would-be start-up costs as business expansion expenses.[241] In this context, a protective statement would have contained all of the required information relative to the new business[242] except it would not have specified any costs or would have specified a nominal amount of costs paid or incurred in connection with starting that business. In a prior regulation preamble, the Treasury Department rejected such zero or nominal elections as ineffective attempts to preserve the benefits of a § 195 election for amounts unsuccessfully claimed as deductible business expansion expenses.[243] The rejection of these protective elections appeared well justified insofar as a taxpayer generally must meet the substantive requirements of an election before that election is considered effective.[244] The omission from an election statement and lack of amortization for costs subject to a purported § 195 election would not have satisfied the substance

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expenditures, the regulations pull the re-characterization within the ambit of the method change procedures (i.e., the improper method can change only with the Commissioner's consent) rather than treating the re-characterization as a correction of an error in applying a single, proper accounting method applicable to all start-up expenditures (i.e., no method would change such that the taxpayer could correct the error with an amended return). *See* § 1.195-1T(b); *see also* Korn Indus., Inc. v. United States, 532 F.2d 1352, 1356 (Ct. Cl. 1976) ("It cannot be said that the omission of three items, while including the rest of the materials costs, was a proper method of accounting. It was most assuredly an error analogous to a mathematical or posting error. There has not been any change in method of accounting . . . but only a correction by plaintiff of an inventory error."); *but see* Rev. Rul. 77-134, 1977-1 C.B. 132 (refusing to follow *Korn Indus.* because the omission of three material items from an inventory value computation established a consistent pattern, which the taxpayer could alter only by changing its method of accounting).

240. *See* Temp. Treas. Reg. § 1.195-1T(c).

241. *See* T.D. 8797, 1999-1 C.B. 362.

242. *See* Treas. Reg. § 1.195-1(c) (1998).

243. *See* T.D. 8797, 1999-1 C.B. 362.

244. *See* Am. Air Filter Co. v. Comm'r, 81 T.C. 709, 719-20 (1983).

of the election.[245] In particular, a taxpayer making the protective election would not have even acknowledged the existence of the item to which the election could apply. Accordingly, the taxpayer's attempt to invoke the election would have been largely hypothetical and would not have expressed any commitment for the election to bind the taxpayer.[246]

Although the temporary regulations have replaced the section of the prior regulations that had forbidden taxpayers from adding previously deducted costs to a protective statement,[247] it does not seem reasonable to construe the deemed election mechanism as preserving an ability to amortize start-up expenditures despite inconsistent positions taken on prior returns. The government's disdain for protective elections, as expressed in the 1998 preamble, reflected an underlying concern—which predated the regulations—about being whipsawed by taxpayers. The government has consistently recognized a need to prevent taxpayers from whipsawing the Service by first deducting their costs as business expansion expenses and, when the Service successfully re-characterizes those costs as start-up expenditures on exam, asserting that the costs were recoverable through amortization under § 195.[248] In essence, the proscription against protective elections established a quasi-doctrine of election[249] that bound a taxpayer to its initial treatment of start-up costs. It appears unlikely that the Treasury Department, in 2008, intended to reverse course and create a whipsawing opportunity through its elimination of the

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245. *See* Reems v. Comm'r, 67 T.C.M. (CCH) 3050, 3051-53 (1994) (finding that compliance with § 195 includes a requirement to claim amortization deductions for start-up expenditures).

246. *See* I.R.S. Field Serv. Adv. Memo. 99-1189 (Mar. 17, 1999), *available at* 1999 FSA LEXIS 1189 (noting that a proper election under § 195 sufficiently informs the Service to what the election applies); *see also* Corporation Failed to Make Valid Election for Start-up Expenses, 1999 TAX NOTES TODAY 127-78 (July 2, 1999).

247. *See* Treas. Reg. § 1.195-1(c) (1998) (forbidding a revision to an election statement to include costs for which a taxpayer had previously taken a return position inconsistent with their treatment as start-up expenditures).

248. I.R.S. Field Serv. Adv. Mem. 95-589 (May 18, 1995), *available at* 1995 FSA LEXIS 589 ("The statutory requirement [to make an election by the due date of the return for the taxable year in which a business begins] makes perfect sense. If taxpayers may make the election during the course of an audit, there is no incentive for correct reporting of the expenses . . . . If the expenses [deducted on the return] are disallowed on audit, the taxpayer makes a fall back election and gets the sixty month amortization.").

249. *Cf.* Hodel v. Comm'r, 72 T.C.M. (CCH) 276, 279 (1996) ("Under the doctrine of election, a taxpayer who makes a conscious election may not, without the consent of the Commissioner, revoke or amend it merely because events do not unfold as planned.").

requirement to identify specific start-up expenditures as a result of implementing deemed election procedures.[250]

The legislative history to § 195 further suggests that a taxpayer cannot rely on a deemed election as a fallback position for an unsuccessful business expansion position. The legislative history expressed an intention that election procedures should prevent taxpayers from making conditional elections under § 195.[251] Without elaborating on the conditional nature of an election, the legislative history reasonably suggests that Congress intended for taxpayers to make elections that were immediately effective and applied for the year in which a business began.[252] As such, it would seem inappropriate to accept a taxpayer's retroactive claim for an amortization benefit under a deemed election once it becomes apparent that the Service will not respect the taxpayer's alternative treatment for particular costs.

These attitudes toward protective and conditional elections would create substantial risk for any taxpayer hoping to rely on a deemed election to support cost recovery in the event of having a business expansion position disallowed. This risk, however, does not imply that it would be undesirable for a taxpayer to amortize its costs.[253] In fact, as discussed above, amortization would allow for a more clear reflection of the taxpayer's income than permanent capitalization.[254] Instead, the risk reflects the fact that amortization remains elective and that a taxpayer's noncompliance with such election on an original return remains exceedingly difficult to cure, even with a deemed election.[255] Only a statutory change, therefore, could eliminate the risk by making amortization under § 195 mandatory rather than elective.[256] Absent an amendment to § 195, the election requirement still seems to invite taxpayers to make a "more prudent decision"[257] and treat their costs as amortizable start-up expenditures on original returns regardless of the merits of those

250. *See* Elections Regarding Start-up Expenditures, Corporation Organizational Expenditures, and Partnership Organizational Expenses, 83 Fed. Reg. 38,910, 38,911 (July 8, 2009) (to be codified at 26 C.F.R. pt. 1).

251. *See* H.R. REP. NO. 96-1278, at 12-13 (1980); S. REP. NO. 96-1036, at 14 (1980).

252. *See* H.R. REP. NO. 96-1278, at 10 (1980).

253. *See supra* Part III.B.1.

254. *Id.*

255. *See supra* Part III.B.2.a.

256. *See* I.R.C. § 195 (2006 & Supp. 2009).

257. *Installment Sales Revision Act of 1980 and Minor Tax Bills: Hearing on H.R. 5729 Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 96th Cong. 14 (1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy).

characterizations. A taxpayer contemplating the filing of an original return, therefore, still encounters a preference for characterizing any business growth as the start of a new business for tax purposes.

b. Changing Tax Return Positions

The continued preference for characterizing business growth as the start of a new business would naturally make a taxpayer inclined to begin amortizing its start-up expenditures on an original return in a manner consistent with a deemed election, but thereafter to file an amended return or refund claim to deduct those costs as business expansion expenses. Such a strategy would seek to preserve amortization under § 195 insofar as the original return position would stand if the Service were to reject the refund claim. As with amortization initially claimed under previously filed election statements,[258] this strategy might seem advantageous in that it creates an opportunity for a taxpayer to assert a business expansion position without risking permanent capitalization if the taxpayer were unable to prevail with the expansion characterization. Accordingly, as had occurred under the prior election statement requirement, taxpayers might pursue a subsequent-change-in-character strategy as a means to circumvent the inherent preference for "new business" characterizations with respect to § 195 elections.[259]

The temporary regulations, however, advance the government's position that a change in an item's characterization as a start-up expenditure could represent a change in accounting method,[260] which might defeat a subsequent-change-in-characterization strategy insofar as a taxpayer cannot change a method through an amended return.[261] The government's position reflects a concern that a re-characterization in this context would affect deduction timing,[262] which is the hallmark of an accounting method change.[263] Without resolving the propriety of the government's position, two aspects are noteworthy.[264]

258. *See supra* text accompanying note 231.

259. *See* I.R.C. § 195 (allowing taxpayers to deduct certain start-up expenditures).

260. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

261. *See* I.R.C. § 446(e) (2006).

262. *See* I.R.S. Tech. Adv. Mem. 05-48-022 (Aug. 23, 2005).

263. *See* Treas. Reg. § 1.446-1(e)(2)(ii)(a) (2009).

264. It is interesting to note that by taking a position that a change in character represents a change in method, the temporary regulations step into a rather controversial area with respect to a Code provision specifically enacted to reduce controversy. *See*

First, as a method change, a taxpayer would need to secure the Service's consent before treating previously amortized costs as deductible expansion expenses.[265] Second, the Service presumably could withhold such consent without abusing its discretion to the extent some basis existed to support the original characterization of the growth as the start of a new business.[266] It seems that, as long as it is possible to characterize business growth in a marginal situation as either a start-up or expansion activity, the Service possesses substantial discretion in granting a taxpayer's request to change the treatment of costs from amortizable start-up expenditures to deductible business expansion expenses.

Without directly addressing whether the Service might withhold consent on method change applications, the temporary regulations contain curious language about method changes under § 195. The regulations state that a change in an item's characterization as a start-up expenditure would involve a method change "if the taxpayer treated the item consistently for two or more taxable years."[267] The reference to a taxpayer's consistent treatment makes sense given that such consistency generally establishes the method that the taxpayer would change.[268] Moreover, requiring consistency over two or more taxable years incorporates a standard that the Service has used to establish an *improper* method of accounting.[269] However the regulations remain notably silent about a taxpayer's treatment of costs on a single return. In particular, the regulations do not address whether a taxpayer's treatment of costs on one return could establish its method, which is a standard that the Service

generally STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 9.07 (2d ed. 2008) (noting a frequently recurring question about whether a change from treating costs as capitalizable and amortizable to treating them as deductible represents a change in method, which requires Service consent, or a change in character, which can occur through amended returns).

265. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

266. *See generally* GERTZMAN, *supra* note 266, at ¶ 8.07[1] (describing the Commissioner's "great discretion" in approving a change from one acceptable method to another that would leave a taxpayer with "virtually no chance of convincing a court that an abuse of discretion has occurred").

267. Temp. Treas. Reg. § 1.195-1T(b).

268. *See* Treas. Reg. § 1.446-1(e)(2)(ii)(a).

269. *See, e.g.*, Rev. Proc. 97-27, 1997-21 I.R.B. 11 ("The treatment of a material item in the same way . . . in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(a).").

has used to establish a *proper* method of accounting.[270] A taxpayer using a proper method would have no reason to change that method; therefore the silence in the regulations seems understandable. On the other hand, a taxpayer with an existing business would therefore face a question about whether compliance with a deemed § 195 election on a single return, with respect to costs for which a characterization was uncertain, would constitute the adoption of a proper method. If so, the use of such proper method could preclude the taxpayer from re-characterizing its activities or pursuits as a business expansion through an amended return.[271]

The Treasury Department and Service appear to believe that a taxpayer with an existing business can properly choose to amortize costs—which it might otherwise characterize as business expansion expenses—as start-up expenditures and thereby adopt a method of accounting by filing a single tax return.[272] In effect, they indicate that a taxpayer has a choice to opt into § 195.[273] The clearest indication of such a choice appears in the statement of Daniel Halperin, as a former Deputy Assistant Secretary of the Treasury for Tax Policy, at a Congressional hearing regarding the enactment of § 195:

> It is our hope that enactment of this bill will induce taxpayers with existing businesses to elect to amortize the start-up costs of a marginally related business .... In the unclear cases, of which there are many, taxpayers should elect to amortize; .... Electing to amortize ... would appear for most taxpayers to be a more prudent decision.[274]

Service guidance echoes this sentiment insofar as it considers a taxpayer's decision to apply § 162 or § 195 to particular costs as being elective.[275] At a minimum, the Service

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270. *See, e.g., id.* ("If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting . . . .").

271. *Id.*

272. *See Installment Sales Revision Act of 1980 and Minor Tax Bills: Hearing on H.R. 5729 Before the Subcomm. on Select Revenue Measures of the Comm. on Ways and Means*, 96th Cong. 14 (1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation).

273. *See id.*

274. *Id.*

275. *See* I.R.S. Field Serv. Adv. Memo. 99-1189 (Mar. 17, 1999), *available at* 1999 FSA LEXIS 1189 (arguing that a taxpayer's deduction of costs under § 162 as business expansion expenses bound the taxpayer, under the doctrine of election, to its choice and necessarily precluded the amortization of such costs under § 195); *see also* Corporation

considers actual qualification under § 195 as being irrelevant where a taxpayer's initial treatment of costs established its accounting method for the costs.[276] Under this logic, it seems that a taxpayer's compliance with a deemed election on an original return might establish a proper method of accounting and foreclose any possibility of changing the treatment of costs through amended returns.[277]

The government, unfortunately, seems to construe the elective nature of § 195 well beyond its intended scope. The election in § 195 merely permits a taxpayer to choose between amortizing and not amortizing capitalizable start-up expenditures.[278] The election does not create a choice to treat expansion costs as start-up expenditures.[279] A taxpayer may only avail itself of the election under § 195 if the taxpayer starts a new business.[280] Although admittedly difficult to determine, a taxpayer should have an opportunity to demonstrate that it had expanded an existing business when it files an amended return.

However, the temporary regulations regrettably bring these character questions largely within the realm of accounting methods.[281] As an accounting methods issue, it seems improbable that the Service would consent to re-characterize costs as business expansion expenses and that a taxpayer could show how a withholding of consent constitutes an abuse of discretion. As a result, prior compliance with a deemed election under § 195, for costs of activities or pursuits with uncertain characters, will likely subject taxpayers to insurmountable burdens were they to seek a different treatment for their costs. Thus, the temporary regulations further the government's desire for taxpayers with existing businesses to elect amortization treatment for all costs of marginally-related businesses without

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Failed to Make Valid Election for Start-up Expenses, 1999 TAX NOTES TODAY 127-78 (July 2, 1999).

276. *See* I.R.S. Tech. Adv. Mem. 05-48-022 (Aug. 23, 2005) (rejecting a taxpayer's attempt to deduct fees, originally amortized under § 195, as business expansion expenses because the Service concluded that the taxpayer "elected to amortize" them and "treat them as 'start-up' expenditures under § 195" and that "[w]hether the costs at issue were actually 'start-up' expenditures is irrelevant[; t]he fact that Taxpayer treated them as such is relevant").

277. *See id.* ("If a taxpayer's treatment of an item is a method of accounting, § 446(e) and § 1.446-1(e)(3) preclude the taxpayer from making a retroactive change in method of accounting by amending prior tax returns . . . .").

278. *See* I.R.C. § 195 (2006 & Supp. 2009).

279. *See id.*

280. I.R.C. § 195(c).

281. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

regard for an ability to characterize them as deductible business expansion expenses.[282]

The election procedures under § 195 therefore encourage a taxpayer to err on the side of amortizing costs whenever the character of its activities or pursuits remains uncertain.[283] A need to comply with a deemed election to preserve the right to amortize costs means a taxpayer would risk permanent capitalization were it to attempt to deduct costs, of an uncertain nature, on an original return. The taxpayer is thereby encouraged to concede that its costs qualify as start-up expenditures despite the uncertainty.[284] In future years, a general inability to change the treatment of previously amortized costs without consent would effectively bind the taxpayer to its original concession. Once again, it seems possible to overcome these shortcomings only by making amortization of start-up expenditures mandatory under § 195. As long as amortization under this provision remains elective, a taxpayer and the Service will focus on whether the treatment of costs complies with a deemed election and whether the taxpayer is bound by such election. In contrast, with mandatory amortization, the focus would shift to determining the proper treatment of costs in accordance with their nature, which is more important in determining taxable income.

The preference for "new business" characterizations and the implications of deemed elections for taxpayers in marginal situations are perhaps most significant for taxpayers performing preliminary investigations of business opportunities. As discussed in Part IV, no greater uncertainty exists about characterizing activities or pursuits than the uncertainty of a taxpayer in an investigatory phase that has not yet decided what activities or pursuits it might undertake and whether to undertake them.[285] Nevertheless, for any costs paid or incurred during the investigatory phase, the taxpayer must decide how to treat those costs in light of the preference for and implications of elections under § 195.[286] In particular, a taxpayer must decide whether to comply with a deemed election under § 195 before the taxpayer knows how it might act in the future, which is another

282. *See* Temp. Treas. Reg. § 1.195-1T.

283. *See* I.R.S. Tech. Adv. Mem. 05-48-022 (Aug. 23, 2005) (citing I.R.C. § 195 (2000 & Supp. 2009)).

284. *See* Lee, *supra* note 30, at 105 (noting that uncertainty about how to treat costs in marginal cases might "force more taxpayers to the certainty of section 195").

285. *See infra* Part IV.A.

286. *See* Rev. Rul. 99-23, 1999-1 C.B. 998.

problem Congress would eliminate through mandatory amortization.[287]

IV. SECTION 195 IMPLICATIONS FOR A GROWING BUSINESS IN AN INVESTIGATORY PHASE

A taxpayer investigating growth opportunities for an existing business faces considerable uncertainty in accounting for investigatory costs. The taxpayer, who might not begin an actual expansion or new business by the due date for a tax return, would encounter problems in determining how to treat costs that are both attributable to the investigation and paid or incurred during the taxable year of that return.[288] Such costs, if attributable to investigating the expansion of an existing business, might be deductible under § 162[289] whereas the costs, if attributable to investigating the start of a new business, might be capitalizable and amortizable under §195.[290] Unfortunately, the taxpayer would likely have insufficient information to decide whether any growth would represent an expansion or new business for that taxpayer because, by remaining in an investigatory phase, the taxpayer could not foresee the growth's character accurately.[291]

A. *Sources of Uncertainty*

A taxpayer could remain understandably indecisive about how to treat investigatory costs by the due date for a tax return. In addition to general problems in distinguishing between efforts to expand and start a business based on degrees of relatedness to an existing business, several aspects of this determination remain particularly troublesome for a taxpayer in an investigatory phase. The trouble arises from the difficult tasks of characterizing future growth, characterizing costs, and identifying relevant costs.

1. Difficulties in Characterizing Future Business Growth

Between the due date for a tax return and the date a taxpayer might commence the business growth it has

287. *See* I.R.S. Tech. Adv. Mem. 05-48-022 (Dec. 2, 2005).
288. *See* H.R. REP. NO. 96-1278, at 9 (1980).
289. *See id.* at 10.
290. *See* I.R.C. § 195(c)(1)(A)(i) (2006 & Supp. 2009) (defining start-up expenditures to include investigatory costs).
291. *See* H.R. REP. NO. 96-1278, at 9 (1980).

investigated, the taxpayer can reasonably expect the nature of that growth to change. Consider, for example, a taxpayer surveying a market to determine the most suitable strategy for penetrating a new market segment with an existing product. Preliminary studies might lead the taxpayer to conclude that its investigatory costs would relate to an expansion of the existing business. Accordingly, the taxpayer might deduct its costs for the taxable year during which they were paid or incurred. As the taxpayer continues to study that market segment in later taxable years, however, the taxpayer might learn that particular demographics, tastes, prices, competitor activities, and the like would require revised or alternative strategies that are new to the taxpayer. Where the taxpayer eventually undertakes a strategy that constitutes the start of a new business, it would appear that all of the investigatory costs attributable to that undertaking represent start-up expenditures, which brings into question the appropriateness of the prior deductions.[292]

With respect to the example above, it might be argued that the taxpayer properly deducted the costs because it did not contemplate starting a new business when it claimed the deductions. But a more accurate description would note that the taxpayer had no reason to deduct the costs originally because the growth could not be characterized when the costs were paid or incurred.[293] A taxpayer in an investigatory phase, which by its very nature means the taxpayer has not reached a final decision about a proposed undertaking,[294] would lack a sufficient reason to characterize future growth in any way other than by guessing. The taxpayer had no reason to assume that events might occur as planned because the taxpayer simply had no plan.

2. Difficulties in Characterizing Costs

Even where a taxpayer clearly contemplates that growth would occur as an expansion of an existing business or as a start of a new business, the means chosen to implement that growth could affect the taxpayer's characterization of investigatory costs.

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292. Start-up expenditures are not temporally limited. I.R.C. § 195(c)(1) (defining start-up expenditures to mean "any amount . . . paid or incurred in connection with . . . investigating the creation or acquisition of an active trade or business").

293. The uncertainty would become more pronounced where a taxpayer investigates two mutually-exclusive options that would either expand an existing business or start a new business such that the taxpayer cannot use a single label to characterize the investigated undertakings.

294. *See* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 11 (1980); Rev. Rul. 99-23, 1999-1 C.B. 998 (characterizing a final decision under § 195, in an acquisition context, as "the point at which a taxpayer makes its decision *whether* to acquire a business, and *which* business to acquire") (emphasis in original).

In particular, the means chosen for implementation could prevent the taxpayer from conducting the new activity or pursuit such that the growth does not actually expand the *taxpayer's* business or start a new business for the *taxpayer*.[295] In those situations, any relatedness between the activity or pursuit and the existing business becomes meaningless insofar as the taxpayer fails to conduct the activity or pursuit as its business.[296]

For example, the structure of a consummated acquisition could affect whether investigatory costs could qualify as either deductible expansion expenses or amortizable start-up expenditures. Generally, in an acquisition context, a taxpayer must acquire business assets in order to characterize the transaction as a business expansion or start of a new business; a taxpayer cannot conduct an acquired business by holding a mere equity interest in an entity that in turn owns the business assets.[297] Nevertheless, the legislative history to § 195 indicates Congress anticipated that certain transactions, which involve acquisitions of equity interests, would qualify as the start of new businesses as long as those transactions in substance represent asset acquisitions and the acquiring taxpayers actively participate in management.[298] The legislative history illustrates that these transactions would include a stock acquisition followed by a complete liquidation of the acquired corporation as well as a stock acquisition followed by the filing of a consolidated return by the acquired and acquiring entities.[299] Although the legislative

295. *See* S. REP. NO. 96-1036, at 11.

296. *See id.* at 12.

297. *See* H.R. REP. NO. 96-1278, at 10; S. REP. NO. 96-1036, at 12-13.

298. H.R. REP. NO. 96-1278, at 10; S. REP. NO. 96-1036, at 12-13.

299. *See* H.R. REP. NO. 96-1278, at 10; S. REP. NO. 96-1036, at 13. Requiring an acquired entity to join in the filing of a consolidated return with an acquiring entity would foreclose most stock acquisitions of foreign entities from qualifying as either a business expansion or a business start-up. *See* I.R.C. § 1504(b)(3) (2006) (excluding foreign corporations from includible corporations, which are eligible to file consolidated returns). Some commentators suggest that an acquired foreign corporation's eligibility to file a consolidated return with an acquiring corporation, determined without regard to the acquired corporation's foreign status, should serve as the standard for treating a stock acquisition as, in substance, an asset acquisition. *See* Jennifer B. Giannattasio & Jeremy B. Blank, Wells Fargo *(The* Norwest *Reversal)—Is it Just the Eye of the Storm?*, 89 TAX NOTES 1433, 1445 n.67 (2000). They note that such standard might avoid an unintended result of excluding all stock acquisitions of foreign corporations from qualifying as business expansions or business start-ups. *See id.* Their interpretation of the legislative history, however, is too broad because the legislative history did not refer to mere eligibility to file a consolidated income tax return and would lead to undesirable results. For example, an acquisition of a U.S. corporation's stock by another U.S. corporation, which together are eligible to file on a consolidated basis but decide to file separately, would not in substance represent an asset acquisition. Moreover, such an approach would unreasonably favor acquisitions of foreign corporations in that it would interpret the legislative history as treating all stock acquisitions of foreign corporations *eligible* (with

history did not explicitly address business expansions, it implies that a deduction for business expansion costs would similarly depend on entering into a transaction that in substance represents an asset acquisition such that the taxpayer conducts the expanded business.[300] Thus, the eventual structure of a consummated acquisition would determine whether investigatory costs could qualify as deductible expansion expenses or amortizable start-up expenditures and, if not, as capitalizable expenditures.[301]

The form of a transaction, however, is rarely determinable prior to the time when a taxpayer has made a final decision to proceed with the transaction. In other words, a taxpayer in an investigatory phase will, by definition, not be certain about whether it intends to pursue a specific transaction,[302] and therefore, cannot accurately evaluate how a variety of potential transaction structures could impact its treatment of investigatory costs.[303] While remaining in an investigatory phase, a taxpayer likely will remain uncertain about whether it will ever, in substance, acquire the assets needed to conduct a business due in part to many structuring possibilities for any future transaction.

Similarly, in a non-acquisition context, the legal entity used to carry out a business expansion or business start-up might affect a taxpayer's treatment of investigatory costs. Many taxpayers use related entities to conduct various aspects of an overall business in order to shield certain assets from potential liabilities or to operate in different jurisdictions.[304] In business expansion and start-up contexts, no rule exists to attribute the

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eligibility determined without regard to foreign status) to file a consolidated return as asset acquisitions whereas it would only treat stock acquisitions of U.S. corporations followed by *actual* filings of consolidated returns as asset acquisitions. *See id.*

300. An implication is made with respect to business expansions from the § 195 legislative history because costs can only qualify as start-up expenditures if they would have been deductible by an existing business. *See* I.R.C. § 195(c)(1)(B) (2006 & Supp. 2009); NCNB Corp. v. United States, 684 F.2d 285, 291 (4th Cir. 1982) (en banc) ("Congress is thus under the impression that expenditures for market studies and feasibility studies, as at issue here, are fully deductible if incurred by an existing business undergoing expansion."); Giannattasio et al., *supra* note 302, at 1436.

301. *See* Rev. Rul. 99-23, 1999-1 C.B. 998.

302. *See id.*

303. *Cf.* Treas. Reg. § 1.263(a)-5(e)(1) (2003) (characterizing certain investigatory costs—which are otherwise considered facilitative (i.e., capitalizable) costs—as non-facilitative (i.e., deductible) costs where paid or incurred to investigate a so-called covered transaction, which is a transaction identifiable only on the basis of transaction form).

304. *See* John A. Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 WM. & MARY L. REV. 319, 384 (2003) (discussing the use of related entities to operate in favorable tax jurisdictions); Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1336 (2006) (discussing the use of related entities to shield assets).

business conducted by one entity to related entities.[305] Businesses activities are not attributed between shareholders and corporations (even in a consolidated return context)[306] or between partners and partnerships.[307] As a result, the ability to treat certain costs as business expansion expenses or start-up expenditures would depend, in part, on whether a taxpayer expands or starts its own business or whether a related entity expands or starts a business.[308] During an investigatory process, however, it can be difficult to attribute costs properly to the taxpayer or a related entity (i.e., whether a taxpayer incurred costs for its own benefit or on behalf of a related entity) because the taxpayer might pay or incur the costs before knowing what entity (including any to-be-formed entity) will conduct the investigated business.[309] The taxpayer, therefore, will likely

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305. *See* I.R.S. Priv. Ltr. Rul. 84-23-005 (Feb. 8, 1984) (refusing to impute a parent corporation's restaurant activities to its wholly owned subsidiary corporations, which were formed to satisfy local ownership requirements for liquor licenses, and requiring the capitalization of start-up costs attributable to the growth of the overall restaurant business through the subsidiaries); *see also* Moline Props., Inc. v. Comm'r, 319 U.S. 436, 438-40 (1943) (business activities are not imputed between separate taxable entities). However, business activities conducted by an entity disregarded for federal income tax purposes would be attributed to its owner. *See, e.g.*, Treas. Reg. § 301.7701-3(b)(1)(ii) (as amended in 2009) (disregarding the separate tax existence of a domestic eligible entity under the check-the-box regulations).

306. *See* Specialty Rests. Corp. v. Comm'r, 63 T.C.M. (CCH) 2759, 2762-63 (1992) (respecting wholly owned subsidiary corporations as entities separate from their parent corporation and concluding that costs incurred to establish a restaurant in each subsidiary corporation were start-up costs of a new business rather than deductible expenses incurred to expand the parent corporation's existing business, albeit in subsidiary form); *cf.* Haas & Assocs. Accountancy Corp. v. Comm'r, 79 T.C.M. (CCH) 2135, 2138 (2000) (characterizing payments prior to a corporate split off as start-up expenditures attributable to the business of a newly formed subsidiary or the business of a distributee shareholder), *aff'd*, 55 F. App'x. 476 (9th Cir. 2003).

307. *See* Brannen v. Comm'r, 722 F.2d 695, 703-04 (11th Cir. 1984) (noting that, where taxpayers choose to operate a business in a partnership, the classification of costs as start-up expenditures occurs with respect to the partnership's business rather than the taxpayers' businesses); Madison Gas & Elec. Co. v. Comm'r, 633 F.2d 512, 517 (7th Cir. 1980) (noting that an approach of only looking at the business activities of partners in identifying business expansions "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"); I.R.S. Tech. Adv. Mem. 75-090-994 (Sept. 9, 1975) (concluding that the treatment of training costs attributable to a joint venture (i.e., partnership), which elected not to be treated as a partnership for purposes of Subchapter K of the Code, was determined on the basis of the partnership's business activities rather than an individual partner's business activities).

308. *But see* Playboy Clubs Int'l v. United States, 37 A.F.T.R.2d 76-1304, 1306 (N.D. Ill. 1976) (arguing that, with the filing of a consolidated income tax return, the treatment of pre-opening costs should not depend on whether a wholly owned subsidiary or a division of a taxpayer adopts a new product or service area).

309. *Cf.* I.R.S. Priv. Ltr. Rul. 08-30-009 (Apr. 11, 2008) (permitting allocations of transaction costs, including investigatory costs, based on the entity to which services were

remain uncertain about whether it can characterize any costs as its own business expansion or start-up costs.

3. Difficulties in Identifying Relevant Costs

A taxpayer can only identify its investigatory costs if it knows that it has begun an investigation.[310] Whereas a pre-opening phase clearly commences on a date when a taxpayer makes a final decision to pursue a business opportunity and continues until the business begins,[311] an investigatory phase begins at some undefined moment and continues until the final decision date.[312] Because a taxpayer must capture costs paid or incurred during an investigatory phase in assessing their deductibility, the taxpayer would need to know when that phase begins and not just when it ends.[313]

Unfortunately, a taxpayer can easily drift into an investigatory phase without realizing or acknowledging its occurrence. Considerations of business opportunities occur on an ongoing basis without discrete starting points associated with each opportunity.[314] Ideas may surface in a business and undergo changes, development, testing, and deliberation before anyone realizes the first steps have been taken to expand or start a business.[315] Regardless of whether this process occurs through product innovation, service enhancement, or diversification efforts, the taxpayer should consider whether costs associated with any investigatory efforts are properly treated for tax purposes.[316] The practical problem is: a taxpayer often will not know when considerations of business opportunities begin and,

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rendered or on behalf of which services were provided in response to a concern that "the proper party to be charged with costs incurred in the [reverse subsidiary merger] may not be readily identifiable because of the structure of the transaction and the many parties involved").

310. *See generally* Rev. Rul. 99-23, 1999-1 C.B. 998.

311. *See generally* H.R. REP. NO. 96-1278, pt. II, at 10 (1980) ("Start-up or pre-opening expenses are costs which are incurred subsequent to a decision to acquire or establish a particular business and prior to its actual operation.").

312. *See generally id.* at 9 ("Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business.").

313. *Id.*

314. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 08-30-009 (Apr. 11, 2008) ("To maintain its market share, protect against the threat of takeover and maximize competitive opportunity, Company has historically monitored and considered corporate development growth strategies and opportunities, consulted frequently with third-party financial advisors for modeling on alternatives, identification of market trends, obtaining recommendations for future strategic alternatives, access to capital markets, etc.").

315. *See* discussion *supra* Part IV.A.1.

316. I.R.S. Priv. Ltr. Rul. 08-30-009 (Apr. 11, 2008).

correspondingly, when the taxpayer must begin capturing costs to analyze their potential qualification as deductible expansion expenses or amortizable start-up expenditures.[317]

The challenge associated with identifying the start of an investigatory phase reflects a problem of making a meaningful distinction between customary activities associated with managing business operations and other activities associated with investigating business opportunities. The successful management of business operations typically requires diligent consideration of various market forces that could impact the business.[318] Those market forces often reveal business opportunities and trigger a taxpayer's responsive actions to those opportunities as well as to its competitors' actions.[319] Costs associated with such general business considerations have historically been considered deductible under a theory that a taxpayer pays or incurs them to protect, promote, or defend a business.[320] That theory readily supports a deduction for business expansion expenses insofar as an expansion serves to protect, promote, or defend a taxpayer's business.[321] A taxpayer with an expanding business, therefore, might deduct costs for general market considerations without more narrowly attributing any costs to investigatory activities.[322] For that taxpayer, drifting into an investigatory phase would appear unimportant because the taxpayer could generally deduct the costs without ascribing them to a business expansion.[323] In

317. *See* discussion *supra* Part IV.A.1.

318. *See, e.g.*, BABETTE E. BENSOUSSAN & CRAIG S. FLEISHER, ANALYSIS WITHOUT PARALYSIS: 10 TOOLS TO MAKE BETTER STRATEGIC DECISIONS 3 (2008).

319. *See generally* Mark J. Cowan, *Tax Planning Versus Business Strategy: The Rise and Fall of Entity Isolation in Sales and Use Taxes*, 44 IDAHO L. REV. 63, 68 (2007) (noting that market conditions and economic efficiency should dictate business, not the tax code).

320. *See, e.g.*, Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775, 787 (2d Cir. 1973) (permitting a deduction for costs attributable to securing franchise agreements in new markets under "the long recognized principle that expenditures for the protection of an existing investment or the continuation of an existing business or the preservation of existing income from loss or diminution are ordinary and necessary within the meaning of § 162").

321. *See* NCNB Corp. v. United States, 684 F.2d 285, 290-91 (4th Cir. 1982) (en banc) (applying the *Briarcliff* reasoning in a business expansion context); Rev. Rul. 00-4, 2000-1 C.B. 331 (citing *Briarcliff*, 475 F.2d at 787 (explaining the deductibility of expansion costs for activities that allow for sales to new customers and in new markets)).

322. *See generally* Ellis Banking Corp. v. Comm'r, 688 F.2d 1376, 1380 (11th Cir. 1982) (stating "a bank that expands into new markets by branching can deduct investigation costs while a bank that expands into new markets by acquiring the stock of other banks must capitalize those investigation costs").

323. *Cf.* Jeffery R. Atkin, Wells Fargo & Co. and Subsidiaries v. Commissioner*: Rethinking the Deductibility of Certain Pre-Merger Expenditures*, 15 BYU J. PUB. L. 221, 241 (2001).

contrast, a taxpayer that responds to market conditions with an action that constitutes the start of a new business would need to identify the start of any investigatory phase and associated nondeductible investigatory costs (i.e., start-up expenditures).[324] Because investigatory activities broadly include routine events such as general considerations of markets and industries,[325] a taxpayer would have no apparent means to distinguish its general business management activities from any investigatory activities in order to comply with the mandates of § 195.[326]

The general nature of many investigatory activities similarly makes it difficult to allocate costs between various opportunities that might lead to the expansion of an existing business or the start of a new business. General considerations of market conditions can reveal numerous or multifaceted opportunities, some or all of which a taxpayer might eventually choose to pursue. Because investigatory costs are usually paid or incurred before a taxpayer has focused on a specific opportunity, the investigatory costs arguably relate to multiple opportunities.[327] The general nature of an investigation might leave a taxpayer unable to substantiate a reasonable allocation of costs between opportunities that develop into business expansions and those that develop into business start-ups. Such allocations might prove particularly troublesome where a service provider—such as an investment banking firm—provides general business advice in addition to analyses of various business opportunities as part of a comprehensive service package.[328] A taxpayer would accordingly face uncertainty in determining what portion of market survey costs, for example, were attributable to efforts that eventually expanded a business in comparison to efforts that eventually started a new business.

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324. *See generally* I.R.S. Priv. Ltr. Rul. 08-30-009 (Apr. 11, 2008).

325. *See* H.R. REP. NO. 96-1278, at 9 (1980) (The report describes investigatory expenses as being "general or specific" in nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business."); Rev. Rul. 99-23, 1999-1 C.B. 998 (characterizing an investment banking firm's research of several industries and review of publicly available financial information as general investigatory activities).

326. *See generally* Rev. Rul. 99-23, 1999-1 C.B. 998.

327. *See* discussion *supra* Part IV.A.1.

328. Although taxpayers might not officially engage investment banking firms to investigate preliminarily business opportunities, investment banking firms usually incorporate into their fee structures some compensation for efforts attributable to presenting such opportunities to taxpayers. *See* I.R.S. Priv. Ltr. Rul. 08-30-009 (Apr. 11, 2008).

B. *Efforts to Report Uncertain Items*

Despite the uncertainty described above, the annual accounting concept would apparently require that a taxpayer file an income tax return for a taxable year—during which the taxpayer remained in an investigatory phase—on the basis of all events that had occurred by year end.[329] Accordingly, it seems that the taxpayer would become obligated to take any investigatory costs paid or incurred during that year into account in computing taxable income.[330] But, with incomplete information, the taxpayer would need to decide whether to treat those costs as deductible business expansion expenses or capitalizable start-up expenditures.[331]

A cautious taxpayer might be inclined to defer recognition for identified investigatory costs until it can more accurately characterize the business growth. Such deferral, however, would create a new set of issues if the taxpayer ultimately expands an existing business.[332] As an initial matter, the deferral could constitute an unauthorized accounting method change insofar as the taxpayer would now defer deductions for costs that the taxpayer had previously deducted when paid or incurred.[333] The taxpayer would then need to follow administrative procedures in seeking the Service's consent before reverting back to the original method.[334] If, alternatively, the taxpayer's method had not changed as a result of the deferral, then the taxpayer presumably could amend prior open-year returns to account for the investigatory costs in the proper periods.[335] The taxpayer thus

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329. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 364-65 (1931) ("A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.").

330. *See* Treas. Reg. § 1.446-1(a)(1) (2006).

331. *See* § 1.446-1(a)(4)(ii).

332. Deferred recognition could also carry a risk of permanent capitalization to the extent that the taxpayer fails to begin amortizing its start-up expenditures in the year the business begins in accordance with a deemed election under § 195. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

333. *See* Treas. Reg. § 1.446-1(e)(2)(i), (ii)(A) (2006). The existence of a method change could depend, in part, on how broadly the taxpayer or the Service defines the relevant item (e.g., costs incurred to investigate the protection, promotion, or defense of a business versus costs incurred to investigate the expansion of a business). *See* Treas. Reg. § 1.446-1(e)(2)(ii)(A) (2006).

334. *See, e.g.,* Rev. Proc. 97-27, 1997-21 I.R.B. 11 (describing procedures to request consent to change a method of accounting).

335. *See* Treas. Reg. § 1.461-1(a)(3) (1999).

faces an increased administrative burden, plus a possible loss of deductions attributable to closed years, by taking a cautious course of action.

A taxpayer might instead seek to deduct its investigatory costs in the year paid or incurred and expect to "correct" the reporting if the taxpayer ultimately starts a new business. In the event that the taxpayer later discovers that it needs to treat its investigatory costs as start-up expenditures, the taxpayer would have no option to tune up the reporting in the taxable year that it learns the character of the growth.[336] Instead, the taxpayer would either need to file an amended return to correct the prior reporting in any open year[337] or follow administrative procedures to secure consent to change a method of accounting for start-up expenditures.[338] Moreover, the taxpayer's ultimate ability to amortize the re-characterized costs in accordance with a deemed election in the later year would depend on whether such amortization remains a viable fallback option for costs improperly deducted as business expansion expenses on an original return.[339]

The uncertainty about how to treat investigatory costs makes it difficult for a taxpayer with an existing business to report them confidently (to the extent relevant costs are identifiable) on a return for the year during which the taxpayer paid or incurred the costs.[340] That uncertainty becomes especially problematic for a taxpayer conducting extensive market testing and evaluation, which could result in a prolonged period of uncertainty prior to an undertaking of an investigated venture. Although the taxpayer might later modify its treatment of costs to accord with the character of any eventual business growth, the process of amending previously filed returns or changing accounting methods is administratively burdensome for taxpayers and the Service.[341] This administrative inefficiency—coupled with the complicated relationship between the deemed, protective, and binding elections for costs and any prior treatment for such costs on original returns[342]—makes options

336. *See id.*

337. *See id.*

338. *See* Temp. Treas. Reg. § 1.195-1T(b) (as amended by T.D. 9411, 2008-34 I.R.B. 398).

339. *See supra* Part III.B.2.a.

340. *See* Dean Jorgensen, *Tax Treatment of Due Diligence and Start-up Costs Remains Uncertain*, TAX ADVISER, Feb. 1, 1999, *available at* http://www.allbusiness.com/accounting-reporting/expenses-expense-accounts/156138-1.html.

341. *See supra* notes 339-41 and accompanying text.

342. *See supra* Part III.B.2.b.

for dealing with investigatory costs undesirable for taxpayers with existing businesses.

C. *Proposed Treatment for Investigatory Costs of Taxpayers with Existing Business*

Much of the present uncertainty confronting taxpayers originates from the fact that, in enacting § 195, Congress included investigatory costs among those costs eligible for treatment as start-up expenditures.[343] Presumably Congress anticipated that the inclusion of such costs within the definition of start-up expenditures would provide individuals entering into their first businesses with some cost recovery.[344] Prior to the enactment of § 195, the courts[345] and Service[346] routinely denied individuals' deductions for investigatory costs largely under the rationale that those costs were personal, rather than business, expenses attributable to the individuals' decision-making processes about entering into ventures.[347] The costs were considered nondeductible as amounts more closely associated with personal investment decisions than with the business ventures themselves.[348] Section 195 introduced a potential recovery for those otherwise nondeductible costs through amortization and thus provided a benefit to an individual entering into a first business venture—arguably providing the incentive that Congress intended for business start-ups.[349]

A desire to preserve this incentivizing aspect of § 195 would justify a definition of start-up expenditures that continues to include those investigatory costs of taxpayers without existing businesses. A taxpayer—as an individual or otherwise—without an existing business would have clearly run afoul of the pre-

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343. *See* Jorgensen, *supra* note 343.

344. *See* H.R. REP. NO. 96-1278, at 9 (1980) ("[B]usiness investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade expenses, viz., because no business exists, within the meaning of section 162 of the Code."); *see* S. REP. NO. 96-1036, at 11 (1980).

345. *See, e.g.*, Bick v. Comm'r, 37 T.C.M. (CCH) 1591, 1593 (1978) (denying an individual's deduction for investigatory costs attributable to a search for new investment opportunities).

346. *See, e.g.*, Rev. Rul. 77-254, 1977-2 C.B. 63 (describing an individual's costs "incurred in the course of a general search for or preliminary investigation of a business or investment" as nondeductible personal expenses).

347. *See* Fleischer, *supra* note 195, at 580 (noting "a dichotomy between operating businesses and those seeking to commence a business" with respect to deducting investigatory costs).

348. *Id.*

349. *See* I.R.C. § 195 (c)(1)(A)(i) (2006 & Supp. 2009); H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 1 (1980).

opening expense doctrine with respect to investigatory costs.[350] Accordingly, there was no need to define such costs as start-up expenditures[351] to make them explicitly nondeductible under § 195[352] because that result follows from existing case law. However, insofar as Congress believed future amortization of those costs would encourage the formation of new businesses, it seems reasonable to leave investigatory costs within the definition of start-up expenditures in accordance with that belief.[353]

But one must recognize that, in establishing the incentive for new businesses under § 195, Congress placed no apparent limit on investigatory costs eligible for amortization, regardless of how remote they seem from the actual business undertaking. Congress knowingly extended amortization to many otherwise personal expenses.[354] These expenses apparently include personal search expenses[355] incurred before an individual had focused on[356] or made a final decision about a particular business.[357] For example, the Service has construed these

350. *See supra* notes 24-36 and accompanying text.

351. *See* I.R.C. § 195(c)(1)(A)(i) (defining "start-up expenditures" to include "any amount . . . paid or incurred in connection with . . . investigating the creation or acquisition of an active trade or business").

352. *See id.* § 195(a).

353. Congress should clarify, however, how an entity would recover investigatory costs paid or incurred by another taxpayer. Some individuals, for example, will invariably pay investigatory costs before those individuals start a business in a newly-formed corporation. *See, e.g.,* Dejean v. Comm'r, 69 T.C.M. (CCH) 2948, 2952 (1995) (treating start-up costs paid by an individual, prior to the incorporation of a planned business, as capital expenditures of the corporation but declining to rule on the possibility of recovering the costs through amortization or loss deductions). When neither an individual nor a corporation carries on a business to justify an immediate deduction for investigatory costs, it seems appropriate for the corporation to amortize the investigatory costs once the business begins. Unfortunately, that result is not readily apparent under § 195. In particular, a corporation's claim for amortization would need to demonstrate that the personal investigatory costs, including those of a general nature, were paid by the individual directly and proximately benefited the to-be-formed corporation's business. *See* Young & Rubicam, Inc. v. United States, 410 F.2d 1233, 1239-41 (Ct. Cl. 1969) (considering the direct and proximate benefit to a taxpayer's business of activities conducted by affiliated entities in determining whether the taxpayer could claim deductions for costs of those activities).

354. *See* H.R. REP. NO. 96-1278, at 9–10 (1980) (citing Seed v. Comm'r, 52 T.C. 880 (1969), *acq.*, 1970-2 C.B. xxi, and Rev. Rul. 77-254, 1977-2 C.B. 63); S. REP. NO. 96-1036, at 1 (1980) (citing the same).

355. *See* I.R.S. Gen. Couns. Mem. 36,915 (1977) (finding personal search expenses nondeductible before the enactment of § 195).

356. *See* Rev. Rul. 77-254, 1977-2 C.B. 63, 64; *cf.* Seed v. Comm'r, 52 T.C. 880, 885 (1960) (concluding that the taxpayer's extensive activities moved it beyond a "mere casual preliminary investigation of a prospective business or investment").

357. *See* H.R. REP. NO. 96-1278, at 10 (1980); S. REP. NO. 96-1036, at 1 (1980); *see also* I.R.S. Priv. Ltr. Rul. 99-01-004 (Sept. 28, 1998) (noting that a final decision, as contemplated by the § 195 legislative history, does not require a binding agreement

unfocused searches as broadly encompassing research conducted across several industries to find a possible acquisition target.[358] Eligible investigatory costs, therefore, could include a wide variety of general search costs for very preliminary activities unrelated to an eventual business undertaking.[359]

The breadth of investigatory costs included within the current scope of start-up expenditures, however, plagues taxpayers with existing businesses insofar as they must distinguish between investigations directed toward business expansions from investigations directed toward business start-ups.[360] Often a taxpayer, which somehow overcomes the burdens of classifying an undertaking as a new business,[361] could only arbitrarily attribute any general investigation to the new business. An unfocused search across businesses and industries simply contradicts a notion that the search was properly attributable to a specific new business, particularly where the search considered both expansion and new business opportunities. Moreover, given that the broad range of investigatory costs captures costs from very preliminary activities, a taxpayer would face an insurmountable challenge to say when its unfocused activities, such as assessments of market conditions and business strategies, shifted from considerations about an existing business to considerations about a new business.[362] Section 195 nevertheless requires that taxpayers treat all such general investigatory costs as start-up expenditures of new businesses.

A taxpayer also cannot adequately disassociate investigatory costs paid or incurred to review a specific business opportunity from efforts to protect, promote, and defend an existing business. A review of a business opportunity does not occur in isolation. A taxpayer conducts a review to reach a decision about acquiring or entering a business.[363] More specifically, the review generally enables a taxpayer to narrow down opportunities to select which

because the tax treatment of one party's investigatory costs is not dependent on another party's commitment).

358. *See* Rev. Rul. 99-23, 1999-1 C.B. 998, 1000 (Situation 1).

359. *See* I.R.S. Gen. Couns. Mem. 36,915 (Mar. 19, 1975).

360. *See* James L. Musselman, *Amortization Of Start-Up Expenditures Under Section 195 Of The Internal Revenue Code And Revenue Ruling 99-23: A Classic Example Of Misinterpretation By The IRS,* 4 Fla. St. U. Bus. Rev. 139, 146-47 (2004-05).

361. *See supra* Part II.B.1. & Part IV.A.1. for questions about determining relatedness to an existing business and characterizing growth during an investigatory phase, respectively.

362. *See supra* Part IV.A.3 for questions about when an investigatory phase begins.

363. *See* S. REP. NO. 96-1036, at 10, 11 (1980).

one to pursue and to decide whether to pursue it.[364] Each effort to gather and evaluate information, particularly where a taxpayer simultaneously considers several distinct opportunities,[365] operates within a larger decision making process relative to existing businesses. That process is not solely directed toward any business that the taxpayer might eventually undertake. Instead, the process helps a taxpayer make a decision about pursuing a business opportunity based, in large part, on the potential impact for existing businesses.[366] Unfortunately, § 195 suggests that such costs might be attributed entirely to a new business without regard to whether a taxpayer paid or incurred them to protect, promote, or defend an existing business.[367]

Due to these problems, Congress should narrow the definition of start-up expenditures to exclude investigatory costs of taxpayers with existing businesses. Aside from reducing the administrative difficulty of properly identifying and reporting such costs[368]—as well as eliminating an unclear record keeping burden for substantiating any character distinctions—a modified definition appears justified for several reasons.

The first justification for modifying the definition of start-up expenditures is that it could eliminate disincentives created by § 195 for taxpayers with existing businesses. As discussed above, Congress clearly intended for § 195 to provide cost recovery for personal investigatory costs.[369] In that way, Congress created an incentive for starting new businesses insofar as § 195 provides amortization for otherwise nondeductible costs.[370] However, for taxpayers with existing businesses, § 195 takes otherwise deductible business expenses and subjects them to fifteen-year amortization.[371] Where a taxpayer undertakes an investigation to protect, promote, or defend an existing business, § 195 precludes a deduction for investigatory costs if the taxpayer ultimately starts a new business.[372] The slower cost recovery does not encourage such investigations and thus produces a result that contradicts a Congressional objective for § 195. By

364. *See* Rev. Rul. 99-23, 1999-1 C.B. 998.

365. *See id.* (describing an evaluation of a company and several of its competitors in Situation 1 and an evaluation of three potential targets in Situation 2).

366. *See, e.g.*, Rev. Rul. 99-23, 1999-1 C.B. 998 (Situation 2).

367. *See* S. REP. NO. 96-1036, at 10, 11-12 (1980).

368. *See supra* Part IV.A-B.

369. *See supra* notes 342-47 and accompanying text.

370. *See* S. REP. NO. 96-1036, at 11 (1980).

371. *See supra* notes 67-69 and accompanying text.

372. *See* Rev. Rul. 99-23, 1999-1 C.B. 998, 1000.

removing those investigatory costs from the definition of start-up expenditures, Congress presumably would encourage more investigatory activities in connection with business growth.

A modified definition of start-up expenditures would also eliminate a disincentive for innovators and early adopters of different technologies, methodologies, and strategies. Change and innovation naturally refine business fields and industries over time. Attempts to identify new businesses for tax purposes, unfortunately, have considered a particular activity relative to "the average trade or business in a particular field"[373] or the "compass" of an existing business[374] relative to "the limits of the typical . . . enterprise" in that industry.[375] The innovators and early adopters in a particular field or industry accordingly might face fifteen-year amortization for their investigatory costs to the extent their business growth does not yet fit the average or typical expectations for that field or industry. In contrast, the late majority and laggards in the same field or industry might immediately deduct investigatory costs paid or incurred to grow their businesses in ways consistent with expectations or traditions established by the innovators and early adopters in the same field or industry. This disadvantageous cost recovery imposed on costs for early investigations of change and innovation could be eliminated through a modified definition of start-up expenditures.

The second justification for modifying the start-up expenditure definition is that no clear reason existed for having the original definition include the investigatory costs of taxpayers with existing businesses. Congress enacted § 195, in part, to provide amortization for costs deemed nondeductible under the pre-opening expense doctrine. As discussed above, that doctrine prohibited deductions where a taxpayer was not yet carrying on the business and where the costs would provide the taxpayer with future benefits.[376] It is not apparent why the doctrine would have applied to the investigatory costs of taxpayers with existing businesses.

The pre-opening expense doctrine should rarely have raised a "carrying on" concern for investigatory costs of a taxpayer with an existing business. Although ample case law has denied claimed deductions for investigatory costs prior to the conduct of

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373. I.R.S. Tech. Adv. Mem. 93-10-001 (Nov. 4, 1992).

374. *Id.*

375. I.R.S. Gen. Couns. Mem. 35,116 (Nov. 14, 1972) (citing York v. Comm'r, 261 F.2d 421, 422 (4th Cir. 1958)).

376. *See, e.g.*, Musselman, *supra* note 364, at 144.

a trade or business,[377] a court would have denied such deductions prior to the enactment of § 195 for a taxpayer with an existing business only where the court found no connection between the business and the costs.[378] Congress seemed to acknowledge this missing connection by describing the pre-opening expense doctrine as denying deductions of a taxpayer, with an existing business, for investigatory costs paid or incurred "in relation to another business."[379] Despite invoking the complex task of resolving the contours of a business,[380] the reference suggests a taxpayer could have deducted investigatory costs as long as it showed a proximate connection or relationship to an existing business.[381] Few situations could have arisen in which a taxpayer would have conducted an investigation into business opportunities—as an unfocused search of an industry or as a focused review of a particular business before committing to pursue it—and in which the investigation bore no connection or relationship to the taxpayer's existing business. Considerations of various investments, restructurings, acquisitions, expansions, diversifications, and similar actions occur as part of the routine operation of most businesses. Given that such investigations occur in an effort to protect, promote, or defend existing businesses, it seems clear that taxpayers would incur investigatory costs in carrying on those businesses.[382]

Immediate deductions taken for investigatory costs of taxpayers with existing businesses would also have produced minimal distortions of income. The pre-opening expense doctrine stopped taxpayers from deducting costs that would have provided benefits primarily in future years.[383] Investigatory costs, in contrast, relate to the information gathering process that enables a taxpayer to make a current decision about how to operate and

377. *See, e.g.*, Frank v. Comm'r, 20 T.C. 511, 513-14 (1953) (finding that taxpayers conducted no trade or business when they incurred investigatory costs).

378. *See, e.g.*, Ewart v. Comm'r, 25 T.C.M. (CCH) 96, 98 (1966) ("Petitioner does not and could not reasonably contend that the preparatory expenditures relating [to the new businesses] had any connection with his public relations work or any other business in which he was regularly engaged in 1957.").

379. *See* H.R. REP. NO. 96-1278, at 9 (1980); S. REP. NO. 96-1036, at 10 (1980).

380. *See supra* Part II.B.1.

381. *See* I.R.S. Field Serv. Adv. 01-09-001 (Mar. 2, 2001), *available at* 2001 FSA LEXIS 001 ("Investigatory expenses incurred in searching for a new business could be deducted, . . . if the taxpayer could show the search was related to an already existing business."); Fleischer, *supra* note 195, at 575 n.43.

382. Musselman, *supra* note 364, at 143 (citing Fishman v. Comm'r, 837 F.2d 309, 312 (7th Cir. 1988)).

383. *Id.* at 143-44.

manage a business.[384] Most information gathered during an investigatory phase has temporal value—market surveys, competitive analyses, company valuations, and the like tend to grow stale over time and lose usefulness once a decision has been made. Taxpayers consequently realize a significant portion of the benefits resulting from investigatory activities no later than the time when their managements make decisions about how to grow their businesses.[385] It would seem inappropriate to defer recovery for costs related to those activities until later taxable years. Therefore, little distortion of income would occur if a taxpayer were to deduct investigatory costs in computing taxable income from an existing business.[386]

The exclusion of investigatory costs from the definition of start-up expenditures, with respect to a taxpayer with an existing business, would thereby render moot questions about when the taxpayer entered into an investigatory phase, whether an investigated venture closely relates to the taxpayer's existing business, and how the taxpayer should treat its costs before making a final decision about a transaction. Without having to deal with complications introduced by § 195, taxpayers with existing businesses would face fewer administrative burdens and controversies associated with filing and amending tax returns or changing accounting methods to take investigatory costs into account. A modified definition of start-up expenditures would moreover permit a clear reflection of income by eliminating a deferral of deductions for investigatory costs, which primarily benefit current operations, until a later taxable period.[387]

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384. *See id.* at 160-63 (explaining how some investigatory costs related to an acquisition have value in the current taxable period).

385. *See* NCNB Corp. v. United States, 684 F.2d 285, 288-89 (1982).

386. A taxpayer's ability to deduct investigatory costs paid or incurred in connection with an existing business would alleviate some concerns that a preliminary investigation might eventually lead to a business conducted by a related entity. *See supra* Part IV.A.2. The taxpayer's deduction would not distort its income because the costs attributable to pre-decision activities relate to the taxpayer's efforts to manage its own business rather than the business of any other entity. In particular, the unfocused or pre-committal nature of the investigations suggests that a taxpayer would not pay or incur such costs on behalf of another entity. *Cf.* Specialty Rests. Corp. v. Comm'r, 63 T.C.M. (CCH) 2759, 2762-63 (1992) (denying a parent corporation's deduction for pre-opening costs, attributable to the establishment of businesses in specific subsidiaries, on the ground that the costs were incurred on behalf of those subsidiaries).

387. Arguably, taxpayers could capitalize all investigatory costs prior to making a final decision about a business opportunity. The capitalization of such costs might appear to provide an administrable way to handle them until their proper treatment can be determined. To illustrate, where costs are related to a business expansion, they are deducted when the final business decision is made; otherwise, they are amortized as start-up expenditures. However, the above described approach seems less desirable than currently deducting all investigatory costs for two reasons. First, the need to capitalize

V. CONCLUSIONS

Section 195 inappropriately encourages taxpayers with growing businesses to make start-up elections for all investigatory and pre-opening costs associated with various business opportunities. Those taxpayers often cannot accurately identify what costs represent investigatory costs or distinguish among opportunities that might expand or start a business. Facing that uncertainty, the taxpayers are encouraged to comply with effectively binding elections to amortize their costs unless they are willing to risk permanent capitalization if the Service were to challenge any immediate deductions for those costs. Because neither a goal of reducing controversy nor a goal of matching costs with the benefits to which they relate can be met as long as permanent capitalization remains an issue, Congress should amend § 195 to make the amortization of start-up expenditures mandatory. Additional controversy and confusion could be avoided by excluding investigatory costs of taxpayers with existing businesses from the definition of start-up expenditures. Therefore, Congress should also amend § 195 to exclude such investigatory costs from the definition of start-up expenditures. The amendment would allow all taxpayers with existing businesses to deduct investigatory costs regardless of whether an investigation might eventually lead to an expansion or start of a business.

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all investigatory costs would place a greater burden on a taxpayer to determine when it first pays or incurs the investigatory costs that it must capitalize (i.e., the taxpayer must determine when an investigatory phase begins), which would introduce this vexing problem from start-up situations into the business expansion area. *See* Rev. Rul. 99-23, 1999-1 C.B. 998; *see* Thomas P. Ochsenschlager, *Tax Treatment of Due Diligence and Start-up Costs Remains Uncertain*, 2-99 TAX ADVISER 85 (1999). Second, the capitalization of costs would effectively shift a deduction for investigatory costs into later taxable periods to which the costs do not relate. *See generally* Rev. Rul. 99-23, 1999-1 C.B. 998. Because investigatory costs primarily benefit the taxable period in which they are paid or incurred, a current deduction for those costs would permit a more clear reflection of income. *See id.*; *see also* Ochsenschlager, *supra*. An alternative solution might require amortization for investigatory costs of both expanding and start-up businesses. Despite providing an administratively appealing rule in this area, that approach would burden taxpayers unduly by imposing obligations to determine the start of any investigatory phase and distinguish routine business management costs from investigatory costs and would create a potential for income distortion through a deferral of deduction for costs properly attributable to an earlier period. *See* Rev. Rul. 99-23, 1999-1 C.B. 998; *see also* Ochsenschlager, *supra*.