

Office of Chief Counsel
Internal Revenue Service

memorandum

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to: Amy Nasto, Revenue Agent,
STOP 4110HOU

from: Associate Area Counsel (Large and Mid-Size Business)

subject: Section 195 Issues

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This is in response to your request for assistance regarding the characterization and the proper tax treatment of certain expenses that Corporation incurred in relating to its acquisition of Corporation.

Facts

Around mid- , the Corporation () Board of Directors decided to target Corporation for acquisition. On , acquired , which became subsidiary and a member of the consolidated group. immediately changed its name to Corporation (). Prior to paid

\$ for professional services relating to its acquisition of . According to letter to , these services include:

(i) advising on the value creation of the Transaction for the Company versus its current stand-alone plan;¹

¹ "Company" refers to and "Transaction" refers to the acquisition of

- (ii) advising on the structuring of the Transaction;
- (iii) advising on acquisition or merger tactics, including situations involving the interference by third parties;
- (iv) assistance in presenting the Transaction to the financial markets (analysts, investors and press) including among other things the organization of road shows following announcement;
- (v) assistance in presenting the Transaction to the regulatory bodies in the US and the European Community;
- (vi) assisting in the coordination of all implementation steps of the Transaction with internal and external advisors to the Company, and assisting with the preparation of documentation, the conduct of due diligence in respect of the Transaction and the implementation of the Transaction;
- (vii) delivering an opinion to the Board of Directors of the Company as to the fairness to the Company, from a financial point of view, of the consideration to be paid by the Company in the Transaction (the "Opinion"), such Opinion to be in a form and with such conditions as are satisfactory to and the Company; and
- (viii) as required, any other work related to the Transaction agreed between the parties.

See letter to . has not provided a breakdown of the amount paid for these services.

 treated the above-mentioned \$ as startup expenditures, and started amortizing it from under I.R.C. ' 195(c)(1). The Service hesitates in allowing this amount to be so characterized and so treated, because the Service is unsure whether the fact that and were in the same field of business before the acquisition would render §195 inapplicable.

 letter to .

Issues:

(a) With respect to amortization of investigatory expenses, does ' 195 apply only to creating a new business or acquiring a business in a field that differs from the acquirer's existing business?

Brief answer: Yes.

(b) How should alleged "investigatory expenses" be treated?

Brief answer: The majority of these expenses should be capitalized under § 263.

Analysis

(a) With respect to amortization of investigatory expenses, does ' 195 apply only to creating a new business or acquiring a business in a field that differs from the acquirer's existing business?

Under the Internal Revenue Code, investigatory expenses, as part of startup expenditures,² are amortizable over 60 months, which, compared with capitalization, is more favorable to taxpayers. See I.R.C. ' 195(b).

Under § 195, investigatory expenses refers to any amount-

(A) paid or incurred in connection with-

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

... ..

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

I.R.C. ' 195(c)(1). (I.R.C. ' 195(c)(1)(A) and I.R.C. ' 195(c)(1)(B) hereinafter are sometimes referred to as Asubparagraph (A)@ and Asubparagraph (B)@ respectively.)

² § 195 addresses startup expenditures, which includes investigatory expenses and startup costs. See discussion infra in this Analysis.

Whether this statute applies to the acquisition of an existing business in the same field as the acquirer's depends on the meaning of "Active trade or business" in subparagraph (A)(i)³.

Neither Subparagraph (A) nor (B) defines "Active trade or business." These two subparagraphs, however, shed much light on the term's meaning when looked at together.

Subparagraphs (A) and (B) together, in pertinent parts, state that, in addition to "in connection with" investigating the creation or acquisition of an active trade or business, a startup expenditure is an expense that would be currently deductible, if it were paid or incurred in connection with the operation of an existing trade or business which is in the same field as that of the one created or acquired.

To illustrate, suppose A creates or acquires B, an active trade or business in field X. A's startup expenditures, including the expenses incurred in connection with investigating the creation or acquisition of B, must be such that, if incurred in connection with the operation of an existing business in field X, are currently deductible.

Whether an expense is currently deductible is controlled by I.R.C. ' 162, which provides that only ordinary and necessary expenses are currently deductible. What kind of expenses, then, paid or incurred in connection with investigating the creation or acquisition of B could have been incurred in connection with operating an existing business in field X and currently deductible? Such expenses are not identifiable, or even conceivable, from the plain language of ' 195(c), although such identification is crucial to the ultimate issue in this case.

"In the absence of a legislative definition, the term must be given a meaning consistent with the overall statutory context." Doe v. Rowe, 156 F. Supp. 2d 35, 46-47 (D. Me. 2001).

³ Of subparagraph (A), only (i) is relevant to the present case.

Section 195 was enacted in 1980. The legislative history reflects that Congress, in enacting ' 195, intended to encompass two types of expenses in startup expenditure, i.e. investigatory expenses and startup costs.⁴ See 96 H. Rpt. 1278 at 9-10.

Congress defined the term "investigatory expenses" as Acosts of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business. Business investigatory expenses may be of either a general or specific nature. The former are related either to businesses generally, or to a category of business; the latter are related to a particular business.@ Id. at 9 (emphasis added).

The word "enter" in the Congressional definition of "investigatory expenses" indicates that the target business is new to the taxpayer: either the taxpayer is not engaged in an existing business or is engaged in a business in a different field.

Grammatically, "business" is the object of both "acquire" and "enter." The meaning of the word "business" in this context, then, must be such that fits both verbs. It is therefore logical to conclude that the word "business" can only mean a business in a field different from the acquirer's. Thus, the Congressional definition of "investigatory expenses" appears to imply that §195 only applies to acquiring a business in a different field.

This implication is more conspicuous when Congress describes the eligibility for amortization under § 195. To be eligible for amortization under §195, states the House Report, "[f]irst, the expenditures must be paid or incurred in connection with creating, or investigating the creation or acquisition of, a trade or business entered into by the taxpayer." Id. at 10 (emphasis added). As already explained, entering into a business suggests that the business is in a different field if the taxpayer is already engaged in an existing business. Here, to be eligible for amortization of the investigatory expenses under §195, it is required that the business must be one entered into by the taxpayer. In other words, if the taxpayer acquires a business, the acquired business must be in a field different from the taxpayer's existing business.

⁴ This Analysis will focus only on investigatory expenses because the present case does not involve startup costs.

This interpretation is consistent with the statutory context of § 195. "Investigatory expenses" is one of the two categories included in "startup expenditures" under §195. The word "startup" connotes originality, newness, or distinctiveness from what already exists. This "newness" notion is more explicitly expressed in the House Report's discussion of "startup costs," the other category included in "startup expenditures:"

Generally, the term "startup costs" refers to expenses which would be deductible currently if they were incurred after the commencement of the particular business operation to which they relate. Such costs may be incurred by a party who is not engaged in any existing business, or by a party with an existing business who begins a new one that is unrelated, or only tangentially related, to his or her existing business.

Id. at 10 (emphasis added).

Although Congress did not state that investigatory expenses must be related to acquiring a business in an unrelated or only tangentially related field, it can be inferred from the overall context of § 195 that Congress did so intend.

In Rev. Rul. 99-23, three hypothetical situations are established to elucidate what qualifies as § 195 amortizable investigatory expenses in an acquisition of an existing active trade or business. In each hypothetical situation the target company is in a field unrelated to the acquirer's. See Rev. Rul. 99-23. Incorporating such a fact pattern in each hypothetical situation of the ruling reveals the IRS's reluctance to extend §195's application to acquiring a business in the same field (if not its position that § 195 only applies to acquiring a business in a different field) with respect to amortizing investigatory expenses.

The inquiry might as well end here. But it may still be asked whether the definition of investigatory expenses could have meant *costs of seeking and reviewing prospective businesses prior to reaching a decision to (1) acquire a business either in the same field as the acquirer's or in a different field; or (2) enter a business in a different field.*

In enacting § 195, Congress did not contemplate ordinary and necessary business expenses paid or incurred in connection with the expansion of an existing business. Congress noted that these expenses were already deductible under the then existing law. See Id. at 11. Congress was only concerned with those that were ordinary and necessary yet could not be deducted under ' 162, because they were not paid or incurred in carrying on a business. As the House Report notes, these expenses were considered as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code.⁵ Id. at 9 (emphasis added).

The above language suggests that Congress contemplated the following scenario in enacting ' 195:

A, engaged in an existing business, incurs "costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire"⁶ B (and later does acquire B). But A cannot deduct these expenses, because they are incurred before B is acquired, so that they are not incurred in carrying on a business.

Why are these expenses not considered as incurred in connection with expanding A's existing business and thus deductible under § 162? There are two possible answers to this question:

(1) B is in a different field as A's, so that "no business exists" for A to deduct the expenses (the effect of acquiring B, a business in a different field, is the same as entering a new business);

(2) B is in the same field as A's, but acquiring a business in the same field is not considered as expanding the acquirer's existing business.

If answer (2) can be excluded, i.e. acquiring a business in the same field is considered a business expansion, leaving answer

⁵ I.R.C. ' 162 provides that A[t]here shall be allowed as deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...@ Under this section, in addition to being ordinary and necessary, a deductible expense must be paid or incurred in carrying on a business.

⁶ Definition of investigatory expenses. See discussion on Page 5 supra.

(1) the only answer to the question, then it can be concluded that § 195, with respect to amortizing investigatory expenses, only applies to acquisition of a business in a different field.

Is acquiring a business in the same field considered as expanding the acquirer's existing business? An instinctive answer would be yes (expanding by buying competitors), but it has little support in either statutory or case law. "Expanding a business," or "business expansion," is not defined either in the Code or in the Regulations. The House Report, as well as § 195 itself, indicates that costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business (Congressional definition of "investigatory expenses") incurred in connection with the expansion of an existing business are deductible under §162. But no example of such deductible expenses has ever been given. No such incidents have been observed. This category of currently deductible expenses only exists as a phantom.

In Wells Fargo v. Commissioner, 224 F.3d 874 (2000), the transaction from which the dispute arises is a bank's acquisition of two other banks. Because the banks are in the same field of business, the government conceded on brief that the transaction is an expansion of an existing business, and, consequently, the investigatory expenses, instead of amortizable under ' 195, are currently deductible. See the Government's Brief for the Appellee, Wells Fargo v. Commissioner at Pages 22-23.

Since the Court did not hold on this issue, merely mentioning it in the opinion, the government's position has no precedential value. Neither did the government provide any legal basis for this position.

The answer to whether acquiring a business in the same field (as the acquirer's) constitutes business expansion has grave ramifications. To answer this question in the affirmative might be interpreted as recognizing that investigatory expenses incurred in connection with acquiring a business in the same field are deductible under § 162.

Inferring any expense's §162 deductibility from interpretation of a different Code section is as undesirable a side effect as it is an inappropriate analytical approach. Since there has been no binding precedent on this issue, the government has yet to take a position thereon. This task, however, is

beyond the authority (and persuading power) of the Chief Counsel's field office.

We therefore only conclude, based on the above analysis, to a reasonable degree of certainty, that with respect to investigatory expenses amortization, § 195 applies only to the creation of a new business or acquisition of a business in a different field.

(b) How should alleged "investigatory expenses" be treated?

treated the \$ paid to as "investigatory expenses" and started amortizing it in under § 195. Whether these expenses in question qualify as investigatory expenses within the meaning of § 195 depends on the relevant facts and circumstances, not on how labels them.

Of all the listed services for which paid

, only the one in (i), advice on value creation of acquisition, ostensibly qualifies under § 195 as "costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire" a business. (The dollar amount to be allocated to this advice is a question of fact, and has to itemize the service fees paid and substantiate the itemization.) However, as discussed in Part (a) in this Analysis, because and were in the same field of business, this expense is not eligible for amortization under § 195.

In any event, the payment for the remaining services should be capitalized under § 263. Section 263 provides that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. I.R.C. ' 263(a). In applying ' 263, instead of solely looking at the increased value to concrete assets, Courts have focused on the long-term effect that expenditures generate, and maintained that there does not have to exist a physical asset for ' 263 to apply. See INDOPCO Inc. v. Commissioner, 503 U.S. 79 (1992); Wells Fargo v. Commissioner, 224 F.3d 874 (2000). AA taxpayer-s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.@ 503 U.S. at 87.

When an expenditure does not create or enhance a separate and distinct asset, the determination whether to capitalize or deduct this expenditure depends, to a certain extent, on the presence of a **long-term benefit** associated with that expenditure. See Wells Fargo, 224 F.3d at 884 (emphasis added). Expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses. @ Id. at 89.

The INDOPCO Court has also stated:

Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure. Although support for these decisions can be found in the specific terms of ' 162, which require that deductible expenses be ordinary and necessary @ and incurred in carrying on any trade or business, @ courts more frequently have characterized an expenditure as capital in nature because the **purpose** for which the expenditure is made has to do with the **corporations operations** and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat **longer than the current taxable year.** @

Id. at 89-90, citing General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964) (emphasis added).

In the present case, purpose in acquiring is that, combined, and can be run more efficiently and can use its capital more profitably than either company on its own, thus creating substantial long-term value. See Form 886-A. Thus the expenses in question, since directly related to seeking the long-term value, should be capitalized. ⁷

⁷ It is possible, though not likely, that among these expenses some are ordinary and necessary in nature and the long-term benefit they generated is only incidental. In that situation, as the INDOPCO Court states, such ordinary and necessary expenses should be allowed as currently deductible. However, it is the taxpayer that has the burden to establish that the expenses should be currently deductible rather than capitalized. INDOPCO Inc. v. Commissioner, 503 U.S. 79, 85 (1992). Therefore, unless

By: _____
DAVID Q. CAO
General Attorney
(Large and Mid-Size Business)