Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:PNX:TL-N-5226-00
RVHosler

date: OCT 16 2000

to: Bob Maio, Team Coordinator
LMSB Division, Group 1351

from: Office of Chief Counsel, LMSB, Area 5, Phoenix

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subject: [redacted]
Request For Advice - [redacted] Project Contract

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ADVICE

This memorandum is to supplement our response, dated September 25, 2000, to your request for advice concerning whether certain expenses incurred by [redacted] in connection with the [redacted] Project Contract were costs incurred in the expansion of an existing business or were costs incurred in the start-up of a new business. Since that date, we have received input from the national office and, while this memorandum presents additional views for consideration, it does not alter our prior conclusion that the costs were incurred in the expansion of an existing business rather than for a new business.

The issue previously addressed was whether the expenses incurred by the [redacted] which were contracted for by [redacted], a wholly owned subsidiary of [redacted], constitute nondeductible start-up costs pursuant to I.R.C. § 195 during the period from [redacted] to [redacted].

An additional issue that you may want to consider is whether [redacted] entered a new trade or business and, therefore, if its expenses were currently nondeductible. The issue of whether the activities of a parent corporation may be imputed to a new subsidiary for purposes of determining whether the subsidiary has entered a new trade or business depends on the facts and circumstances of each case.

In Baltimore Aircoil Co., Inc. v. United States, 333 F. Supp. 705 (D. Md. 1971), the parent was allowed to deduct its subsidiary's start-up costs because separate corporate forms were illusory and could be disregarded. Expenses for training personnel and other activities in opening a new wholly-owned subsidiary were held to be deductible on their consolidated tax return, since at the time the court considered the subsidiary as merely a branch or division of the parent.

On occasion, the courts have disregarded corporate lines between parent and subsidiary corporations, but generally these cases involved extraordinary or "peculiar" circumstances where disregarding the corporate lines was done to arrive at a "just taxing basis." North Jersey Title Ins. Co. v. Commissioner, 84 F.2d 898, 901 (3d Cir. 1936); Continental Oil Co. v. Jones, 113 F.2d 557 (10th Cir. 1940); Gulf Oil Corp. v. Lewellyn, 248 U.S. 71 (1918). Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918).

On the other hand, in Bennett Paper Corporation and Subsidiaries v. Commissioner, 78 T.C. 458 (1982), aff'd, 699 F.2d 450 (8th Cir. 1983), the court held that there was no continuity between the parent and subsidiary. The taxpayer was the parent of an affiliated group of corporations filing a consolidated return for 1974, the year in issue. A new subsidiary was created in 1974 whose business purpose was to establish a marina and yacht club. Marina activities prior to 1974 had been carried on by the parent of this subsidiary. The new subsidiary did not begin its operations until 1975. Nevertheless, the taxpayer deducted on its consolidated return preopening expenses incurred by the subsidiary in 1974. The court held that these amounts were not deductible under section 162(a) because the taxpayer's trade or business had not commenced in the tax year in issue.

In the current case, sufficient facts have not been set forth to make a definitive determination of whether the activities of [redacted] should be attributed to [redacted]. We know that all of the members of the Board of Directors of

[redacted] were employees/officers of [redacted] and that as soon as [redacted] was formed [redacted] began soliciting investors to purchase the company. (Traditionally, [redacted] has operated in much the same manner. [redacted] takes a project to development, then forms a subsidiary which is sold.) But it is not clear whether [redacted] was established just to spin-off the project or if it actually operated as a separate business during the period at issue.

If you have any comments or questions regarding the above, please contact me at (602) 207-8056.

RICK V. HOSLER
Attorney

Approved:

JOHN W. DUNCAN
Acting Associate Area Counsel

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SWD:PNX:TL-N-5226-00
RVHosler

date: SEP 25 2000

to: Bob Maio, Team Coordinator
LMSB Division, Group 1351

from: District Counsel, Southwest District, Phoenix

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subject: [redacted]
Request For Advice - [redacted]

DISCLOSURE STATEMENT

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ADVICE

This memorandum is in response to your request for advice concerning whether certain expenses incurred by [redacted] in connection with the [redacted] were costs incurred in the expansion of an existing business or were costs incurred in the start-up of a new business. Although the issue has not been completely factually developed, it appears, based on the facts presented, that these costs were incurred in the expansion of an existing business rather than for a new business.

ISSUE

Whether the expenses incurred by the [redacted] which were contracted

for by [redacted], a wholly owned subsidiary of [redacted], constitute nondeductible start-up costs pursuant to I.R.C. § 195 during the period from [redacted] to [redacted].

FACTS

[redacted] has been in the [redacted] business since [redacted]. Since that time, [redacted] has been extensively involved in research and development related to [redacted] activities. Presently, [redacted] manufactures and sells a diverse line of [redacted]

During [redacted], [redacted] began research to develop a [redacted] of [redacted]. The research project was known as the [redacted]. The project was to ultimately consist of a [redacted] of [redacted] which would [redacted] with [redacted] systems referred to as [redacted]. The [redacted] linked the [redacted] with [redacted].

[redacted] formed a special business unit, [redacted], to conduct the development of the System. The special business unit was a division of [redacted]'s [redacted] Group. The unit was assigned personnel from the [redacted] Group and used the group's accounting and administrative systems.

On [redacted], [redacted] formed a wholly owned subsidiary, [redacted], to own and operate the System. Immediately thereafter, [redacted] began soliciting investors in the project to shift the financial risk of the project and provide working capital. In [redacted], about [redacted] outside investors purchased shares of [redacted] stock such that [redacted]'s ownership interest fell to approximately [redacted]%. (Thus, as [redacted]'s interest was less than [redacted]%, [redacted] no longer qualified as a member of the [redacted] consolidated group.)

On [redacted], [redacted] entered into [redacted] contracts with [redacted]. The [redacted] contracts provided for the construction of the four functional components of the System which were: (1) [redacted], (2) [redacted], (3) [redacted], and (4) [redacted].

The construction of the [redacted] segment was provided for in the contract referred as the [redacted]. The stated purpose of this contract was to function as a mechanism whereby [redacted] would sell to [redacted] the [redacted] portion of the System. The [redacted] refers to the integrated combination of [redacted] segment and system control segment. The [redacted] segment consists solely of the [redacted].

The system control segment consists of the various [redacted] facilities used to manage and control the [redacted].

During the period from [redacted] to [redacted], [redacted] generally expensed all of the costs associated with the [redacted] project. The [redacted] period was examined in the prior audit cycle and the issue of whether the [redacted] project was an expansion of [redacted]'s current business or an entirely new business was raised. The Appeals Office concluded that the project was an expansion of [redacted]'s current business.

DISCUSSION

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

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

In the case of an existing business, pre-opening or start-up expenses do not include business expenses paid in connection with the expansion of a business. Expenses associated with the expansion of an existing business are currently deductible.

Whether a business is an expansion of an existing trade or business or new trade or business depends on the facts and circumstances of each case. S. Rep No. 1036, 96th Cong., 2d Sess. 12 (1980); See also Higgins v. Commissioner, 312 U.S. 212, 217 (1941). We have found no authorities that provide a test for determining when an existing business begins a new trade or business. However, the Service generally applies the law defining when a trade or business begins for a new enterprise or entity to determine the most likely approach for answering this question. (See, e.g., IRS Letter Ruling 9331001.)

The leading case defining when a trade or business begins is Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965). In Richmond Television, the taxpayer was a corporation organized to operate a television station. The court held that the taxpayer was not a "going concern" until the broadcasting license was issued and broadcasting commenced. Because the costs of training prospective employees were incurred

before the license was issued and before broadcasting commenced, the court held that the costs were capital expenditures and were not deductible under section 162(a) of the Code.[1]

The crucial prerequisite for deductibility of trade or business expenses under section 162 is that the enterprise incurring them must be beyond the point of mere preparation and actually be engaged in the primary activities intended. Applying this rule to the question of when an entity already engaged in a trade or business begins a new trade or business, it is appropriate to look for a change in the nature of the activities engaged in by the entity[2]. Cases dealing with this issue are generally consistent in finding that an entity is not beginning a new business when its seeks to expand its customer base by adding new product, opening stores, or by changing marketing strategy.

In the current case, sufficient facts have not been set forth to make a definitive determination of whether the research and development expenses of the [redacted] project were an expansion of [redacted]'s existing trade or business or constituted a new trade or business. The facts do not state in detail precisely

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

[2] For example, in Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228-29 (1985), the court noted that nuclear generation of electricity differs substantially from the production of electricity in conventional fossil fuel plants. The employees must be trained to a higher degree. Heat is produced by different means. Finally, support systems are required at a nuclear reactor that are not required for conventional plants. Therefore, the court concluded that the training expenses incurred in connection with the opening of the nuclear plant should be capitalized as a one-time expenditure necessary to begin a new business. See also Radio station WBIR v. Commissioner, 31 T.C. 803 (1959) (holding that the operation of a radio station is not the same business as the operation of a television station); First Security Bank of Idaho v. Commissioner, 63 T.C. 644 (1975), aff'd, 592 F.2d 1050 (9th Cir. 1979) (holding that initiation of consumer credit cards plans was an expansion of existing banking activities).

what the activities of [redacted] were before and after the [redacted]. For instance, facts could be developed regarding changes in the in the operations of each division of [redacted], primary customers, specific products/services, key personnel, training, and the distribution systems. As noted above, the concern is a factual issue not a legal issue.

However, based on the facts that were provided, it appears that the expenses incurred in connection with the initiation of the [redacted] project were for an expansion of [redacted]'s existing business. [redacted] has been engaged in research and development in the [redacted] industry for many years. The expenses incurred by [redacted] in connection with the [redacted] project are continuation of this type of business. The legislative history of section 195 provides that a taxpayer is required to capitalize costs relating to a new activity only if the activity is "unrelated or only tangentially related" to the taxpayer's existing business. S. Rep. No. 1036, 96th Cong., 2d Sess. 11 (1980). In the current case, the costs incurred appear to clearly be related to what has historically been [redacted]'s traditional [redacted] business activity. Thus, these cost would be considered to have been incurred in connection with the expansion of [redacted]'s business activities.

We consider the statements of law expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at (602) 207-8056.

DAVID W. OTTO
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By: Rick V. Hosler
RICK V. HOSLER
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cc: Regional Counsel, Western Region
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