

1,1998, *U* entered into an acquisition agreement with *V* to purchase all the assets of *V*. *U* did not prepare and submit a letter of intent, or any other preliminary agreement or written document evidencing an intent to acquire *V* prior to executing the acquisition agreement.

Situation 2

In May 1998, corporation *W* began searching for a trade or business to acquire. In anticipation of finding a suitable target to acquire, *W* hired an investment banker to evaluate three potential businesses and a law firm to begin drafting regulatory approval documents for a target. Eventually, *W* decided to purchase all the assets of corporation *X*. *W* and *X* entered into an acquisition agreement on December 1, 1998.

Situation 3

In June 1998, corporation *Y* hired a law firm and an accounting firm to assist in the potential acquisition of corporation *Z* by performing certain services that the parties labeled as “preliminary due diligence.” These “due diligence” services included conducting research on *Z*’s industry (including information relating to competitors of *Z*), and analyzing financial projections for *Z* for 1998 and 1999. In September 1998, at *Y*’s request, the law firm prepared and submitted a letter of intent to *Z*. The offer contained in the letter of intent resulted from prior discussions between *Y* and *Z*, and specifically stated that a binding commitment with respect to the proposed transaction would result only upon execution of an acquisition agreement. Thereafter, the law firm and accounting firm continued to provide services labeled as “due diligence,” including a review of *Z*’s internal documents relating to insurance policies, employee agreements, and lease agreements, an in-depth review of *Z*’s books and records, and preparation of an acquisition agreement. On October 10, 1998, *Y* entered into an acquisition agreement with *Z* to purchase all the assets of *Z*.

In each of the three situations, the trades or businesses of the targets are active trades or businesses unrelated to the trades or businesses of *U*, *W*, and *Y*. *U*,

W, and *Y* each use an accrual method of accounting and a calendar taxable year. Each of the acquisition agreements entered into by *U*, *W*, and *Y* were subject to customary conditions of closing. Finally, *U*, *W*, and *Y* each completed the acquisitions in 1998 and timely elected on their 1998 federal income tax returns to amortize start-up expenditures over a period of not less than 60 months under § 195(b).

LAW AND ANALYSIS

Section 195(a) provides that, except as otherwise provided in § 195, no deduction is allowed for start-up expenditures.

Section 195(b) provides that start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses that are allowed as a deduction prorated equally over a period of not less than 60 months (beginning with the month in which the active trade or business begins).

Section 195(c)(1) defines “start-up expenditure,” in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (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. Thus, in order to qualify as start-up expenditures under § 195(c)(1), a taxpayer’s “investigatory costs” must satisfy the requirements in both §§ 195(c)(1)(A) and (B). In addition, the term “start-up expenditure” does not include any amount with respect to which a deduction is allowable under §163(a), 164, or 174.

Sections 162 and 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts generally have construed § 162 as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) ordinary, (3) necessary, (4) paid or incurred during the taxable year, and (5) made to carry on a trade or business. See *Commissioner v. Lincoln Savings and Loan Ass’n.*, 403 U.S. 345 (1971).

Rev. Rul. 99-23

ISSUE

When a taxpayer acquires the assets of an active trade or business, which expenditures will qualify as investigatory costs that are eligible for amortization as start-up expenditures under § 195 of the Internal Revenue Code?

FACTS

Situation 1

In April 1998, corporation *U* hired an investment banker to evaluate the possibility of acquiring a trade or business unrelated to *U*’s existing business. The investment banker conducted research on several industries and evaluated publicly available financial information relating to several businesses. Eventually, *U* narrowed its focus to one industry. The investment banker evaluated several businesses within the industry, including corporation *V* and several of *V*’s competitors. The investment

banker then commissioned appraisals of *V*’s assets and an in-depth review of *V*’s books and records in order to determine a fair acquisition price. On November

Sections 263 and 1.263(a)–1(a) provide that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)–2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Through provisions such as §§ 162(a) and 263(a), the Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. *See, e.g., INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992).

In describing the law prior to § 195, Congress explained that “investigatory expenses,” which were “costs incurred in seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business,” normally were not deductible because they were not incurred in carrying on a trade or business within the meaning of § 162. *See* H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9 (1980) (House Report); S. Rep. No. 1036, 96th Cong., 2d Sess. 10 (1980) (Senate Report). The “carrying on a trade or business” requirement was not met where investigatory expenses were incurred by a taxpayer who was not yet carrying on any trade or business, or where a taxpayer was carrying on a trade or business but incurred costs to investigate the creation or acquisition of another, unrelated trade or business. *Id.* However, a taxpayer incurring costs to investigate the expansion of an existing business generally could deduct those costs under § 162, assuming the other requirements of that section were met. This disparity in the tax treatment of investigatory expenses resulting from the “carrying on a trade or business” requirement discouraged taxpayers from investigating the creation or acquisition of new trades or businesses. Section 195 was enacted, in part, to minimize this disparity and thereby encourage formation of new businesses by providing an amortization deduction for eligible investigatory expenses.

Accordingly, under § 195(c)(1)(B), expenditures described in § 195(c)(1)(A) that are incurred before the establishment of an active business are deemed to be paid or incurred in the operation of an existing active trade or business (in the same field as the business that the taxpayer is investigating whether to create or acquire), *i.e.*, they are deemed to satisfy the carrying on a trade or business requirement. However, because § 195(c)(1)(B) also requires that an expenditure described in § 195(c)(1)(A) be allowable as a deduction for the taxable year in which paid or incurred, the expenditure still must meet all the other requirements of § 162. Thus, the expenditure must be an ordinary expense under § 162, and not a capital expenditure, to be a start-up expenditure under § 195. “Section 195 did not create a new class of deductible expenditures for existing businesses. . . . [I]n order to qualify under section 195(c)(1)(B), an expenditure must be one that would have been allowable as a deduction by an existing trade or business when it was paid or incurred.” *FMR Corp. v. Commissioner*, 110 T.C. No. 30 (June 18, 1998). *See also* §§ 161 and 261 (deductions are allowed, subject to capitalization provisions). Whether an expenditure is an ordinary expense or is capital in nature is a question of fact that depends on the context in which the expenditure is incurred. *See Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974); *Deputy v. duPont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933).

The legislative history of § 195 provides the following guidance regarding whether an expenditure is an ordinary investigatory cost that is an eligible start-up expenditure, or a capital acquisition cost:

Eligible expenses consist of investigatory costs incurred prior to reaching a final decision to acquire or enter that business. These costs include expenses incurred for the analysis or survey of potential markets, products, labor supply, transportation facilities, etc.

Start-up expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowed to an existing trade or business for the taxable year in which the expenditure was paid or incurred. . . . In addition, the amortization election for start-up expenditures does not apply to amounts paid or incurred as part of the acquisition cost of a trade or business. Also, start-up expenditures do not include amounts paid or incurred for the acquisition of property to be held for

sale or property which may be depreciated or amortized based on its useful life. . . . Whether an amount is consideration paid to acquire a business depends upon the facts and circumstances of the situation.

House Report at pages 10–11; Senate Report at pages 11–12.

Rev. Rul. 77–254, 1977–2 C.B. 63, which is specifically referenced by the legislative history of § 195 (House Report at 9, Senate Report at 10), considers which costs incurred in the potential acquisition of a new business are capital acquisition costs for purposes of §§ 165 and 263. That ruling provides that expenses incurred in the course of a general search for, or an investigation of, a business that relate to the decisions *whether* to purchase a business and *which* business to purchase are investigatory costs. However, once a taxpayer has focused on the acquisition of a specific business, expenses that are related to an attempt to acquire that business are capital in nature. Thus, the “final decision” referred to in the legislative history of § 195 is the point at which a taxpayer makes its decision *whether* to acquire a business, and *which* business to acquire, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction.

Courts have long held that legal, brokerage, accounting, appraisal, and similar costs incurred to acquire a capital asset are capital expenditures under § 263. *Woodward v. Commissioner*, 397 U.S. 572 (1970) (when property is acquired by purchase, nothing is more clearly a part of the process of acquisition than the establishment of a purchase price); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Beneficial Industrial Loan Corp. v. Handy*, 16 F. Supp. 110, 112 (D. Del. 1936), *aff’d*, 92 F.2d 74 (3d Cir. 1937); Rev. Rul. 73–580, 1973–2 C.B. 86.

For example, in *Ellis Banking Corp. v. Commissioner*, T.C. Memo. 1981–123, *aff’d in part & rem’d in part*, 688 F.2d 1376 (11th Cir. 1982), the taxpayer incurred expenses for office supplies, filing fees, travel, and accounting services in connection with its examination of target’s books and records. The examination was performed pursuant to an acquisition agreement for the purchase of target’s stock that was contingent on several terms and conditions, such as regulatory approval. The Tax Court concluded that the

expenses were nondeductible capital expenditures incurred in the acquisition of a capital asset. The Court of Appeals for the Eleventh Circuit substantially affirmed, noting that the requirement that costs be capitalized extends beyond the price payable to include any costs incurred by the buyer in connection with the purchase, such as appraisals of the property or the costs of meeting any conditions of sale.

Accordingly, expenditures incurred in the course of a general search for, or an investigation of, an active trade or business, *i.e.*, expenditures paid or incurred in order to determine *whether* to enter a new business and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation), are investigatory costs that are start-up expenditures under § 195. Alternatively, costs incurred in the attempt to acquire a specific business are capital in nature and thus, are not start-up expenditures under § 195. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of the acquisition. The label that the parties use to describe the cost and the point in time at which the cost is incurred do not necessarily determine the nature of the cost.

In *Situation 1*, an examination of the nature of the costs incurred indicates that *U* made its decision to acquire *V* after the investment banker conducted research on several industries and evaluated publicly available financial information. The costs incurred to conduct industry research and review public financial information are typical of the costs related to a general investigation. Accordingly, the costs incurred to conduct industry research and to evaluate publicly available financial information are investigatory costs eligible for amortization as start-up expenditures under § 195. However, the costs relating to the appraisals of *V*'s assets and an in-depth review of *V*'s books and records to establish the purchase price facilitate consummation of the acquisition, and thus, are capital acquisition costs. The costs incurred to evaluate *V* and *V*'s competitors also may be investigatory costs, but only

to the extent they were incurred to assist *U* in determining whether to acquire a business and which business to acquire. If the evaluation of *V* and *V*'s competitors occurred after *U* had made its decision to acquire *V* (for example, in an effort to establish the purchase price for *V*), such evaluation costs are capital acquisition costs.

In *Situation 2*, the costs incurred to evaluate potential businesses are investigatory costs eligible for amortization as start-up expenditures under § 195 to the extent they relate to the *whether* and *which* decisions. However, the costs incurred to draft regulatory approval documents prior to the time *W* decided to acquire *X* are not start-up expenditures under § 195. The costs related to such activities, even if the activities occurred during the period *W* is engaged in a general search for a business, were not incurred in order to investigate whether to acquire a business and which business to acquire, but rather to facilitate an acquisition.

In *Situation 3*, an examination of the nature of the costs incurred by *Y* indicates that *Y* made its decision to acquire *Z* in September 1998, around the time that *Y* instructed the law firm to prepare and submit the letter of intent. The costs related to the "preliminary due diligence" services provided prior to that time (including the costs of conducting research on *Z*'s industry and in reviewing financial projections of *Z*) are typical of the costs incurred during an investigation to determine whether to acquire a new business and which new business to acquire. Thus, these costs are investigatory costs that are eligible for amortization as start-up expenditures under § 195. The costs related to "due diligence" services provided after that time, however, relate to the attempt to acquire the business and must be capitalized under § 263 as acquisition costs. Thus, the "due diligence" costs incurred to review *T*'s internal documents, books and records, and to draft the acquisition agreements are not eligible for amortization under § 195.

HOLDING

Expenditures incurred in the course of a general search for, or investigation of, an active trade or business in order to determine *whether* to enter a new business

and *which* new business to enter (other than costs incurred to acquire capital assets that are used in the search or investigation) qualify as investigatory costs that are eligible for amortization as start-up expenditures under § 195. However, expenditures incurred in the attempt to acquire a specific business do not qualify as start-up expenditures because they are acquisition costs under § 263. The nature of the cost must be analyzed based on all the facts and circumstances of the transaction to determine whether it is an investigatory cost incurred to facilitate the *whether* and *which* decisions, or an acquisition cost incurred to facilitate consummation of an acquisition.

DRAFTING INFORMATION

The principal author of this revenue ruling is Susie K. Bird of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Ms. Bird on (202) 622-4950 (not a toll-free call).