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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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SEP 28 [redacted]

Appeals Office

Sep. 28, 1998

Taxpayer's Name:
Taxpayer's ID Number:
Taxpayer's Address:

Tax Years Ended:
Date of Conference:

LEGEND:

Taxpayer =

Entity X =

Corp A =

Corp B =

Corp C =

Corp D =

Corp E =

Financial Advisor =

Law Firm =

Accounting Firm =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

r =

s =

t =

u =

v =

ISSUE:

Whether the expenditures incurred by the Taxpayer in connection with the acquisition of Corp C qualify as start-up expenditures under § 195(c)(1) of the Internal Revenue Code.

CONCLUSION:

The expenditures incurred by the Taxpayer in the course of a general or preliminary investigation in order to determine whether to acquire Corp C qualify as start-up expenditures under § 195(c)(1). However, once the Taxpayer made its decision to acquire Corp C, expenditures incurred in that attempt do not qualify as start-up expenditures because they must be capitalized under § 263 as acquisition costs. The determination of when a taxpayer has gone beyond a general search or preliminary investigation and made its decisions as to whether to enter a transaction and which transaction to enter, requires a facts and circumstances analysis. The facts and circumstances of this case indicate that the Taxpayer had completed its preliminary investigation and made its decision to acquire Corp C when the decision was made to prepare and submit the Letter of Intent.

FACTS:

During a, the Corp A Board of Directors decided to explore the sale of its b percent owned subsidiary, Corp C. Corp B owned the remaining g percent of Corp C. During c, Financial Advisor was retained for the purpose of effectuating the sale. During d, Financial Advisor approached a number of potential buyers of Corp C who were not in the same business or industry as Corp C. One of the potential buyers was Entity X.

After conducting a "preliminary due diligence investigation" of Corp C, Entity X submitted a Letter of Intent dated f containing an offer of $e for Corp C. As outlined in the Letter of Intent, the transaction would occur via a cash purchase by Entity X of all of the outstanding stock of Corp A and Corp B. On f, the Corp A Board of Directors and

Corp B's sole shareholder approved the offer. The Letter of Intent specifically stated that "[a] binding commitment with respect to the proposed transaction will result only from a definitive purchase agreement subject to the conditions expressed therein." Consummation of the transaction would be subject to "customary terms and conditions for a transaction of this kind," including the negotiation and execution of an acquisition agreement, verification of information, and "completion of our accounting and legal due diligence investigation." Further, the terms of the Letter of Intent prohibited Corp A and Corp B from discussing or negotiating any transaction involving the merger, consolidation, sale of substantial assets, sale of capital stock or similar transactions, with any entity other than Entity X and its affiliates until v. Thus, on f, negotiations with all other potential buyers were terminated.

Following acceptance of the offer, Entity X continued "investigatory activities" by using its own personnel and the services of Law Firm and Accounting Firm. On h, Corp A and Corp B approved a "final" acquisition agreement for the sale of Corp C. The partnership agreement between Entity X, as general partner, and its limited partners, required creation of an acquisition company, Corp D, in order to accomplish the acquisition. On i, Corp D, through its wholly-owned subsidiary Corp E, corporations formed by affiliates of Entity X, entered into an Agreement of Purchase and Sale to acquire all of the outstanding stock of Corp A and Corp B for $u, including cash payments totaling $j. The balance of the purchase price consisted of the redemption of outstanding Corp A debentures, special payments, and Corp E stock issued in the exchange. The purchase closed on k.

After completion of the sale, Corp C, on behalf of Corp D, received and paid invoices from Entity X, Law Firm, and Accounting Firm for "investigatory" services rendered prior to the sale. On Corp D's consolidated income tax return for the tax year ended l, which included Corp A, Corp B, Corp C, and Corp E , a timely election was made under § 195(d) to amortize start-up expenditures over a period of not less than sixty months in accordance with § 195(b). In its § 195 election, the Corp D affiliated group claimed $m of start-up expenditures.[1] The amount amortized for the period beginning n, through l, was $o. Subsequently, Corp D changed its name to the Taxpayer. The amount amortized for Taxpayer's tax year ended p was $q.

The $m of claimed start-up expenditures consists of the following "investigatory costs" paid by Corp C on behalf of Corp D (hereinafter, the Taxpayer). Entity X received $r for its "preliminary due diligence investigation" of Corp C. Entity X's investigation involved reviewing an offering memorandum on Corp C prepared by Financial Advisor, Corp C's financial statements, and its budgets; researching the

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1. For purposes of this technical advice memorandum, the dollar amounts of the Taxpayer's "investigatory costs" are not in dispute.

industry and competitors; analyzing Corp C's products and margins; designing and directing market surveys; interviewing distributors and Corp C's management; and coordinating due diligence activities with legal, accounting, and other advisors. Law Firm received $s for its review of Corp C's internal corporate documents (including minutes and stockholder ledgers), lease agreements, union contracts, royalty agreements, personnel files and employment agreements, federal and state tax returns, "key man" insurance policies, etc. Accounting Firm received $t for an extensive review and analysis of Corp C's financial and accounting records and procedures. The Taxpayer has not provided information concerning when each "investigatory" service provided by Entity X, Law Firm and Accounting Firm was performed in relation to the Letter of Intent, but has represented that the services were performed prior to the date the Agreement of Purchase and Sale was entered into.

Upon examination of the Taxpayer's consolidated returns, including the § 195 election statement for the acquisition of Corp C, the district director concluded that all of the expenditures incurred by the Taxpayer in connection with its acquisition of Corp C (i.e., the amounts paid to Entity X, Law Firm and Accounting Firm) are capital expenditures under § 263. The appeals office agrees with the district director's conclusion.

LAW AND ANALYSIS:

Section 195(a) provides that except as otherwise provided therein, no deduction is allowed for start-up expenditures. Under § 195(b), start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses are allowed as a deduction prorated equally over a period of not less than 60 months (beginning in the month the active trade or business begins).

Section 195(c)(1) defines "start-up expenditure." In relevant part, the term means any amount paid or incurred in connection with investigating the creation or acquisition of an active trade or business, within the meaning of § 195(c)(1)(A), and 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, within the meaning of § 195(c)(1)(B). Start-up expenditures, however, do not include any amounts that may be deducted under § 163(a), 164, or 174.

Generally under § 162(a), a deduction is allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Courts have generally construed this provision as containing five conditions that an expenditure must meet to qualify for deduction. The expenditure must be (1) an expense, (2) an ordinary expense, (3) a necessary expense, (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).

In order to qualify as amortizable start-up expenditures under § 195(c)(1), the Taxpayer's "investigatory costs" must satisfy the requirements in both §§ 195(c)(1)(A)(i) and 195(c)(1)(B). The appeals office has not questioned whether the Taxpayer's costs satisfy the requirements in § 195(c)(1)(A)(i).[2] However, the appeals office has questioned whether the Taxpayer's costs at issue satisfy § 195(c)(1)(B), which requires that the costs must be of a type that would be deductible if paid or incurred in connection with the operation of an existing active trade or business in the same field as the acquired business ("allowable as a deduction" test). Accordingly, the issue in this case is to what extent the Taxpayer's expenditures qualify as investigatory costs that satisfy the "allowable as a deduction" test of § 195(c)(1)(B).

The Taxpayer's basic position is that all "investigatory costs" incurred in connection with the acquisition of a trade or business prior to the time a final decision (i.e., a legally binding decision) to acquire or enter that business is made are start-up costs amortizable under § 195. The Taxpayer's position is premised on its theory that the "allowable as a deduction" test of § 195(c)(1)(B) provides a "hypothetical framework" under which the deductibility of expenditures is determined by assuming

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2. This memorandum does not address (1) whether the "investigatory costs" at issue were incurred by Entity X, Corp C, Corp E, or the Taxpayer (formerly Corp D), or (2) whether the payments to Entity X, Law Firm, and Accounting Firm by Corp C for the "investigatory costs" incurred constitute a constructive dividend by Corp C to the Taxpayer.

Moreover, for purposes of this request for technical advice, this memorandum assumes that the Taxpayer's purchase of the stock of Corp C is in substance the acquisition of the assets of Corp C's trade or business. The legislative history underlying § 195 indicates that although investigatory expenses attributable to the acquisition of corporate stock generally will not be eligible for amortization, the investigatory expenses are eligible for amortization if in substance a transaction is the acquisition of the assets of a trade or business, even though one of the steps of the transaction involved the acquisition of stock, e.g., the acquisition of a corporation which is then liquidated. Thus, a corporate taxpayer will be considered to have acquired the trade or business assets of an acquired corporation, rather than having made a portfolio investment in stock, if the acquired corporation becomes a member of an affiliated group which includes the taxpayer incurring the investigatory expenses and a consolidated income tax return is filed for that group." H.R. Rep. No. 1278, 96th Cong. 2d Sess. 12 (1980) (House Report); S. Rep. No. 1036, 96th Cong., 2d Sess. 13 (1980) (Senate Report).

the expenditures were incurred in the operation of a trade or business, but not in the context of an acquisition. Notwithstanding that the Taxpayer's expenditures were incurred in connection with an acquisition, the Taxpayer argues that determining the capital or deductible nature of the expenditures as if incurred in connection with an acquisition in the operation of a business would be inconsistent with the ordinary meaning of the word "operation." The Taxpayer further argues that determining the deductibility of expenditures in the context of an acquisition would only make sense if the word "operation" means "acquisition." The Taxpayer finds support in the amendment to § 195 by the Tax Reform Act of 1984[3] involving the substitution of the word "operation" for "expansion" in what is now § 195(c)(1)(B). The Taxpayer has summarized its position as follows:

> [Y]ou begin with a hypothetical framework created by § 195: investigatory costs should be viewed as costs incurred in connection with the operation of an existing business. Within that hypothetical framework, investigatory costs would be deductible in the year incurred. This leads to the conclusion that they must be amortized under § 195.

Thus, the Taxpayer argues that the costs of business and strategic planning, market surveys, annual financial audits, etc., relating to the investigation of Corp C meet the "allowable as a deduction" test because these items generally are deductible expenses in the daily operations of a business.

Moreover, under the Taxpayer's hypothetical framework, its costs of investigating a potential acquisition incurred prior to the execution of a final, legally binding contract should qualify for amortization since such costs would be considered currently deductible if incurred in connection with the operation of an active trade or business. According to the Taxpayer, its decision to acquire Corp C was not final until all due diligence activities were completed, all contingencies in the Letter of Intent were removed, and the Agreement of Purchase and Sale was entered into on i. Thus, the Taxpayer argues that since all of its "investigatory costs" were incurred before the Taxpayer had made a final decision to acquire Corp C, i.e., before the Taxpayer was legally obligated to acquire Corp C, all of its "investigatory costs" are amortizable as start-up expenditures under § 195. In support of its position, the Taxpayer cites the legislative history under § 195, which provides that "eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business." House Report at page 10; Senate Report at page 11 (emphasis added).

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3. See § 94(a) of the Deficit Reduction Act of 1984, 1984-3 C.B. (Vol. 1) 122.

The Taxpayer believes that § 195(c)(1)(B) does provide a limitation, but that limitation only applies to certain costs, such as costs incurred to acquire assets used in connection with investigating the business, costs incurred subsequent to a final decision to acquire the business, costs incurred to finance the acquisition of the business, and consideration paid for the business. Thus, the Taxpayer believes, for example, that costs incurred in negotiating and drafting a final agreement, costs incurred to raise capital, and to prepare and submit regulatory filings are not qualifying investigatory costs even though they may be incurred prior to the "final" decision. Instead, the Taxpayer argues that investigatory costs include all costs incurred in deciding whether and which business to enter or acquire, a decision the Taxpayer argues cannot be made until the Agreement of Purchase and Sale is entered into.

We believe the Taxpayer's "hypothetical framework" is not the proper reading of the literal language of the "allowable as a deduction" test of § 195(c)(1)(B) and results in a much broader scope of amortizable costs than Congress intended. Instead, we believe the purpose of § 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 § 162 (i.e., because the expenses were incurred prior to the commencement of business operations). In describing the law prior to § 195, the legislative history states:

> Under present law, ordinary and necessary expenses paid or incurred in carrying on a trade or business, or engaging in a profit-seeking activity, are deductible. Expenses incurred prior to the establishment of a business normally are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity. . . .
>
> Investigatory expenses are costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business. . . .
>
> Business investigatory expenses of a general nature normally are viewed as being either nondeductible personal expenses, or as not being ordinary and necessary trade or business expenses, viz., because no business exists, within the meaning of section 162 of the Code. . . .
>
> Startup or preopening expenses are costs which are incurred subsequent to a decision to acquire or establish a particular business and prior to its

> actual operation. 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.

House Report at pages 9-10; Senate Report at pages 10-11.

It is clear from these quoted passages that one of Congress' chief concerns was the disparate tax treatment of expenditures incurred to investigate and commence a business resulting from the lack of the "carrying on a trade or business" requirement under § 162. We believe the language in § 195(c)(1)(B) addresses this concern by providing the assumption that the expenses described in § 195(c)(1)(A)(i) were 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 § 195(c)(1)(A)(i)).

Regarding the substitution of the word "operation" for "expansion" in what is now § 195(c)(1)(B), the Taxpayer appears to be arguing that determining the deductibility of expenditures should not be made in connection with any acquisition. In its explanation of the substitution, the Joint Committee on Taxation Staff explained that the term "operation" includes the "expansion of an existing trade or business."[4] Since the Taxpayer's facts involve "investigatory costs" incurred in connection with an acquisition of a business, the hypothetical deductibility of these expenditures under § 195(c)(1)(B) should be tested by assuming that the expenditures were made for the same purpose but in the context of an expansion.

Although § 195(c)(1)(B) provides an assumption that the "carrying on a trade or business" requirement of § 162 is met, the assumption must be applied in the same context in which the expenses were actually paid or incurred to determine if the other conditions for deductibility under § 162(a) have been met. Whether an expenditure incurred in connection with the operation of a trade or business is ordinary or must be capitalized depends on the context in which the expenditure is incurred. For example, see Commissioner v. Idaho Power Co., 418 U.S. 1 (1974) (in support of its conclusion that depreciation on equipment used in the construction of a capital asset must be capitalized, the court noted that wages paid in constructing or acquiring a capital asset must be capitalized, even though reasonable wages paid in carrying on a trade or business are generally deductible); and Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220 (1985) (requiring capitalization of employee training and advertising costs incurred by a utility incident to putting into operation a new nuclear power plant). Thus, contrary to the Taxpayer's position, an expenditure incurred in the

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4. See Joint Committee on Taxation Staff, General Explanation of the Tax Reform Act of 1984, 98th Cong., 2d Sess. 295 (1984).

operation of a business that might normally be deductible may nonetheless be capital in nature depending on the context in which the expenditure is incurred. Nothing in the statutory language or the legislative history indicates Congress intended to disregard the context in which the expenses were actually paid or incurred. Instead, the unambiguous statutory language along with the legislative history of § 195 makes it clear that Congress intended that expenditures eligible for amortization meet two separate requirements:

> In general, expenditures eligible for amortization must satisfy two requirements. First, 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. Second, the expenditure involved must be one which would be allowable as a deduction for the taxable year in which it is paid or incurred if it were paid or incurred in connection with the expansion of an existing trade or business in the same field as that entered into by the taxpayer.
>
> Under this provision, eligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business.

House Report at page 10; Senate Report at page 11 (emphasis added).

Thus, § 195(c)(1)(B) must be applied in this case by considering the "investigatory costs" as having been incurred not only in the operation of Corp C's existing business, but also in the context of an acquisition. If an expenditure is not deductible because it would be a capital expenditure if incurred in the operation of an existing trade or business, the expenditure does not qualify for amortization under § 195. That is, § 195 does not override § 263. See §§ 161, 261; Duecaster v. Commissioner, T.C. Memo. 1990-518 (in response to the taxpayer's argument that education costs were incurred in connection with creating a new trade or business and would have been deductible if they had been paid in connection with the operation of an existing trade or business (e.g., as continuing legal education), the Tax Court concluded that "nothing in the statute or the 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" if incurred in an existing trade or business); FMR Corp. v. Commissioner, 110 T.C. No. 30 (June 18, 1998) ("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").

Moreover, the Taxpayer's hypothetical framework would result in treating taxpayers expanding a business differently (less favorably) than taxpayers acquiring or creating a new business. Depending on the facts and circumstances, a taxpayer expanding an existing business through an acquisition may have some currently deductible costs and some costs that are capital in nature. Under the Taxpayer's hypothetical framework, however, the costs incurred by a taxpayer to investigate the acquisition of a new trade or business would be amortizable under § 195, even though some of those costs, if incurred by a taxpayer expanding an existing business, would be capital in nature. There is simply no indication that Congress intended to place taxpayers acquiring a new business in a better position than taxpayers expanding an existing business.

The Taxpayer relies heavily on the reference to "a final decision" in the legislative history, arguing that it manifests Congressional intent that § 195 amortization would be available for all "investigatory costs" incurred in investigating a potential acquisition up to the time at which the acquisition is evidenced by a binding commitment. A "final decision" in that sense, however, would require that both the taxpayer and the seller be bound to the acquisition transaction. Nothing in the statute or legislative history suggests that the tax treatment of a prospective purchaser's investigatory costs is dependent upon the seller's commitment to the transaction. Rather, we believe the reference to a final decision describes the point at which a taxpayer makes its own decision whether to acquire a specific business, and subsequently incurs costs in an effort to consummate the acquisition. At that point the general and preliminary investigation ceases and the taxpayer initiates its acquisition process. Costs incurred in connection with this process must be capitalized. Whether a taxpayer is ultimately successful in its negotiations with a seller is not relevant to the determination of when the investigatory process ends and the acquisition process begins.

The legislative history provides the following guidance regarding which costs are eligible for amortization under § 195:

> 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. . . . 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.

These quoted passages support the conclusion that in order to determine whether an expenditure qualifies for amortization under § 195, an analysis of whether the expenditure is deductible if incurred in the operation of an existing trade or business must be made. If the expenditure is not deductible because it would be a capital expenditure, then the expenditure does not qualify for amortization under § 195. In making this determination, Congress did not indicate that any special rules other than those set forth under prior law should apply.

The determination of which costs are amortizable investigatory costs and which costs are capital acquisition costs can be made by looking at the treatment of those costs under §§ 162 and 165. The Service's position regarding the deductibility of costs incurred to investigate the potential acquisition of a new trade or business is articulated in Rev. Rul. 77-254, 1977-2 C.B. 63. That ruling provides guidance on when a transaction is entered into for profit, i.e., when a taxpayer has entered into a capital transaction.[5] In that ruling, the taxpayer placed advertisements in several newspapers and traveled to various locations throughout the country to investigate various businesses that were for sale. The taxpayer commissioned audits to evaluate the potential of several of these businesses. Eventually, the taxpayer decided to purchase a specific business and incurred expenses in an attempt to purchase the business (the example in the ruling is that the individual retained a law firm to draft the documents necessary for the purchase). The taxpayer ultimately abandoned all attempts to acquire the business and reported a § 165 loss.

Rev. Rul. 77-254 provides that expenses incurred in the course of a general search for or preliminary investigation of a business or investment include those expenses related to the decisions whether to enter a transaction and which transaction to enter. Once the taxpayer has focused on the acquisition of a specific business or

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5. Although Rev. Rul. 77-254 involves the issue of whether some or all of an individual's expenses incurred to acquire a business could be deducted under § 165(c)(2), we believe the analysis of the ruling is still relevant to the issue at hand, i.e., whether expenditures paid or incurred in connection with the creation or acquisition of a business are investigatory or acquisition costs. The ruling was specifically referenced by the legislative history of § 195 and there is no indication Congress was either attempting to change or disagreed with the analysis of the ruling. See House Report at page 9; Senate Report at page10.

investment, expenses that are related to an attempt to acquire such business or investment are capital in nature. Thus, the ruling concluded that "the expenses for advertisements, travel to search for a new business, and the cost of audits that were designed to help the individual decide whether to attempt an acquisition were investigatory expenses" that were not deductible under § 165(c)(2). However, the expenses of retaining a law firm to draft the purchase documents and any other expenses incurred in the attempt to complete the purchase of the business were capital in nature and thus, were deductible under § 165(c)(2) (emphasis added).

Under § 263, costs of acquiring property having a useful life substantially beyond the taxable year must be capitalized. Thus, costs incurred in a capital transaction, e.g., an acquisition of a capital asset, must be capitalized under § 263. Some general examples of capital expenditures are provided in § 1.263(a)-2(a) of the regulations and include costs of acquisition of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year. Under this general regulatory provision, courts have long held that "legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of such property are capital expenditures." Woodward v. Commissioner, 397 U.S. 572 (1970), citing Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963); United States v. St. Joe Paper Co., 284 F.2d 430 (5th Cir. 1960). For example, in Woodward v. Commissioner, 397 U.S. 572 (1970), the taxpayer was required to capitalize attorney, accountant and appraiser fees incurred in connection with appraisal proceedings as part of the cost of the stock acquired since ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it. The Supreme Court concluded "[w]hen property is acquired by purchase, nothing is more clearly a part of the process of acquisition than the establishment of a purchase price." Id. at 579. See also United States v. Hilton Hotels Corp., 397 U.S. 580 (1979) (costs of appraisal proceeding must be capitalized since the capitalization requirement extends beyond the price payable to the seller to include any cost incurred in connection with the purchase such as appraisals or costs of meeting any conditions of sale); Beneficial Industrial Loan Corp. v. Handy, 16 F. Supp. 110, 112 (D. Del. 1936), aff'd. 92 F.2d 74 (3d Cir. 1937) (it is "too clear for argument" that accounting fees to review financial statements and to value acquired properties pursuant to a reorganization agreement are capital expenditures); Rev. Rul. 73-580, 1973-2 C.B. 86 (portion of compensation paid by a corporation to its employees attributable to services performed in connection with corporate mergers and acquisitions must be capitalized; however, such amounts paid with respect to abandoned plans for merger or acquisitions are deductible as losses in the year of abandonment).

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 a target bank's books and records. The examination was performed pursuant to an acquisition agreement that was contingent on several terms and conditions, such as regulatory approval. The taxpayer ultimately acquired the stock of the target bank. The Tax Court concluded that the expenses were nondeductible capital expenditures incurred in the acquisition of a capital asset. Furthermore, the court determined that this would be the result even if the taxpayer had been in the business of acquiring banks. On appeal the Eleventh Circuit substantially affirmed the lower court decision but remanded for a factual determination as to whether some part of the fees for accounting services was for general auditing duties unrelated to the acquisition that, therefore, would be deductible. The court agreed that the expenditures were made without a firm commitment to buy. However, the court further stated that the fact that the decision to make the investment was not final at the time of the expenditure did not change the character of the investment or the result that the expenses could not be deducted under § 162. The Tax Court stated "[t]he success or failure of the acquisition process, however, is not relevant in determining the character of the expenditure," and "[t]he link between the expenditures in issue and the stock acquisition is not negated by the absence of a contractual obligation to obtain the . . . stock when the expenditures were incurred."

Thus, based on the above authorities, only those expenditures incurred in the course of a general search for or preliminary investigation of a business, i.e., investigatory expenditures incurred in order to determine whether to enter into a transaction and which transaction to enter, may be amortized under § 195. Once a taxpayer has made the "whether and which" determinations, all costs incurred in the attempt to acquire the business must be capitalized under § 263 as acquisition costs. That decision is not the final, legally binding decision to acquire the business. Congress explained that "[e]ligible expenses consist of investigatory costs incurred in reviewing a prospective business prior to reaching a final decision to acquire or to enter that business," but did not indicate that final means legally binding as to both the potential purchaser and seller. The determination of whether a taxpayer's expenditures are incurred in the course of a general search or preliminary investigation, or in an attempt to acquire a specific business, will depend on all the facts and circumstances.

Rev. Rul. 77-254 draws the distinction between non-capital costs and capital costs at the point where the "whether and which" decisions are made, and concludes that once those decisions are made, costs incurred in an attempt to acquire a specific new business are capital in nature. The Taxpayer does not appear to dispute this standard, but argues that its final decision as to whether to acquire Corp C could not be made without the benefit of all the information gathered pursuant to "investigatory" and due diligence activities both before and after the Letter of Intent, and up to the time the Agreement of Purchase and Sale was entered into. Thus, the Taxpayer argues that all

"investigatory costs" incurred prior to the time the Agreement of Purchase and Sale was entered into meet the requirements of § 195(c)(1)(B).

We do not believe, however, that either Rev. Rul. 77-254 or the legislative history to § 195 supports the Taxpayer's argument. Instead, Rev. Rul. 77-254 illustrates that the whether and which decisions can be made prior to the time a final acquisition agreement is signed. We believe the term "final decision" was intended to be read in a manner consistent with Rev. Rul. 77-254, and thus, final decision refers to the point in time at which a taxpayer has made the decisions whether to enter a transaction and which transaction to enter.

The facts and circumstances of this case indicate that the Taxpayer made its decision to attempt to acquire Corp C when the decision was made to prepare and submit the Letter of Intent.[6] Prior to the Letter of Intent, Entity X was one of several potential buyers approached by Financial Advisor. Pursuant to the terms of the Letter of Intent, negotiations with other potential buyers were terminated on f, and Entity X became the only candidate eligible to purchase Corp C. Although the Letter of Intent states that it was "not intended to constitute a binding commitment," it further provides that, notwithstanding that disclaimer, Corp A and Corp B are prohibited from entering into or participating in any discussions or negotiations with any other prospective purchaser. Accordingly, we believe that the Letter of Intent manifests the Taxpayer's decision to attempt to acquire Corp C.

In connection with the acquisition of Corp C, the Taxpayer incurred, and Corp C paid on the Taxpayer's behalf, $m to Entity X, Law Firm, and Accounting Firm for "due diligence" expenditures. The descriptions provided of the "investigatory services" rendered by Entity X, Law Firm and Accounting Firm do not connect the descriptions of the services with a time line of when such services were performed. Thus, we are unable to determine exactly which services enabled the Taxpayer to make the decision to attempt to acquire Corp C. At a minimum, however, the services performed by Entity X, Law Firm and Accounting Firm after the Taxpayer made the decision to prepare and submit the Letter of Intent furthered the Taxpayer's acquisition of Corp C. As such, they do not qualify as investigatory costs eligible for amortization under § 195 but rather as the costs of acquisition. Under § 263, those expenditures are capital expenditures that would not be allowable as a current deduction if paid or incurred in connection with an existing active trade or business in the same field as the acquired business. Accordingly, those expenditures do not satisfy the "allowable as a deduction" test under § 195(c)(1)(B). However, all expenditures incurred by the

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6. All of the Taxpayer's costs related to the potential acquisition of only one business. Even though the Taxpayer arguably knew "which" transaction to enter, we believe that the "whether" determination is still relevant under these circumstances.

Taxpayer before the Taxpayer decided to prepare and submit the Letter of Intent qualify as start-up expenditures under § 195 to the extent those expenditures were incurred in order to determine whether to acquire Corp C.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

- END -