

# COMMENT

## LIVING THE DREAM: HOW I.R.C. § 195 CAN JUMP-START THE AMERICAN ECONOMY\*

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were started in the United States between 2005 and 2006.<sup>5</sup> Entrepreneurs claim some of the benefits of starting a business include the ability to innovate, the flexibility to respond to an evolving market, and being passionate about their work.<sup>6</sup>

The government formally recognized the importance of start-up business when it established the Small Business Administration (SBA) in 1953.<sup>7</sup> The goal of the SBA was to:

aid, counsel, assist, and protect insofar as is possible the interests of small-business concerns in order to preserve free competitive enterprise, to insure that a fair proportion of the total purchases and contracts for supplies and services for the Government be placed with small-business enterprises, and to maintain and strengthen the overall economy of the Nation.<sup>8</sup>

Today, the SBA supports and tracks both employer and nonemployer businesses.<sup>9</sup> In 2006, there were 26,790,682 firms in the United States.<sup>10</sup> Overall, 99.9% of these businesses consist of less than 500 employees,<sup>11</sup> the SBA definition of a small business, and 99.6% have less than 100 employees.<sup>12</sup> Of the 140 million business employees,<sup>13</sup> 45% of the workforce is employed by businesses with less than 100 employees, and 58% by businesses with less than 500 employees.<sup>14</sup> Small business also steadily

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5. See U.S. SMALL BUS. ADMIN., OFFICE OF ADVOCACY, FIRM SIZE DATA: STATISTICS OF U.S. BUSINESSES AND NONEMPLOYER STATISTICS, [http://www.sba.gov/advo/research/data\\_uspdf.xls](http://www.sba.gov/advo/research/data_uspdf.xls) [hereinafter SBA DATA], at Tab dyn89\_06 (last visited Aug. 17, 2009) (noting 2006 firm deaths totaled 599,333 for a net increase of over 70,000 firms).

6. See Ralph F. Wilson, Network Services & Consulting Corporation, Small Business Benefits (2002), <http://www.enetsc.com/DoctorEbiz.htm> (last visited Sept. 19, 2009) (listing the benefits of small business).

7. Small Business Act of 1953, Pub. L. No. 83-163, 67 Stat. 232, 232.

8. *Id.*

9. U.S. SMALL BUS. ADMIN., OFFICE OF ADVOCACY, FIRM SIZE DATA, <http://www.sba.gov/advo/research/data.html> (last visited Sept. 19, 2009). Nonemployer businesses only employ the owner, while employer businesses include additional employees. *Id.*

10. See SBA DATA, *supra* note 5, at Tab us88\_06 (reporting 20,768,555 nonemployer and 6,022,127 employer firms in 2006).

11. See *id.* at Tab us88\_06 (detailing the number of employees per firm). Of the roughly 26.8 million firms, 26.68 and 26.77 million contain less than 100 and 500 employees, respectively. *Id.*

12. U.S. SMALL BUS. ADMIN., *supra* note 9 (defining a small business as “an independent business having fewer than 500 employees”).

13. See SBA DATA, *supra* note 5, at Tab us88\_06 (noting the 120 million Americans employed by employer firms and the 20 million owners of nonemployer firms).

14. See *id.* (detailing employment statistics by size of the firm). Employees in firms with less than 100 people total 42,686,395. Adding this to nonemployer firms, total employment is 63,454,950. Employment by firms with less than 500 employees is 60,223,740, which in addition to the nonemployer firms, totals 80,992,295. *Id.*

contributes over 50% to the private nonfarm gross domestic product.<sup>15</sup>

The importance of small business to the American economy was in the mind of the 96th Congress when it enacted § 195 of the Internal Revenue Code (I.R.C. or the Code).<sup>16</sup> Section 195 details the tax treatment of start-up expenses incurred by owners prior to the operation of an active trade or business.<sup>17</sup> With § 195, Congress intended to decrease litigation surrounding the deductibility of certain expenses, encourage business formation, and treat business and nonbusiness taxpayers equally.<sup>18</sup> Subsequent revisions to the Code have strayed from the original intent of § 195, with current business owners receiving much larger tax incentives than potential business owners.<sup>19</sup> These tax advantages lead to cost efficiencies and economies of scale for existing business owners and act as a barrier to entry for new businesses, making it more difficult for entrepreneurs to compete and succeed in the competitive business environment.<sup>20</sup>

The current version of § 195 will expire in July 2011.<sup>21</sup> Given the current economic environment,<sup>22</sup> it is of paramount importance for Congress to not only extend but also amend § 195 to fulfill the intent of the 96th Congress. If drafted appropriately,

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15. See KATHRYN KOBE, SMALL BUS. ADMIN., THE SMALL BUSINESS SHARE OF GDP 1 (2007) (noting that the small business percentage has been less than fifty percent only once since 1998).

16. See Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102(c), 94 Stat. 3521, 3522 (codified at I.R.C. § 195 (1982)); see also S. REP. NO. 96-1036, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301 (outlining legislative intent behind the enactment).

17. I.R.C. § 195 (2006).

18. See S. REP. NO. 96-1036, at 11; see also *infra* Part II.B.1 (summarizing Congress's intent in enacting § 195).

19. See, e.g., I.R.C. § 179 (2006) (allowing depreciation of qualified business property at an accelerated rate); I.R.C. § 168(k) (2006) (allowing additional depreciation of qualified property used by existing businesses); see also William G. Gale & Peter R. Orszag, *An Economic Assessment of Tax Policy in the Bush Administration, 2001-2004*, 45 B.C. L. REV. 1157, 1170 (2004) (analyzing the effects of the changes to § 179).

20. KENNETH D. GEORGE, CAROLINE JOLL & E.L. LYNK, INDUSTRIAL ORGANISATION: COMPETITION, GROWTH AND STRUCTURAL CHANGE 260-62 (4th ed. 1992) (discussing the effect barriers to entry have on competition).

21. Temp. Treas. Reg. § 1.195-1T(e) (2008).

22. See, e.g., V. Dion Haynes, *Circuit City Shutting Down, Leaving 34,000 out of Work*, WASH. POST, Jan. 17, 2009, at D1 (discussing the closing of all 567 Circuit City stores nationwide); News Release, Bureau of Labor Statistics, The Employment Situation: January 2009 (Feb. 6, 2009), available at [http://www.bls.gov/news.release/archives/empsit\\_02062009.pdf](http://www.bls.gov/news.release/archives/empsit_02062009.pdf) (noting the unemployment rate had risen 2.7% over the past 12 months); First Quarter Layoffs: Selection of Job Cuts by Major Companies, Real Time Economics (Jan. 8, 2009, 13:14 EST), <http://blogs.wsj.com/economics/2009/01/08/first-quarter-layoffs-selection-of-job-cuts-by-major-companies> (listing all first-quarter layoffs by company, date of announcement, and the number of jobs lost).

a revised § 195 will encourage taxpayers to start new businesses, reduce unemployment, spur both economic growth and technological innovation, and help the economy recover more quickly from the current downturn.<sup>23</sup>

This Comment discusses the history of § 195 and how it should be amended to encourage start-up businesses. Part II examines Congress's intent regarding the effect of § 195 on small business formation and the original statutory construction of § 195. Part III analyzes the initial case law affecting the assumptions underlying the provision. Part IV looks at later case law and subsequent statutory and regulatory amendments affecting § 195's application. Part V recommends changes to § 195 prior to its expiration in 2011, and Part VI concludes with a focus on the future and the importance of the provision.

## II. THE ENACTMENT OF § 195

### A. *The Treatment of Start-Up Expenses Prior to 1980*

Prior to 1980, the I.R.C. contained no provision for the treatment of start-up expenses; instead, start-up expenses were treated as non-deductible personal expenses. The modern tax code originated in 1954<sup>24</sup> and was designed to help taxpayers calculate their tax liability for a given year.<sup>25</sup> Implicit in this calculation is the determination of what to include in income and which deductions to take.<sup>26</sup> The Code creates a bright-line rule between personal and business consumption. Deductions for personal consumption are expressly disallowed, while business related expenditures are generally deductible.<sup>27</sup>

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23. See Spence L. Wise & Morgan P. Miles, *The Internal Revenue Service As a Stimulus to the Entrepreneurial Search Process*, 26 BUS. F. 8, 8 (2001) (noting the potential for growth in the small business sector and the innovative successes derived from entrepreneurs).

24. See Internal Revenue Code, Pub. L. No. 83-591, 68A Stat. 1 (1954). The 1954 Code replaced the 1939 version of the Code, which had only reorganized the existing tax law into volume 26 of the U.S. Code. See Internal Revenue Code, 53 Stat. iii (1939) ("These statutes are codified without substantive change and with only such change of form as is required [for] consolidation."); see also JOSEPH M. DODGE, J. CLIFTON FLEMING, JR. & DEBORAH A. GEIER, *FEDERAL INCOME TAX: DOCTRINE, STRUCTURE AND POLICY* 29 (3d ed. 2004) (discussing the history of federal tax statutes).

25. See DODGE, FLEMING & GEIER, *supra* note 24, at 43–63 (detailing the tax base under the current income tax code).

26. See *id.* (discussing what is included and deducted to create the taxpayer's tax base).

27. Compare I.R.C. § 162(a) (2006) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid . . . in carrying on any trade or business . . ."), with I.R.C. § 262(a) (2006) ("[N]o deduction shall be allowed for personal, living, or family expenses."); see also DODGE, FLEMING & GEIER, *supra* note 24, at 57–58 (noting the

One of the goals of the Code is to temporally match expenses incurred with the income generated.<sup>28</sup> Thus, the Code does not allow immediate deductions for capital expenditures.<sup>29</sup> A capital expenditure is a “cost[] incurred in the acquisition or disposition of a capital asset”<sup>30</sup> with a useful life beyond one year.<sup>31</sup> In an attempt to match expenses with income, the cost of capital expenditures are distributed, or capitalized, throughout the life of the asset.<sup>32</sup> The Code achieves this through depreciation and amortization.<sup>33</sup> In contrast, losses may be deducted under § 165 in the year of the loss.<sup>34</sup>

This background sets the stage for the non-deductibility of start-up expenses. An entrepreneur incurs start-up costs for all activities undertaken *prior* to the operation as a trade or business.<sup>35</sup> Thus, the Internal Revenue Service (IRS) treated these expenses as personal rather than business expenses.<sup>36</sup> For example, in 1957 the IRS ruled that start-up expenses associated with a failed business could only be deducted if the taxpayer actually engaged in and then abandoned a “transaction for profit.”<sup>37</sup> These activities had to be “more than investigatory,” thereby excluding all general start-up expenses from deduction.<sup>38</sup>

This principle was later reaffirmed and clarified in a 1977 ruling.<sup>39</sup> In Revenue Ruling 77-254, the IRS held that the costs associated with a specific, unsuccessful target acquisition were

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limited classes of deductions and those expressly disallowed under the Code).

28. See, e.g., *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992) (“[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.”).

29. See I.R.C. § 263(a) (2006).

30. *Woodward v. Comm’r*, 397 U.S. 572, 575 (1970). The Code defines a capital asset as any taxpayer property excluding specifically listed assets. See I.R.C. § 1221(a) (2006) (excluding inventory, property subject to depreciation, property created by personal efforts, and clearly identified hedging transactions).

31. Treas. Reg. § 1.263(a)-2(a) (2008).

32. *Id.*

33. See I.R.C. § 167 (2006) (allowing depreciation for tangible business property); I.R.C. § 197 (2006) (allowing amortization for intangible business property).

34. See I.R.C. § 165(c) (2006) (providing that losses are deductible if incurred in a trade or business, in a for-profit transaction, or from casualty or theft).

35. See, e.g., *Fishman v. Comm’r*, 837 F.2d 309, 311–12 (7th Cir. 1988) (describing start-up costs as pre-opening expenses, unable to be deducted).

36. See I.R.C. § 162(a) (2006) (allowing deductions for expenses incurred while carrying on a trade or business); see also I.R.C. § 262(a) (2006) (disallowing personal consumption deductions).

37. Rev. Rul. 57-418, 1957-2 C.B. 143, 143.

38. *Id.*

39. Rev. Rul. 77-254, 1977-2 C.B. 63, 64.

deductible as losses under § 165(c)(2).<sup>40</sup> By contrast, it held that “[t]he 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 [personal] investigatory expenses and are not deductible.”<sup>41</sup> Subsequent case law supported this proposition—consistently holding that pre-opening, investigatory expenses were not deductible.<sup>42</sup> Thus, without a specific provision regarding start-up expenses, the combination of a bright-line rule between personal and business deductions and the requirement of temporal matching prohibited the deduction of start-up expenses.

### B. *The Miscellaneous Revenue Act of 1980*

In 1980, the 96th Congress amended the Code to include I.R.C. § 195, allowing for the amortization of start-up expenses for both business and nonbusiness taxpayers.<sup>43</sup>

1. *Congressional Intent.* Congress hoped § 195 would decrease the controversy regarding the classification of start-up expenditures.<sup>44</sup> The courts were often asked to determine the classification and deductibility of start-up expenses.<sup>45</sup> Congress intended for the provision to clarify the definition and treatment of start-up expenditures and reduce the strain on the courts.<sup>46</sup>

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40. *Id.*; see also I.R.C. § 165(c)(2) (2006) (allowing a deduction for “losses incurred in any transaction entered into for profit, though not connected with a trade or business”).

41. Rev. Rul. 77-254, 1977-2 C.B. 63, 64. The IRS based this ruling on *Seed v. Comm’r*, 52 T.C. 880 (1969). In that case, the tax court allowed the expenses associated with the failure of a specific business acquisition to be deducted. *Id.* at 885 (“Congress intended to grant a deduction for a loss which arose out of activities which constituted something less than the carrying on of a trade or business. To hold otherwise would be to render [§] 165(c)(2) a nullity . . .”).

42. See, e.g., *Fishman v. Comm’r*, 837 F.2d 309, 311–14 (7th Cir. 1988) (holding that rent paid for land prior to the generation of income was a start-up expense and not deductible under § 212); *Wimmer v. Comm’r*, 25 T.C.M. (CCH) 951, 952 (1966) (“It is, of course, well established that the expenses which one incurs in investigating and promoting a contemplated new business are not deductible under [§] 162.”); *Vanlandingham v. Dep’t of Revenue*, 9 Or. Tax 308, 310 (1983) (“[Section] 162 allows a deduction for trade or business expenses only if incurred in connection with a trade or business, not if incurred in the preliminary investigation of a business.”).

43. Miscellaneous Revenue Act of 1980, Pub. L. No. 96-605, § 102(a), 94 Stat. 3521, 3522 (codified at I.R.C. § 195 (1982)).

44. S. REP. NO. 96-1036, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301 (citing the desire to “decrease controversy and litigation arising under present law with respect to the proper income tax classification of startup expenditures” as one of the reasons for changing the law).

45. See *supra* note 42 and accompanying text (noting cases dealing with the deductibility of start-up and investigatory expenditures).

46. See William C. Lathen & Robert L. Lathen, *The “Gap Period” Problem in Section*

Additionally, this section was viewed as a codification of the Second Circuit's holding in *Briarcliff Candy Corp. v. Commissioner*,<sup>47</sup> in which a taxpayer was allowed to deduct significant expansion costs.<sup>48</sup>

Congress also wanted to treat business and nonbusiness taxpayers equally.<sup>49</sup> Under existing law, start-up costs were included in the basis of the business and were only recoverable upon sale or abandonment.<sup>50</sup> Existing businesses, however, were able to deduct or capitalize the start-up costs associated with expansion and acquisition, allowing owners to recoup their investment more quickly.<sup>51</sup> Congress hoped § 195 would correct this difference<sup>52</sup> and treat the similarly situated taxpayers equally, in line with the norm of horizontal equity.<sup>53</sup>

Lastly, Congress hoped to encourage new business development.<sup>54</sup> In the late 1970s, a worldwide recession fueled by high energy prices hurt big business.<sup>55</sup> Congress hoped small business, with its ability to respond quickly to new opportunities, would help the economy recover.<sup>56</sup> Under the existing law, however, potential business owners were at a disadvantage.<sup>57</sup> The

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195, 62 TAXES 416, 416 (1984) (noting the enactment was an attempt to "defuse the controversy arising over the tax treatment of start-up expenses").

47. *Briarcliff Candy Corp. v. Comm'r*, 475 F.2d 775 (2d Cir. 1973); see also George B. Javaras & Todd F. Maynes, *Do Briarcliff Candy and Code Section 195 Stiff National Starch?*, 49 TAX NOTES 1223, 1227 (1990) (discussing § 195 as the codification of the *Briarcliff* holding); John Paul LeBlanc, Note, *The Supreme Court Attempts to "Iron Out" the Wrinkles in National Starch*, 54 LA. L. REV. 437, 462 (1993) ("[T]hat these expenses did not create an asset . . . was the impetus behind [§] 195 allowing the sixty-month amortization deduction . . .").

48. *Briarcliff Candy*, 475 F.2d at 786–87; see also *infra* notes 94–98 and accompanying text (discussing the *Briarcliff* decision).

49. See *Vanlandingham v. Dep't of Revenue*, 9 Or. Tax 308, 310 (1983) ("The addition of IRC § 195 was an attempt to equalize the treatment given corporate and noncorporate taxpayers in respect to finding a new business venture.").

50. See, e.g., *Woodward v. Comm'r*, 397 U.S. 572, 574–75 (1970) ("Such expenditures are added to the basis . . . and are taken into account . . . either through depreciation or by reducing the capital gain . . . when the asset is sold."); Lathen & Lathen, *supra* note 46, at 416 ("[S]tart-up costs . . . were required to be capitalized and were recoverable only upon the sale or cessation of the business.").

51. See Lathen & Lathen, *supra* note 46, at 416 (noting that existing businesses were able to deduct these expenses under § 162(a), while new businesses could not).

52. See *id.* (noting that § 195 was enacted to "treat these identical costs in a more consistent manner").

53. See DODGE, FLEMING & GEIER, *supra* note 24, at 122 (discussing the equity norms guiding tax policy).

54. S. REP. NO. 96-1036, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301.

55. See BLACKFORD, *supra* note 3, at 166 (noting the depressed economy that led to a decrease in employment among *Fortune* 500 companies).

56. *Id.*

57. See *supra* notes 50–53 and accompanying text (noting the differing treatment

treatment of pre-opening expenses created a barrier to entry, discouraging business development and innovation.<sup>58</sup> Section 195 was an attempt to remove this barrier and encourage growth.<sup>59</sup> While Congress's remedy violated the neutrality norm and encouraged taxpayer behavior that may not have been undertaken otherwise,<sup>60</sup> tax incentives are often used to modify behavior, especially when the aggregate social gains earned by the modified behavior outweigh the total costs.<sup>61</sup>

2. *The Text of § 195.* The 1980 enactment allowed qualifying start-up expenses to be amortized over sixty months once the business began.<sup>62</sup> To qualify for amortization, the expenditure had to be paid or incurred in investigating the creation or acquisition of a trade or business<sup>63</sup> and deductible by an existing trade or business.<sup>64</sup> An additional requirement of successful operation could be inferred from the tolling of the amortization period until the business began.<sup>65</sup> In application, the Section served as a tool to defer expenses for those who eventually began a trade or business.<sup>66</sup> It did not create a new class of deductions; it merely allowed entrepreneurs to amortize

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for pre-opening expenses under then-existing law).

58. See GEORGE, JOLL & LYNK, *supra* note 20, at 260 (defining barriers to entry as “costs that have to be borne by an entrant that are not borne by established firms”).

59. See S. REP. NO. 96-1036, at 11 (noting that Congress hoped to “encourage [the] formation of new businesses”).

60. See DODGE, FLEMING & GEIER, *supra* note 24, at 128 (describing neutrality as the “fundamental free-market norm relevant to tax systems”); see also Matthew A. Melone, *Should the United States Tax Sovereign Wealth Funds?*, 26 B.U. INT’L L.J. 143, 218 (2008) (discussing the concept of tax neutrality).

61. See DODGE, FLEMING & GEIER, *supra* note 24, at 131 (discussing the Kaldor-Hicks efficiency theory). The theory applies a cost-benefit analysis to determine if the tax incentive and its violation of the neutrality principle, both measured in terms of utility and not in nominal dollars, create an aggregate positive addition to the economy. *Id.*; see also NICHOLAS MERCURO & STEVEN G. MEDEMA, *ECONOMICS AND THE LAW: FROM POSNER TO POST-MODERNISM* 45–50 (1997) (discussing the economic effect of a government policy or legal change on society).

62. See I.R.C. § 195(a) (1982) (allowing the taxpayer to amortize expenses “beginning with the month in which the business begins”).

63. I.R.C. § 195(b)(1) (1982); see also S. REP. NO. 96-1036, at 11 (describing the circumstances under which the expense must be incurred).

64. I.R.C. § 195(b)(2) (1982); see also S. REP. NO. 96-1036, at 11 (requiring deductibility by a current business).

65. See S. REP. NO. 96-1036, at 14 (detailing the length of the amortization period and when it begins). Using the phrase “business begins” confused Congress’s intent. See *infra* notes 234–41 and accompanying text (discussing the frustration caused by this poor word choice).

66. See *Vanlandingham v. Dep’t of Revenue*, 9 Or. Tax 308, 309 (1983) (discussing the treatment of expenditures under § 195); I.R.C. § 195(a) (1982) (allowing the amortization once the business begins).

expenses current business owners could already deduct or amortize.<sup>67</sup>

In 1984, Congress enacted the Deficit Reduction Act, substantially revising the section.<sup>68</sup> A general provision required capitalization of all start-up expenses except those specifically provided for in the Section.<sup>69</sup> The definition of expenses qualifying for amortization was extended to include expenses for “any activity engaged in for profit and for the production of income” prior to becoming an active trade or business<sup>70</sup> and excluded expenses covered by §§ 163(a), 164, or 174.<sup>71</sup>

### III. INITIAL APPLICATION OF § 195

#### A. General Application

Two early cases illustrate the limited application of the Section. In *Pino v. Commissioner*, the taxpayer attempted to deduct start-up expenses associated with an unsuccessful import-export business.<sup>72</sup> The expenses included consulting fees, travel, advertising, and certain utilities, all of which Congress had listed as eligible for § 195 expenses.<sup>73</sup> The court refused to allow a deduction under § 162<sup>74</sup> or to amortize the costs under § 195, finding that eventual participation in an active trade or business was required for amortization.<sup>75</sup>

The Tax Court was asked to define more clearly the second requirement, deductibility by an existing trade or business, in *Duecaster v. Commissioner*.<sup>76</sup> The taxpayer attempted to amortize

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67. See *infra* note 83 and accompanying text (discussing the § 162 requirement in §§ 195 and 212); see also *infra* Part III.B.

68. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 94, 98 Stat. 494, 614 (codified at I.R.C. § 195 (1988)).

69. I.R.C. § 195(a) (1988).

70. I.R.C. § 195(c)(1)(A)(iii) (1988); see also I.R.C. § 212 (2006) (using similar language to deduct expenses not associated with a trade or business).

71. I.R.C. § 195(c) (1988); see also I.R.C. § 163(a) (1988) (providing for the deduction of interest payments); I.R.C. § 164 (1988) (providing for the deduction of taxes paid); I.R.C. § 174 (1988) (providing for the deduction of research and development expenses).

72. *Pino v. Comm’r*, 52 T.C.M. (CCH) 1388, 1391 (1987).

73. *Id.*; see also S. REP. NO. 96-1036, at 11–12 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301–02 (listing examples of expenses eligible for amortization upon taxpayer election).

74. *Pino*, 52 T.C.M. (CCH) at 1391. Though it is not discussed in the opinion, the taxpayer has the option to include the expenses as a § 165(c)(2) loss. See Rev. Rul. 77-254, 1977-2 C.B. 63, 63–64 (allowing deductions for losses incurred that were not in connection with a trade or business).

75. *Pino*, 52 T.C.M. (CCH) at 1392 (citing H.R. REP. NO. 96-1278, at 11–13 (1980)).

76. *Duecaster v. Comm’r*, 60 T.C.M. (CCH) 917, 918–19 (1990); see *supra* note 64 and accompanying text (discussing the second requirement under § 195).

the cost of his legal education under § 195.<sup>77</sup> In disallowing the amortization, the court determined the cost of legal education was not an otherwise allowable expense under § 162 and therefore was not deductible under § 195.<sup>78</sup>

*B. Section 162's Impact on § 195*

*Pino* and *Duecaster* illustrate § 195's reliance on § 162 in determining whether an expense qualifies for a current deduction.<sup>79</sup> Section 162 allows a deduction for "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."<sup>80</sup> The legislative history and statutory construction of § 195 also point to this dependency.<sup>81</sup> In this way, § 195 is similar to § 212, which allows a deduction for expenses associated with the production of income but not incurred by a trade or business.<sup>82</sup> Neither section creates a new class of deductions that were not previously deductible under § 162.<sup>83</sup> Both merely permit taxpayers to deduct or amortize at stages of business development that were not previously allowed. Thus, qualification as a § 195 expense is determined by what qualifies as an otherwise deductible expense under § 162.<sup>84</sup>

1. *Lincoln Savings & Loan Association and the "Separate and Distinct Asset" Test.* The first major case determining what constituted a § 162 expense was *Commissioner v. Lincoln Savings & Loan Association*.<sup>85</sup> The Supreme Court was asked to determine the character of a required premium payment made by Lincoln Savings to the Federal Savings and Loan Insurance

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77. *Duecaster*, 60 T.C.M. (CCH) at 918.

78. *Id.* at 920; see I.R.C. § 162(a) (2006) (providing for the deduction of ordinary and necessary expenses).

79. See I.R.C. § 195(c)(1)(B) (1988) (defining a start-up expenditure as one which "if paid or incurred in connection with the operation of an existing active trade or business . . . would be allowable as a deduction for the taxable year").

80. I.R.C. § 162(a) (2006).

81. See S. REP. NO. 96-1036, at 11-12 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301-02 (requiring deductibility by an ongoing trade or business in order to qualify as an expenditure eligible under § 195).

82. See I.R.C. § 212 (2006).

83. See *Duecaster*, 60 T.C.M. (CCH) at 920 ("Nothing in the statute or the legislative history suggests that [§] 195 was intended to create a deduction . . . which would not . . . have been deductible under prior law."); see also *United States v. Gilmore*, 372 U.S. 39, 46 (1963) (noting that the only deductible expenses under a precursor to § 212 are those that meet the limitations set in a precursor to § 162).

84. See, e.g., *Duecaster*, 60 T.C.M. at 920 ("[T]he role of [§] 195 is comparable to that of [§] 212 . . . . It has long been established that [§ 212] creates no deduction for an expenditure that would not have been deductible under [§] 162 . . . .").

85. *Comm'r v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345 (1971).

Corporation.<sup>86</sup> The Court noted that § 162 requires an item to be an ordinary and necessary expense, which was paid or incurred during the taxable year for the carrying on of a trade or business.<sup>87</sup> The Tax Court held that the premium did not qualify as an ordinary and necessary expense under § 162, therefore requiring capitalization.<sup>88</sup> The Ninth Circuit reversed.<sup>89</sup>

The Supreme Court affirmed the Tax Court's classification of the expense as a capital expenditure, arguing that "[w]hat is important and controlling . . . is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense."<sup>90</sup> The Court noted that this was the correct inquiry because "many expenses concededly deductible have prospective effect beyond the taxable year."<sup>91</sup>

After *Lincoln Savings*, courts almost universally applied the "separate and distinct test" to determine whether an expense was deductible under § 162 or whether it required capitalization.<sup>92</sup> Application of the test did not always result in capitalization.<sup>93</sup> In *Briarcliff Candy Corporation v. Commissioner*, an established candy retailer incurred significant expansion costs associated with securing franchise and distributor contracts with existing retailers.<sup>94</sup> The Commissioner argued that the contracts were

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86. *Id.* at 345–46.

87. *Id.* at 352; *see also* *Comm'r v. Tellier*, 383 U.S. 687, 689 (1966) (deferring to the taxpayer's decision regarding necessary business expenses); *Welch v. Helvering*, 290 U.S. 111, 114–15 (1933) (defining ordinary expenses as those which are common and accepted by the business community). "Paid or incurred" refers to the taxpayer's method of accounting, either cash (paid) or accrual (incurred). *See* I.R.C. § 446 (2006) (providing rules regarding accounting methods); *see also* DODGE, FLEMING & GEIER, *supra* note 24, at 354–58 (discussing the different methods of accounting available to taxpayers).

88. *Lincoln Sav. & Loan Ass'n v. Comm'r*, 51 T.C. 82, 107 (1968); I.R.C. § 263(a) (1964) (requiring capitalization in the absence of a specific provision to the contrary).

89. *Lincoln Sav. & Loan Ass'n v. Comm'r*, 422 F.2d 90, 94 (9th Cir. 1970).

90. *Lincoln Sav.*, 403 U.S. at 354.

91. *Id.*

92. *See, e.g., NCNB Corp. v. United States*, 684 F.2d 285, 293 (4th Cir. 1982) (determining that marketing expenses associated with an expansion were deductible because they did not create a separate asset); *United States v. Miss. Chem. Corp.*, 405 U.S. 298, 309–11 (1972) (holding that new shares of a bank were a separate asset); *see also* Dion Mathewson, Note, *Certain Business Expansion and Startup Expenses Are Not Deductible as Ordinary and Necessary Expenses: FMR Corp. v. Commissioner*, 52 TAX LAW 417, 418 n.18 (1999) (citing other cases that applied the separate and distinct test).

93. *See, e.g., NCNB Corp.*, 684 F.2d at 289–90 (using the separate and distinct test to determine that the expenses were currently deductible).

94. *Briarcliff Candy Corp. v. Comm'r*, 475 F.2d 775, 777–78 (2d Cir. 1973). The company incurred substantial advertising costs, aimed at recruiting distributors, rather than end consumers. *Id.* at 777. The court held that the distinction was insignificant and

capital assets with benefits lasting beyond the year in which they were executed.<sup>95</sup> The Second Circuit, following *Lincoln Savings* and a long line of cases regarding the deductibility of self-preservation expenses,<sup>96</sup> held that the expenses should be deductible.<sup>97</sup> The court interpreted *Lincoln Savings* as requiring the creation of a separate and distinct asset in order to capitalize the costs.<sup>98</sup>

In *NCNB Corporation v. United States*, the Fourth Circuit held that the expenses associated with “metro studies, feasibility studies, and applications to the Comptroller” were deductible.<sup>99</sup> Finding that the expenses did not create a separate asset,<sup>100</sup> the court focused instead on the bank’s need to analyze trends and market positions in order to stay competitive in its industry.<sup>101</sup> The court also noted the effect this holding had on the application of § 195. Specifically, the court remarked:

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. An interpretation by us to the contrary would render § 195 meaningless for it would

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allowed Briarcliff Candy to expense both advertising costs. *Id.* at 784. The court reasoned that to hold otherwise would be “plainly a most unjust and unequal interpretation of the law, unsupported by legislative, regulatory or judicial authority. All sellers . . . must be treated alike—in the absence of the acquisition of a capital asset, their expenses for advertising and promotion should be deductible under § 162.” *Id.*

95. *Id.* at 785–86; see also *Briarcliff Candy Corp. v. Comm’r*, 31 T.C.M. (CCH) 171, 177 (1972) (finding the distributor contracts to be capital assets).

96. See, e.g., *Allen v. Comm’r*, 283 F.2d 785, 790–91 (7th Cir. 1960) (“Expenditures by a taxpayer to protect an established business are fully deductible as ordinary business expense[s].”); *Lutz v. Comm’r*, 282 F.2d 614, 617, 620 (5th Cir. 1960) (noting deductible ordinary and necessary business expenses include payments to protect and promote a business); *Comm’r v. Surface Combustion Corp.*, 181 F.2d 444, 447 (6th Cir. 1950) (“The payments were made to preserve an existing asset rather than to acquire a new one, and should not be capitalized.”).

97. *Briarcliff Candy*, 475 F.2d at 786 (“The Supreme Court, however, in *Lincoln Savings* . . . held that the [fact] that an ensuing benefit may have some future aspect is not controlling . . .”). The court went on to say, “[W]hat was important and controlling was that the expenditures served to create or enhance for the taxpayer what is essentially a separate and distinct additional asset.” *Id.*

98. *Id.* at 786 (noting that the contracts created “no property interest [whatsoever]”); see also James David Ruffner, II, Comment, *Corporate Reorganization Expenses: An Overview of the Denial of Current Federal Tax Deductibility and Resulting Capitalization*, 19 U. DAYTON L. REV. 197, 213–14 (1993) (interpreting “the existence of a separate and distinct asset as a prerequisite to the creation of a capital asset”).

99. *NCNB Corp. v. United States*, 684 F.2d 285, 293–94 (4th Cir. 1982).

100. See *id.* at 293 (“The branch has no existence separate and apart from the parent bank . . .”).

101. See *id.* at 294 (“In order to maintain this network, NCNB must continually evaluate its market position . . .”); Ruffner, *supra* note 98, at 216 (“The court used the bank’s needs as the rationale to characterize the costs as ordinary and necessary business expenses.”).

obliterate the reference point in the statute—"the expansion of an existing trade or business."<sup>102</sup>

Not all courts, however, interpreted *Lincoln Savings* as requiring a separate, physical asset. In *Bilar Tool & Die Corp. v. Commissioner*, the Sixth Circuit held that the legal fees incurred in dividing a company required capitalization even though they did not create a separate asset.<sup>103</sup> The court found that the fee was "an expenditure to enhance capital which was calculated to benefit the taxpayer for much more than one year."<sup>104</sup>

After determining that a separate asset had been created, other issues still arose. In *Commissioner v. Idaho Power Co.*, it was undisputed that the utility company created a separate asset when it constructed a new facility.<sup>105</sup> The issue was instead the correct period of time over which to depreciate the equipment used in the construction of the asset.<sup>106</sup> The Court held that the equipment should be depreciated over the life of the asset created, not the life of the equipment itself.<sup>107</sup> The Court noted that § 263 takes precedence over the current depreciation deductions allowed in § 167,<sup>108</sup> in an attempt to "comport[] with accounting and taxation realities."<sup>109</sup> These inconsistencies in interpreting *Lincoln Savings* and the focus on matching expenses with income production led the Supreme Court to reevaluate the separate and distinct asset test in 1992.<sup>110</sup>

2. *INDOPCO and the "Future Benefit" Test.* In *INDOPCO, Inc. v. Commissioner*, the Supreme Court again looked at the

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102. *NCNB Corp.*, 684 F.2d at 291 (quoting I.R.C. § 195(b)(2) (1982)).

103. *Bilar Tool & Die Corp. v. Comm'r*, 530 F.2d 708, 713 (6th Cir. 1976) (discussing what constitutes ordinary and necessary under § 162).

104. *Id.*

105. *See* *Comm'r v. Idaho Power Co.*, 418 U.S. 1, 5–6 (1974) ("Nearly all the relevant facts are stipulated. . . . [The] equipment was used in part . . . for the construction of capital facilities . . .").

106. *Id.*

107. *Id.* at 16–17.

108. *Id.* at 17. This was in accord with § 263(a), whose purpose was "to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." *Id.* at 16; *see also* Ruffner, *supra* note 98, at 215 ("[T]he purpose of I.R.C. § 263 is to match the amortization of an asset's cost with its income-producing years . . ."). Ruffner also notes that the "priority-ordering directive of I.R.C. § 161 mandates" capitalization over deductibility. *Id.*

109. *Idaho Power Co.*, 418 U.S. at 10.

110. *See* Brett M. Alexander, Case Comment, *An Analysis of INDOPCO, Inc. v. Commissioner*, 54 OHIO ST. L.J. 1505, 1507 (1993) (noting the split in the circuit courts over the interpretation of *Lincoln Savings*); *see also* Ruffner, *supra* note 98, at 215 (noting that the Supreme Court's "dogmatic adherence to the matching principle [in *Idaho Power*] . . . set the stage" for *INDOPCO*).

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## LIVING THE DREAM

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issue of which expenses qualify for a deduction under § 162.<sup>111</sup> In late 1977, Unilever, a customer of INDOPCO, expressed interest in acquiring INDOPCO in a friendly takeover.<sup>112</sup> The shareholders approved the takeover, and INDOPCO paid \$2.2 million to investment bankers hired to facilitate the acquisition; INDOPCO claimed the bankers' fee as a § 162 deduction in 1978.<sup>113</sup> The IRS disallowed the deduction.<sup>114</sup>

Focusing on the long-term benefit INDOPCO received from the services, the tax court held that the fee was a capital expenditure and not deductible under § 162.<sup>115</sup> The Third Circuit affirmed, holding that "both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of [INDOPCO]."<sup>116</sup> The Third Circuit rejected INDOPCO's argument that "expenses are not to be capitalized unless they result in the creation or enhancement of a separate and distinct asset."<sup>117</sup>

The Supreme Court affirmed, holding that the expenses were not currently deductible.<sup>118</sup> Clarifying its original position in *Lincoln Savings*, the Court opined:

*Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that 'serves to create or enhance . . . a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263 . . . . In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure.<sup>119</sup>

Retreating from previous statements in *Lincoln Savings*,<sup>120</sup> the Court remarked that "[a]lthough the mere presence of an incidental future benefit—'some future aspect'—may not warrant

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111. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 82–83 (1992). INDOPCO was formerly known as National Starch and was referred to as such in the lower court opinions. See *Nat'l Starch & Chem. Corp. v. Comm'r*, 93 T.C. 67 (1989); *Nat'l Starch & Chem. Corp. v. Comm'r*, 918 F.2d 426 (3d Cir. 1990).

112. *INDOPCO*, 503 U.S. at 80.

113. *Id.* at 81–82.

114. *Id.* at 82.

115. *Nat'l Starch*, 93 T.C. at 75.

116. *Nat'l Starch*, 918 F.2d at 432–33.

117. *Id.* at 429–31.

118. *INDOPCO*, 503 U.S. at 90.

119. *Id.* at 86–87 (first alteration in original).

120. See *Comm'r v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971) ("[T]he presence of an ensuing benefit that may have some future aspect is not controlling . . .").

capitalization, a 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."<sup>121</sup> Finding that the merger created a substantial future benefit for both companies, extending well beyond the year in question, the Court held the costs were correctly classified as capital expenditures.<sup>122</sup>

#### IV. LIMITS TO THE APPLICATION OF *INDOPCO*

On its face, the *INDOPCO* decision had the potential to severely restrict the application of § 195.<sup>123</sup> If *INDOPCO* required capitalization of *any* expense that created a future benefit, the category of start-up costs eligible for deduction under § 195 would be limited to those that did not create any benefit beyond the taxable year.<sup>124</sup> Start-up costs, by definition, create future benefits, or at least the potential for future benefits.<sup>125</sup> The Supreme Court's replacement of the separate and distinct asset test in *INDOPCO*, on which § 195 was loosely based,<sup>126</sup> seemed to frustrate the general intent of Congress.<sup>127</sup> Upon closer inspection, however, *INDOPCO* arguably does not have such a far-reaching effect and should not be read to completely limit the application of § 195.

##### A. *Hostile Takeovers*

In the aftermath of *INDOPCO*, many anticipated that the IRS would attempt to extend the *INDOPCO* holding to the costs

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121. *INDOPCO*, 503 U.S. at 87.

122. *Id.* at 88.

123. See generally Sarah R. Lyke, Note, *INDOPCO, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1265 (1994) (noting the limited application of § 195 post-*INDOPCO*); Ruffner, *supra* note 98, at 223–24 (“Such a position will defeat the purpose of I.R.C. § 195 . . . .”); Lee A. Sheppard, *The INDOPCO Case and Hostile Dense Expenses*, 54 TAX NOTES 1458, 1459 (1992) (“Read broadly, *INDOPCO* means that the taxpayer always loses . . . .”).

124. See I.R.C. § 195(b)(2) (1988) (requiring current deductibility or classification as an expense if incurred by an ongoing trade or business); LeBlanc, *supra* note 47, at 462 (“A literal application of *INDOPCO* would seem to result in the capitalization of these expenditures because, arguably, they generate a ‘not insignificant future benefit that is more than merely incidental.’” (quoting *Nat'l Starch & Chem. Corp. v. Comm'r*, 918 F.2d 426, 431 (3d Cir. 1990))).

125. W. Eugene Seago, *The Treatment of Start-Up Costs Under Section 195*, 66 J. TAX'N 362, 362 (1987).

126. See *supra* notes 47–48, 94–98 and accompanying text (discussing *Briarcliff's* role in the enactment of § 195).

127. See S. REP. NO. 96-1036, at 11 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7293, 7301 (“Eligible expenses [for amortization] also include startup costs . . . .”).

incurred defending against a hostile takeover.<sup>128</sup> The IRS's position regarding these costs had changed many times prior to *INDOPCO*.<sup>129</sup> Relying on the Third Circuit's holding in *National Starch*,<sup>130</sup> the IRS had already issued Private Letter Ruling 91-44-042, in which it required capitalization for costs associated with both friendly and hostile takeovers.<sup>131</sup>

In the Private Letter Ruling, the IRS advised that "the nature of a proposed corporate takeover (i.e., whether it is friendly or hostile) is not determinative of the proper tax treatment . . . . Rather, the proper inquiry . . . is whether the target corporation obtained a long-term benefit as a result of making the expenditures."<sup>132</sup> The IRS placed the burden on the taxpayer to prove there was not a substantial future benefit<sup>133</sup> and assessed deficiencies against companies that had deducted the costs of defending against a hostile takeover.<sup>134</sup>

The IRS took this position in *In re Federated Department Stores, Inc.*, arguing that the bankruptcy court's decision allowing the deduction of certain costs conflicted with *INDOPCO*, and therefore capitalization was required.<sup>135</sup> In an attempt to defend against an unsolicited takeover bid, Federated entered into "white knight"<sup>136</sup> negotiations with Macy, the terms of which included a break-up fee provision.<sup>137</sup> Federated eventually

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128. See Lyke, *supra* note 123, at 1257–58 (discussing the possible expansive interpretation of *INDOPCO*).

129. See *id.* at 1257 n.138 (detailing contradictory Technical Advice Memoranda issued by the IRS regarding hostile takeover defense costs).

130. See *Nat'l Starch & Chem. Corp. v. Comm'r*, 918 F.2d 426, 434 (3d Cir. 1990) (requiring capitalization of costs associated with a friendly takeover).

131. See I.R.S. Priv. Ltr. Rul. 91-44-042 (July 1, 1991) (extending capitalization from friendly takeovers, as in *INDOPCO*, to hostile takeovers). Private Letter Rulings may not be cited as precedent but are used to show the IRS's position. See I.R.C. § 6110(k)(3) (2006).

132. I.R.S. Priv. Ltr. Rul. 91-44-042 (July 1, 1991).

133. *Id.*

134. See Lyke, *supra* note 123, at 1257 (noting that millions of dollars in tax deficiencies were asserted against corporations involved in mergers and acquisitions during the 1980s); Sheppard, *supra* note 123, at 1458 (discussing tax deficiencies against oil and gas companies).

135. *United States v. Federated Dep't Stores, Inc.* (*In re Federated Dep't Stores, Inc.*), 171 B.R. 603, 608 (S.D. Ohio 1994), *aff'g* 135 B.R. 950 (Bankr. S.D. Ohio 1992).

136. See BLACK'S LAW DICTIONARY 1627 (8th ed. 2004) (defining white knight as "[a] person or corporation that rescues the target of an unfriendly corporate takeover, [especially] by acquiring a controlling interest in the target corporation or by making a competing tender offer"). For a recent example of a white knight transaction, see Suzy Jagger et al., *Bear Stearns Seeks White Knight as Fed Steps in to Avert Collapse*, TIMESONLINE, Mar. 15, 2008, [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3556254.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3556254.ece) (discussing JPMorgan's role in the bailout of the storied investment bank).

137. *In re Federated Dep't Stores*, 171 B.R. at 606.

recommended the takeover to its shareholders, paid Macy sixty million dollars under the break-up fee agreement, and deducted the fee as a § 162 expense.<sup>138</sup> The district court affirmed the bankruptcy court's decision, finding that the expenses did not accrue a future benefit and should be classified under § 162.<sup>139</sup> With regard to *INDOPCO*, the court commented:

*INDOPCO*, however, does not undermine the earlier decisions. It merely adds another criteria that courts should examine in ascertaining the tax classification of an expenditure—whether an expenditure creates a future benefit. *INDOPCO* does not stand for the principal that any expenditure that merely preserves the existing corporate structure or policy must be capitalized. The Court considers the expenses incurred in defending against a proxy fight as expenditures that protect the existing policies or structure of a business. Such expenditures are currently deductible and do not require capitalization.<sup>140</sup>

The Seventh Circuit commented on hostile takeovers in *A.E. Staley Manufacturing Co. v. Commissioner*.<sup>141</sup> Staley Continental incurred millions in banking fees when it attempted to resist a hostile takeover.<sup>142</sup> The tax court disallowed a deduction for the fees, concluding that “any distinctions between this case . . . and [*INDOPCO*] . . . are distinctions without a difference.”<sup>143</sup> The Seventh Circuit reversed, deferring to the “well-worn notion that expenses incurred in defending a business and its policies from attack are necessary and ordinary—and deductible—business expenses.”<sup>144</sup> The court found that Staley was defending its business against attack,<sup>145</sup> and the defense failed to produce a benefit beyond the taxable year, limiting *INDOPCO* to friendly acquisitions.<sup>146</sup>

### *B. The Realization Versus the Expectation of Benefit*

*INDOPCO* required capitalization because the taxpayer realized “benefits beyond the year in which the expenditure [was]

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138. *Id.*

139. *Id.* at 609.

140. *Id.* at 610.

141. *A.E. Staley Mfg. Co. v. Comm’r*, 119 F.3d 482, 487 (7th Cir. 1997).

142. *Id.* at 485.

143. *A.E. Staley Mfg. Co. v. Comm’r*, 105 T.C. 166, 198 (1995).

144. *Id.* at 487.

145. *Id.* at 489.

146. *See id.* at 489 & n.6, 491–92.

incurred.”<sup>147</sup> Comparing *INDOPCO* to *Briarcliff Candy*, the variant seems to be the expectation, rather than the realization, of the future benefit produced by the expenditure.<sup>148</sup> In *Sun Microsystems v. Commissioner*, the tax court focused on this distinction.<sup>149</sup> Sun Microsystems granted warrants to a strategic partner “[a]s additional incentive for an ongoing business relationship.”<sup>150</sup> The Commissioner argued the costs incurred by Sun Microsystems and associated with the exercise of the warrants should be capitalized under *INDOPCO*.<sup>151</sup> In allowing Sun to deduct the expenses, the court noted that “the anticipated long-term benefits to [Sun] from the relationship . . . were ‘softer’ and were speculative,”<sup>152</sup> qualifying them as “incidental future benefit[s].”<sup>153</sup>

The Tax Court looked at this issue again in *FMR Corp. v. Commissioner*.<sup>154</sup> FMR was a holding company for regulated investment companies (RICs).<sup>155</sup> From 1985 to 1987, FMR contracted for eighty-two RICs and deducted the associated expenses.<sup>156</sup> The Commissioner argued that these expenses should be capitalized, relying on the expectation of future benefit analysis from *INDOPCO*.<sup>157</sup> While the tax court agreed these were capital expenses, it focused on the realization, not the expectation, of benefit. The court looked at the fee arrangement,

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147. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 87–88 (1992).

148. See *Briarcliff Candy Corp. v. Comm’r*, 475 F.2d 775, 784 (2d Cir. 1973) (“It is not enough that it may have a favorable expectancy or that in the course of its use it increases sales and produces income.”). Focusing on the expectation of benefit, the *Briarcliff* court went on to say that the contracts “acquired little more than an expectation or hope of future sales . . . . [W]e do not believe this minor additional factor is sufficient to justify our concluding that [Briarcliff] purchased some intangible capital assets by these contracts.” *Id.* at 786 n.5; see also *supra* notes 94–98 and accompanying text (discussing *Briarcliff*’s facts); W. Eugene Seago & D. Larry Crumbley, *INDOPCO: A Tiger, a Pussycat, or a Creature Somewhere in Between?*, 94 J. TAX’N 14, 18 (2001) (noting that *Briarcliff*’s expenditures created “little more than an expectation or hope of future sales”). The *INDOPCO* court focused instead on the realization of the benefit, rather than the mere expectation. See *supra* notes 111–22 and accompanying text (discussing the *INDOPCO* holding). *Briarcliff* was not explicitly overruled by *INDOPCO* and the two holdings coexist. See *FMR Corp. v. Comm’r*, 110 T.C. 402, 416–17 (discussing both *INDOPCO* and *Briarcliff* as relevant and applicable case law).

149. *Sun Microsystems, Inc. v. Comm’r*, 66 T.C.M. (CCH) 997, 1005 (1993).

150. *Id.* at 999. A warrant is “[a]n instrument granting the holder a long-term (usually) a five- to ten-year) option to buy shares at a fixed price. It is commonly attached to preferred stocks or bonds.” BLACK’S LAW DICTIONARY 1617 (8th ed. 2004).

151. *Sun Microsystems*, 66 T.C.M. (CCH) at 1005.

152. *Id.*

153. *Id.*

154. *FMR Corp. v. Comm’r*, 110 T.C. 402, 414 (1998).

155. *Id.* at 404.

156. *Id.* at 404, 409, 413–14.

157. *Id.* at 415–16 & n.9.

the perpetual existence of the RICs, and the history of RIC success to determine that FMR actually received a future benefit from the contracts.<sup>158</sup> Additionally, the court distinguished *Briarcliff* from *INDOPCO* by “[e]mphasizing the importance of the realization of a significant future benefit in determining whether an expenditure should be capitalized.”<sup>159</sup>

### C. Other Limitations

The Third Circuit limited *INDOPCO*'s application to loan origination costs in *PNC Bancorp, Inc. v. Commissioner*.<sup>160</sup> In light of *INDOPCO*'s position that “deductions are exceptions to the norm of capitalization,”<sup>161</sup> and a Statement of Financial Standards requiring banks to separate loan origination costs from other expenses,<sup>162</sup> the tax court held that the costs should be capitalized over the life of the loan.<sup>163</sup> On appeal, the Third Circuit noted that “[h]istorically, the costs at issue have been deductible in the year that they are incurred.”<sup>164</sup> Focusing on a line of pre-*INDOPCO* cases that permitted current deductions for loan creation costs and day-to-day bank operation expenses, the court reversed in favor of PNC, allowing the deduction.<sup>165</sup>

*INDOPCO* also had the potential to influence which costs were included as expenses associated with the substantial future benefit. *Wells Fargo v. Commissioner* concerned a dispute involving in-house costs associated with a bank merger.<sup>166</sup> The bank deducted \$150,000 in salaries paid to employees who

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158. See *id.* at 417–18 (“[P]etitioner expects to be awarded the initial contract to manage the new fund, as well as the annual renewals of that contract for as long as the RIC exists. Here, petitioner’s expectation was in fact realized.”).

159. *Id.* at 424–25.

160. *PNC Bancorp, Inc. v. Comm’r*, 212 F.3d 822, 834 (3d Cir. 2000), *rev’g* 110 T.C. 349 (1998).

161. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992).

162. See *PNC Bancorp*, 212 F.3d at 825 & n.1 (noting that Statements of Financial Standards are established by an independent private sector organization and that the SEC recognizes these standards as authoritative); see also Jezabel Llorente, *Nothing Left of INDOPCO: Let’s Keep It That Way!*, 29 FLA. ST. U. L. REV. 277, 285 (2001) (discussing the requirement that banks separate costs associated with loan procurement and origination from other expenses); Gary L. Maydew, *To Deduct or Capitalize: Courts and IRS Interpret INDOPCO*, 63 PRAC. TAX STRATEGIES 145, 149–50 (1999) (discussing the negative impact of Statement of Financial Standards No. 91 on the bank’s case in *PNC Bancorp*).

163. *PNC Bancorp, Inc. v. Comm’r*, 110 T.C. 349, 375 (1998).

164. *PNC Bancorp*, 212 F.3d at 824.

165. *Id.* at 830–31; see also *Iowa-Des Moines Nat’l Bank v. Comm’r*, 68 T.C. 872, 877–78, 880 (1977) (holding that the cost to investigate customer credit worthiness in connection with extending loans was ordinary and necessary and should be currently deducted), *aff’d*, 592 F.2d 433 (8th Cir. 1979).

166. *Wells Fargo & Co. v. Comm’r*, 224 F.3d 874, 879–80 (8th Cir. 2000).

assisted with the merger.<sup>167</sup> The Commissioner disallowed the deduction, claiming the employee's efforts contributed to the merger, creating a substantial future benefit and requiring capitalization.<sup>168</sup> The tax court agreed.<sup>169</sup> Using complex symbolic logic to interpret the *INDOPCO* decision,<sup>170</sup> the Eighth Circuit reversed and allowed the deduction, holding that the indirect salaries associated with the merger were not comparable to the direct expenses in *INDOPCO*.<sup>171</sup>

*D. What's Left of § 195?*

In addition to the limitations above, the IRS has ruled directly on many specific classes of expenses that do not create a substantial future benefit. For example, Revenue Ruling 92-80 stated that *INDOPCO* did not affect the deductibility of advertising expenses.<sup>172</sup> Revenue Ruling 94-12 confirmed pre-*INDOPCO* law by stating that incidental repair expenses are deductible expenditures.<sup>173</sup> And, Revenue Ruling 96-62 held that training costs were still deductible as business expenses post-*INDOPCO*.<sup>174</sup>

Most significantly for § 195 analysis, Revenue Ruling 2000-4 held that certain expenditures to expand an existing business do not necessarily result in a future benefit.<sup>175</sup> The IRS focused on the speculative and incidental nature of the benefits, noting "the mere ability to sell in new markets and to new customers, without more, does not result in significant future benefits."<sup>176</sup>

In an attempt to further clarify which expenses qualify for § 195 treatment, Revenue Ruling 99-23 specifically discussed

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167. *Id.* at 880.

168. *Id.*

169. *See* *Norwest Corp. v. Comm'r*, 112 T.C. 89, 102-03 (1999).

170. *See Wells Fargo*, 224 F.3d at 881-86 (defining variables to analyze *INDOPCO*; for example, stating "[t]he Tax Court is saying that C must result because of the presence of B. This is equivalent to 'if B then C,' which we have previously proven to be a false statement").

171. *Id.* at 886 ("The *INDOPCO* case addressed costs which were *directly* related to the acquisition, while the instant case involves costs which were only *indirectly* related to the acquisition."). The Eighth Circuit also discussed Rev. Rul. 99-23's applicability to this case and other § 162 expense cases. *Id.* at 888-89; *see also infra* notes 177-83 and accompanying text (discussing Revenue Ruling 99-23's impact on § 195).

172. Rev. Rul. 92-80, 1992-2 C.B. 57, 57; *see also* LeBlanc *supra* note 47, at 460-61 (analyzing advertising costs in light of *INDOPCO*).

173. Rev. Rul. 94-12, 1994-1 C.B. 36, 37; *see also* Peter L. Faber, *INDOPCO: The Still Unsolved Riddle*, 47 TAX LAW. 607, 625 (1994) (noting that the IRS's reading of *INDOPCO* in Rev. Rul. 94-12 "in effect views [*INDOPCO*] as not affecting any of the prior case law").

174. Rev. Rul. 96-62, 1996-2 C.B. 9, 9.

175. *See* Rev. Rul. 2000-4, 2000-1 C.B. 331, 331-32.

176. *Id.* at 332; *see also supra* Part IV.B (discussing the effect mere expectation, as opposed to actual realization, has on determining the correct tax treatment).

start-up expenditures.<sup>177</sup> The IRS differentiated between expenses incurred prior to making a “final decision” and those incurred afterwards.<sup>178</sup> The final decision is “the point at which a taxpayer makes its decision *whether* to acquire a business, and *which* business to acquire.”<sup>179</sup> Expenditures incurred prior to the final decision are classified as investigatory costs and are eligible for amortization under § 195.<sup>180</sup> Costs incurred to acquire a specific business after the “*whether* and *which*” decisions cannot be included under § 195.<sup>181</sup>

Revenue Ruling 99-23 also succinctly described the relationship between §§ 162 and 195, stating, “[t]hus, the expenditure must be an ordinary expense under § 162, and not a capital expenditure, to be a start-up expenditure under § 195.”<sup>182</sup> Possible expenses that qualify for amortization include costs to survey potential markets, advertising, salaries, and travel expenses.<sup>183</sup>

The Treasury issued final regulations under § 263(a) in late 2003, attempting to simplify the interplay of §§ 195 and 263(a).<sup>184</sup> Unfortunately, the regulations further complicated the relationship between the two sections.<sup>185</sup> For example, the final regulations do not allow for the amortization of start-up costs, although this is specifically allowed under § 195.<sup>186</sup> Another issue arises if costs were previously included as § 195 expenses but now require capitalization.<sup>187</sup>

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177. Rev. Rul. 99-23, 1999-1 C.B. 998.

178. *Id.* at 998–99; see also S. REP. 96-1036, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301 (“[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.”).

179. Rev. Rul. 99-23, 1999-1 C.B. 998, 999. This is also referred to as the “whether-and-which” test. RONALD W. BLASI, 2008 U.S. MASTER BANK TAX GUIDE 348.

180. Rev. Rul. 99-23, 1999-1 C.B. 998, 1000; see also 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, 169 (2005) (criticizing Rev. Rul. 99-23).

181. Rev. Rul. 99-23, 1999-1 C.B. 998, 1000.

182. *Id.* at 999.

183. *Id.* (quoting S. REP. NO. 96-1036, at 11–12). See generally Todd F. Maynes, *Start-Up Expenditures*, in TAX MANAGEMENT A-39, A-39 to -51 (2008) (discussing what qualifies as start-up expenditures under § 195).

184. See Carol Conjura, Timothy A. Zuber & Peter C. Beale, *To Capitalize or Not? The INDOPCO Era Ends with Final Regulations Under Section 263(a)*, 100 J. TAX’N 215, 215 (2004).

185. *Id.* at 225.

186. See Treas. Reg. § 1.263(a)-5(a) (2008) (listing the ten transactions that require capitalization, which does not include start-up expenditures).

187. See Conjura, Zuber & Beale, *supra* note 184, at 225 (discussing the many conflicting issues between § 195 and the final § 263(a) regulations). Compare Wells

In 2004, the 108th Congress passed the American Jobs Creation Act in order to “make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad.”<sup>188</sup> The Act provided for consistent amortization of intangibles throughout the Code, including those provided for in § 195.<sup>189</sup> Additionally, the Act amended § 195 to allow up to \$5,000 of start-up expenditures to be immediately deductible.<sup>190</sup> Until 2004, § 195 only allowed for the amortization of expenditures once the business began.<sup>191</sup> This change did not resolve the debate between §§ 162 and 263,<sup>192</sup> but it did encourage the formation of new businesses by giving an immediate deduction to potential business owners.<sup>193</sup>

*INDOPCO* restated the oft-quoted rule that “an income tax deduction is a matter of legislative grace.”<sup>194</sup> While the Code may prefer capitalization in absence of a specific provision to the contrary, § 195 specifically exempts start-up expenditures from the default requirement of automatic capitalization.<sup>195</sup> *INDOPCO*’s failure to mention § 195 despite the Court’s ten years of interpretive jurisprudence<sup>196</sup> should not be read to limit the application of § 195.<sup>197</sup>

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Fargo & Co. v. Comm’r, 224 F.3d 874, 885–86 (8th Cir. 2000) (holding that the merger expenses are deductible), *with* Treas. Reg. § 1.263-5(a) (2008) (requiring capitalization for the costs associated with a merger).

188. American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418, 1418 (2004) (codified at I.R.C. § 195).

189. *See* I.R.C. § 195(b)(1)(B) (2006) (providing for a consistent 180-month amortization period).

190. I.R.C. § 195(b)(1) (2006).

191. *See* I.R.C. § 195(b)(1) (1988).

192. *See supra* Part III.B and Part IV (discussing the struggle between current expenses and capital expenditures).

193. *See* I.R.C. § 195(b)(1)(A)(ii) (2006) (providing for a deduction of up to \$5,000). Taxpayers prefer current deductions rather than capitalization due to the time-value of money. *See* DODGE, FLEMING & GEIER, *supra* note 24, at 25–26 (illustrating why “money not available until a future time isn’t worth as much as money presently in hand”).

194. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 84 (1992); *see also* *Interstate Transit Lines v. Comm’r*, 319 U.S. 590, 593 (1943) (“[W]e examine the argument in the light of the now familiar rule that an income tax deduction is a matter of legislative grace . . .”); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940) (“It depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.” (internal quotation marks omitted)); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (“Whether and to what extent deductions shall be allowed depends upon legislative grace . . .”).

195. I.R.C. § 195 (2006).

196. *See INDOPCO*, 503 U.S. 79 (1992) (failing to mention § 195 in any part of the opinion); LeBlanc, *supra* note 47, at 462–63 (noting the Court’s failure to mention § 195 in its analysis).

197. *See* Lyke, *supra* note 123, at 1266 (noting Congress’s mandate regarding the current deductibility of certain start-up costs).

## V. RECOMMENDATIONS

Section 195 will expire in July 2011 if it is not extended or amended.<sup>198</sup> The current iteration of the provision does not adequately meet Congress's stated goals—treating taxpayers equally, reducing litigation, and encouraging small business development and growth.<sup>199</sup> Each of these goals could be met by amending the provision.

A. *Equal Treatment*

Consider two taxpayers, each of whom spends \$52,000 for technology infrastructure for his or her business, including hardware, software, networking, and support.<sup>200</sup> Taxpayer A is currently engaged in an ongoing trade or business and is therefore able to rely on § 162.<sup>201</sup> Additionally, Taxpayer A can also invoke §§ 168 and 179 to expense certain capital assets.<sup>202</sup> Taxpayer B is in the process of starting a business and therefore can rely only on § 195.<sup>203</sup> For the 2008 taxable year, Taxpayer A would be able to deduct the entire \$52,000 cost of the technology.<sup>204</sup> Taxpayer B, however, would only be able to deduct

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198. Temp. Treas. Reg. § 1.195-1T(e) (2008).

199. See *supra* Part II.B.1 (discussing Congress's intent in enacting § 195).

200. See, e.g., Angela Mueller, *Angels We Have Heard on High*, ST. LOUIS BUS. J., Dec. 21, 2007, <http://stlouis.bizjournals.com/stlouis/stories/2007/12/24/story1.html> (demonstrating the high costs that can be associated with technology-based start-up companies, with investments ranging from \$50,000 to \$4.73 million). Technology infrastructure is a large but often necessary expenditure for most entrepreneurs. See Mark Henricks, Amanda C. Kooser, Gwen Moran & Chris Penttila, *75 Startup Secrets*, ENTREPRENEUR'S STARTUPS, Mar. 2006, <http://www.entrepreneur.com/magazine/entrepreneursstartups/2006/march/83560.html> (discussing the technology requirements for starting a business).

201. See I.R.C. § 162(a) (2006) (providing deductions for all ordinary and necessary business expenses).

202. See I.R.C. §§ 168(k)(1)(A), 179(a) (2006) (allowing business taxpayers to expense the costs of capital assets placed into service during the taxable year). To qualify for a deduction, the property must meet certain requirements. See I.R.C. § 179(d)(1) (2006) (stating that § 179 property must be tangible property, computer software, or § 1245 property and used in an active trade or business); I.R.C. § 167 (2006) (defining depreciable property); I.R.C. § 168 (2006) (allowing for the depreciation of tangible property); I.R.C. § 197 (2006) (allowing for the amortization of intangibles); I.R.C. § 1245 (2006) (defining qualified property as any depreciable business personal property or other non-building property).

203. I.R.C. § 195 (2006). Section 195 is not the exclusive remedy to an individual taxpayer in the process of starting their business. See Musselman, *supra* note 180, at 145 (noting which costs continue to be currently deductible). Section 195 specifically exempts deductions allowable under §§ 163(a), 164, and 174 from the definition of start-up expenditures. I.R.C. § 195(c)(1) (2006); see also *supra* note 71 (noting the deductions excluded from the definition of start-up expenses).

204. 26 U.S.C.A. § 179(b)(7) (West Supp. 2009). For 2008, taxpayers can deduct up to

\$3,000 of the cost.<sup>205</sup> Had the total expenses been \$60,000, Taxpayer A would still be able to deduct the entire amount, but Taxpayer B would not be able to deduct *any* of the expenses.<sup>206</sup>

This is inconsistent with Congress's intent to treat similar taxpayers equally, and presents a problem for entrepreneurs hoping to use § 195.<sup>207</sup> In 2003, the SBA released a study on the costs associated with starting a business.<sup>208</sup> The average expense associated with a new business was forecast at \$7,000 for solo entrepreneurs and \$23,200 for teams of entrepreneurs.<sup>209</sup> Of the 830 entrepreneurs surveyed, 388 (or 46.7%) were solo entrepreneurs,<sup>210</sup> making the expected value of expenses per

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\$250,000 for § 179 property placed into service during the year, with a limit of \$800,000 before the deduction decreases. *Id.* The deduction and limits vary depending on the taxable year. *See, e.g.*, 26 U.S.C.A. § 179(b)(1), (2) (West Supp. 2009) (providing limits for 2005 would be \$25,000 and \$200,000 respectively, whereas limits for 2009 would be \$125,000 and \$500,000 respectively). The 2009 limits were changed with the passage of the American Recovery and Reinvestment Act of 2009. *See infra* notes 250–59 and accompanying text (discussing the effect of the 111th Congress's bailout bill); H.R. 1, 111th Cong. § 1402 (2009) (extending the favorable 2008 depreciation deduction limits through 2009).

205. *See* I.R.C. § 195(b)(1)(A)(ii) (2006). Under § 195, the deduction is reduced by the amount the expenditures exceed \$50,000 for the year. *Id.* Therefore, the actual deduction is \$5,000 – (\$52,000 – \$50,000) = \$3,000.

206. *See supra* notes 201–02, 204 (noting current business owners can take advantage of I.R.C. §§ 162, 168, and 197). Taxpayer A is well under the 2008 limit for § 179 deductions (\$25,000) and would be able to fully expense the costs. 26 U.S.C.A. § 179(b)(7) (West Supp. 2009). Taxpayer B's expenses exceed the \$50,000 limit by \$10,000, reducing the current deduction from \$5,000 to \$0. I.R.C. § 195(b)(1)(A)(ii) (2006). Instead, \$60,000 will be added to the basis of B's business once it begins and amortized over 180 months. I.R.C. § 195(b)(1)(B) (2006). If Taxpayer A's expenses were associated with an expansion project unrelated to his or her current business, the results may be more similar to those of Taxpayer B. *See* FMR Corp. v. Comm'r, 110 T.C. 402, 428 (1998) (noting Congress's intent to differentiate between the expansion costs of an existing business and those "paid or incurred in the creation or acquisition of a new trade or business to which [§] 195 [does] apply"). *But see* Rev. Rul. 2000-4, 2000-1 C.B. 331, 331 (noting that the classification of expansion costs depends on the speculative nature of the future benefit).

207. *See supra* notes 49–53 and accompanying text (discussing Congress's intent to treat both business and nonbusiness taxpayers equally).

208. SBA OFFICE OF ADVOCACY, EXPECTED COSTS OF STARTUP VENTURES (2003) [hereinafter SBA STARTUP COSTS].

209. *Id.* at 22, 27. Solo entrepreneurs estimated \$6,000 in start-up expenses and an additional \$1,000 operating cash for the first month of business. *Id.* at 22. Teams of entrepreneurs required \$20,000 and \$3,200 respectively. *Id.* at 27. Entrepreneurs have a tendency to underestimate the time and money necessary to start a business. *See* KEVIN SCHEHRER, STARTUP!: BEYOND THE MYTHS TO THE REALITY OF STARTING A COMPANY 179 (2002) (discussing the importance of a plan that includes multiple sources of funding and a timeframe for securing financing); Gayle F. Santana, *Funding Your Business Venture*, THE GLOW PROJECT, Jan. 2009, at 40, 42 (noting that "the cost of getting started exceeded [entrepreneur's] expectations" even after creating business plans).

210. SBA STARTUP COSTS *supra* note 208, at 18, 20.

startup \$15,627.<sup>211</sup> The average actual investment for solo entrepreneurs is \$8,026 with a standard deviation of \$25,752; for teams the average is \$37,975 with a standard deviation of \$182,201.<sup>212</sup> The 95% confidence interval for self-investment by solo and team entrepreneurs is \$0 to \$59,530 and \$0 to \$402,377, respectively.<sup>213</sup> At this high level of expenditure, business owners minimally benefit from the \$5,000 deduction in § 195.<sup>214</sup> Alternatively, most of these same expenses would be deductible by an ongoing business.<sup>215</sup>

Section 179 has a structure similar to § 195, although its benefits are only available to ongoing businesses.<sup>216</sup> Enacted in 1958, § 179 was intended to give small business owners a depreciation bonus for new assets.<sup>217</sup> Under the provision, taxpayers could expense 20% of the cost of property placed in service during the taxable year.<sup>218</sup> There was a \$10,000 limit on the deduction, ensuring that only small businesses could take advantage of the provision.<sup>219</sup> The deduction was changed to a dollar amount, rather than a percentage, in 1981,<sup>220</sup> a reduction threshold was added in 1986,<sup>221</sup> and an additional income limitation was added in 1988.<sup>222</sup> Since 1981, Congress has often

211. See PAUL NEWBOLD, WILLIAM L. CARLSON & BETTY THORNE, STATISTICS FOR BUSINESS & ECONOMICS 135–37 (6th ed. 1995) (noting the formula for expected value ( $E(X)$ ) is  $\sum xP_x(x)$  or the sum of each outcome multiplied by the probability of each outcome). Therefore, the total expected costs are  $[(388/830) * \$7,000 + (442/830) * \$23,200 = \$15,626.5]$ .

212. SBA STARTUP COSTS *supra* note 208, at 22–23, 27–28. The high standard deviation indicates that the data is largely dispersed around the mean. See NEWBOLD, *supra* note 211, at 53–54 (discussing the use of standard deviation as a measurement of dispersion among sample data).

213. See NEWBOLD, *supra* note 211, at 56 (approximating that 95% of a population lies within two standard deviations on each side of the normal distribution). This assumes that the distribution of costs is normal, which is common among large samples with random outcomes. *Id.* at 197.

214. See I.R.C. § 195(b)(1)(A) (2006).

215. See I.R.C. § 162(a) (2006) (providing for ordinary and necessary business deductions). *But see* I.R.C. § 263(a) (2006) (requiring capitalization for capital expenditures with a useful life beyond one year).

216. See I.R.C. § 179(d)(1)(C) (2006) (requiring “use in [an] active conduct of a trade or business”).

217. Small Business Tax Revision Act of 1958, Pub. L. No. 85-866, § 204(a), 72 Stat. 1606, 1679 (codified at I.R.C. § 179 (1958)).

218. I.R.C. § 179(a) (1958) (stating the general rule for qualified property).

219. I.R.C. § 179(b) (1958) (limiting the deduction to assets under \$10,000).

220. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 202(a), 95 Stat. 172, 219 (codified at I.R.C. § 179(b) (1982)).

221. Tax Reform Act of 1986, Pub. L. No. 99-514, § 202(a), 100 Stat. 2085, 2142–43 (codified at I.R.C. § 179(b)(2) (1988)) (reducing the deduction if the assets placed in service during the year exceed \$200,000).

222. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647,

updated the amount of the deduction available under § 179(b)(1), as well as the phase-out limits.<sup>223</sup>

The limits under § 179 are much higher than those under § 195, allowing more taxpayers to use the incentives under the depreciation provision.<sup>224</sup> Section 195 should have similar limits, derived from the amount of expenditures actually incurred by entrepreneurs. By increasing the maximum deduction from \$5,000 to \$50,000, the percentage of businesses able to apply the § 195 deduction increases from 45.2% to 94.8% for solo start-ups and 42.9% to 52.8% for team start-ups.<sup>225</sup> Increasing the threshold at which the deduction decreases from \$50,000 to \$400,000 would increase the percentage of start-ups able to take advantage of the provision from 96.6% to 100% for solo entrepreneurs and from 53.6% to 98.8% for teams.<sup>226</sup> These changes would allow the majority of start-up companies to take advantage of the tax incentives and would satisfy the fairness norm of horizontal equity.<sup>227</sup>

Start-up expenses alone do not insure long term success. Twenty to thirty percent of new businesses fail within their first year, and, of those that survive, less than eighty percent remain after six years.<sup>228</sup> While team start-ups are initially more successful, the rate of success after six years for both types of

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§ 1002(b)(1), 102 Stat. 3342, 3357 (codified at I.R.C. § 179(b)(1) (1988)) (limiting the deduction to the taxpayer's taxable income for the year).

223. See I.R.C. § 179(b) (2006) (providing the current limits); *supra* note 204 (discussing the changing limits and reduction thresholds in recent years).

224. Compare Economic Stimulus Act of 2008, Pub. L. No. 110-185, § 102, 122 Stat. 613, 618 (providing a new deduction limit of \$250,000, with the reduction beginning at \$800,000), with I.R.C. § 195(b)(1)(A) (2006) (providing a deduction limit of \$5,000, with the reduction beginning at \$50,000).

225. See SBA STARTUP COSTS, *supra* note 208, at 23, 28 (noting the mean and standard deviation of investment by solo and team startups). Using the z-statistic formula,  $P(z) = (x - \mu) / \sigma$ , the z-statistic of solo startups under the current law is negative 0.12, which is used to determine the probability under the normal curve. See NEWBOLD, *supra* note 211, at 835 (finding the  $P(z = 0.12) = 0.5478$ ). Subtract this number from 1 to get the actual probability for the negative z-statistic, 0.4522. See *id.* at 199 (noting treatment for negative z-statistics). Repeat this process for the teams and for the suggested deduction of \$50,000 to calculate the other probabilities.

226. See *supra* note 225 (discussing the method for calculating percentages based on the mean and standard deviation of a normally distributed sample). For this calculation  $x = 450,000$ , the level of expenditure above which startups would be unable to take any deduction. See I.R.C. § 195(b)(1)(A)(ii) (2006) (providing for the reduction of the deduction for expenditures above the threshold amount).

227. See DODGE, FLEMING & GEIER, *supra* note 24, at 122 (discussing the idea that similarly situated taxpayers should be taxed equally).

228. SBA STARTUP COSTS *supra* note 208, at 5; see SCOTT A. SHANE, THE ILLUSIONS OF ENTREPRENEURSHIP: THE COSTLY MYTHS THAT ENTREPRENEURS, INVESTORS, AND POLICY MAKERS LIVE BY 99 (2008) (showing that 40% of businesses founded in 1992 survived until 1998).

start-ups is roughly equal.<sup>229</sup> One way to protect against failure is having adequate financing in place prior to beginning a business.<sup>230</sup> Another is the development of a business plan, considered by many to be the most critical step to ensuring the success of a business.<sup>231</sup> Giving start-up businesses the same tax incentives enjoyed by ongoing businesses will give entrepreneurs the time they need to adequately develop business plans and secure funding, rather than feeling rushed to begin the business in order to obtain tax advantages.<sup>232</sup>

### B. Reducing Litigation with Clear Statutory Construction

Revenue Ruling 99-23 differentiates between costs incurred prior to the “*whether* and *which*” decisions and those incurred after.<sup>233</sup> The legislative history of § 195 points to another span of time within which amortizable costs can occur—“subsequent to a decision to establish a particular business and prior to the time when the business begins.”<sup>234</sup> The intent was for “[o]rdinary and necessary expenses incurred before the business functions as a going concern [to] fall within the proposed section. Section 162 applies to expenses incurred after the business begins functioning as a going concern.”<sup>235</sup>

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229. See Erik Stam & Veronique Schutjens, *The Fragile Success of Team Start-Ups* 6, (Max Planck Inst. for Research into Econ. Sys., Discussion Papers on Entrepreneurship, Growth and Public Policy No. 1705, 2005), available at <ftp://papers.mpiew-jena.mpg.de/egp/discussionpapers/2005-17.pdf> (noting the six-year success rate of solo start-ups is 37.5% (449 out of 1196) compared with 35.6% (32 out of 90) for team start-ups).

230. See Gwen Moran, *50 Steps to Startup Success*, ENTREPRENEUR'S STARTUPS, Sept. 2008, available at <http://www.entrepreneur.com/magazine/entrepreneursstartups/magazine/2008/september/197322.html> (“The worst thing you could do is give them enough to get halfway there. Then they will need to devote resources to raising more money when they haven't really accomplished anything yet.”).

231. See Stam & Schutjens, *supra* note 229, at 9 (noting the negative growth of “unfocused” teams without business plans, compared to the positive growth of “focused” teams with business plans); see also Tim Berry, *15 Reasons You Need a Business Plan*, ENTREPRENEUR.COM, Mar. 13, 2006, <http://www.entrepreneur.com/startingabusiness/businessplans/businessplancoachtimberly/article83818.html>.

232. See Joseph Anthony, *Business Startup Costs: Write Off!*, STARTUPNATION.COM, [http://www.startupnation.com/articles/1178/1/AT\\_How-to-Write-Off-Your-Startup-Costs.asp](http://www.startupnation.com/articles/1178/1/AT_How-to-Write-Off-Your-Startup-Costs.asp) (last visited Sept. 19, 2009) (advising entrepreneurs that “[o]nce you open your business and start generating revenues, you can write off many of those initial business startup costs at tax time”).

233. Rev. Rul. 99-23, 1999-1 C.B. 998, 1000; see also *supra* notes 177–83 and accompanying text (discussing the treatment of expenses prior to and after determining whether to enter or acquire a business and which one to enter or acquire).

234. S. REP. NO. 96-1036, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7293, 7301.

235. Lathen & Lathen, *supra* note 46, at 419 (quoting Daniel Sharp, *Tax Relief for New Businesses: Equitable Treatment of Start-Up Costs*, 57 TAXES 695, 699 (1979)).

The use of the term “when an active trade or business begins,”<sup>236</sup> as opposed to “function as a going concern” has frustrated the intent of Congress.<sup>237</sup> Revenue Ruling 99-23 makes it clear that expenses incurred after the decision to enter a specific business are not included under § 195.<sup>238</sup> Under this interpretation, expenses incurred after this decision would be treated as capital expenditures and added to the basis of the business.<sup>239</sup> Congress’s intent was for § 162 to apply as soon as § 195 was no longer applicable.<sup>240</sup> The inclusion of advertising and salaries as deductible start-up expenses does not make sense if all expenses incurred after the entry decision had to be capitalized.<sup>241</sup> Adjusting the terminology so it is consistent between the two provisions will simplify the application of the Section and reduce the court’s burden in interpreting these provisions.

### C. Encouraging Small Business Growth

Encouraging the formation of new business is at the heart of § 195.<sup>242</sup> Congress was concerned that the unequal treatment of taxpayers (the cause) was limiting small business development (the effect).<sup>243</sup> Specifically:

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

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236. I.R.C. § 195(c)(2)(A) (2006).

237. See Lathen & Lathen, *supra* note 46, at 417–18 (noting the Code’s silence as to the treatment of expenses in the “gap period”—after the business begins but before it becomes a going concern).

238. Rev. Rul. 99-23, 1999-1 C.B. 998, 999.

239. *Id.*

240. See S. REP. NO. 96-1036, at 11 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7293, 7301 (“Eligible expenses also include startup costs . . . prior to the time when the business begins.”); Lathen & Lathen, *supra* note 46, at 418–19 (explaining legislative intent, as told by the sponsor of the Senate Report).

241. S. REP. NO. 96-1036, at 12 (“[S]tartup costs include advertising, salaries and wages paid to employees who are being trained and their instructors, travel and other expenses incurred . . . .”); see also Musselman, *supra* note 180, at 168–71 (criticizing the IRS’s interpretation of § 195 in Revenue Rule 99-23).

242. See S. REP. NO. 96-1036, at 11 (providing reasons for changing the treatment of start-up expenditures); Lathen & Lathen, *supra* note 46, at 417 (noting the connection between parity in taxpayer treatment and the encouragement business formation in § 195); see also Lyke, *supra* note 123, at 1264 (noting that Congress recognized the unequal treatment of taxpayers and enacted § 195 as a remedy to encourage small business).

243. See *supra* notes 49–61 and accompanying text (discussing congressional intent).

this disparity and *thereby encourage formation of new businesses by providing an amortization deduction for eligible investigatory expenses.*<sup>244</sup>

With the state of the current economy, small business optimism is at the lowest levels in recent history.<sup>245</sup> In 2006, nonemployer firms increased only 1.9% from the previous year, as opposed to 4.5%, 4.7% and 5.7% the previous three years.<sup>246</sup> As more companies lay off employees during this economic downturn, and the unemployment numbers continue to grow, more people will be looking for alternative employment.<sup>247</sup>

Noting that “start-ups . . . will create the high-wage, high-tech jobs of tomorrow,” then-presidential candidate Obama pledged to help small business.<sup>248</sup> He planned to “improv[e] access to capital and invest[] in innovation and development.”<sup>249</sup> The new administration’s first attempt to deliver on this promise was the American Recovery and Reinvestment Act of 2009.<sup>250</sup> The much debated \$787 billion stimulus package<sup>251</sup> intends to “provide investments needed to increase economic efficiency by spurring technological advances in science and health.”<sup>252</sup> The Act includes tax incentives for businesses<sup>253</sup> and some provisions for small businesses in particular.<sup>254</sup>

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244. Rev. Rul. 99-23, 1999-1 C.B. 998, 999 (emphasis added).

245. WILLIAM C. DUNKELBERG & HOLLY WADE, NAT’L FED’N OF INDEP. BUS., SMALL BUSINESS ECONOMIC TRENDS 4 (2009), available at <http://www.nfib.com/Portals/0/PDF/sbet/sbet200907.pdf>.

246. See SBA DATA, *supra* note 5, at Tab us88\_06 (listing the number of nonemployer firms per year).

247. See *supra* note 22 (highlighting current high unemployment rate).

248. Senator Barack Obama, Presidential Nomination Acceptance Speech, Democratic National Convention (Aug. 28, 2008), available at [http://elections.nytimes.com/2008/president/conventions/videos/20080828\\_obama\\_speech.html](http://elections.nytimes.com/2008/president/conventions/videos/20080828_obama_speech.html).

249. Barack Obama and Joe Biden’s Plan for Small Business, available at <http://www.barackobama.com/pdf/SmallBusinessFINAL.pdf> [hereinafter Obama & Biden’s Plan] (last visited Sept. 16, 2009).

250. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115.

251. See, e.g., Paul Krugman, *Bad Faith Economics*, N.Y. TIMES, Jan. 26, 2009, at A23 (criticizing opponents of the stimulus bill); Michael Gerson, *A Bad, Necessary Bill*, WASH. POST, Feb. 18, 2009, at A13 (noting the good and bad of the stimulus plan).

252. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 3(a)(3), 123 Stat. 115, 116.

253. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1201–62, 123 Stat. 115, 333–44; see also Mickey Meece, *Stimulus Law Aids Small Business, but Benefits Are Not Easy to Find*, N.Y. TIMES, Feb. 20, 2009, at B3 (discussing the limited benefits business owners hope to receive from the stimulus).

254. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1211–12, 123 Stat. 115, 335–37.

None of these provisions, however, encourages the formation of new businesses.<sup>255</sup> The Act extends the favorable tax treatment under §§ 168(k)<sup>256</sup> and 179,<sup>257</sup> but these provisions are only available to ongoing businesses.<sup>258</sup> The Act also revises § 172 to allow net operating losses (NOLs) to be carried back 5 years.<sup>259</sup> NOLs occur when tax deductions exceed gross income, for both business and nonbusiness activities.<sup>260</sup> Nonbusiness deductions are allowed only to the extent that there is offsetting nonbusiness net income.<sup>261</sup> Start-up activities are considered nonbusiness, and allowable deductions are therefore severely limited.<sup>262</sup> To encourage small business formation, this provision should be amended to exclude start-up activities from nonbusiness activities, allowing nonbusiness expenses and the associated unused deductions to be carried forward, giving entrepreneurs the same benefits as existing business owners.

As a candidate, President Obama pledged to also “eliminate all capital gains taxes on small and start-up businesses to encourage innovation and job creation.”<sup>263</sup> Capital gains taxes are paid on gains from capital assets by both business and nonbusiness taxpayers.<sup>264</sup> While a taxpayer thinking of starting his or her own business may eventually benefit from this, he or she will not receive any upfront benefits or incentives to begin the business.<sup>265</sup>

As the economic condition of the country continues to worsen, it will become increasingly difficult to secure start-up

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255. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1201–12, 123 Stat. 115, 333–37 (providing incentives for businesses that meet the ongoing trade or business requirement).

256. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1201(a), 123 Stat. 115, 333.

257. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, §§ 1202(a), 123 Stat. 115, 335.

258. See *supra* notes 19, 202, 204, 216–24 and accompanying text (discussing the ongoing business requirement in §§ 168 and 179).

259. Compare American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1211(a), 123 Stat. 115, 335 (allowing taxpayers to carry back NOLs for five years); with I.R.C. § 172(b)(1) (2006) (allowing NOLs to be carried back 2 years and forward 20 years).

260. I.R.C. § 172(c) (2006); see also DODGE, FLEMING & GEIER, *supra* note 24, at 765 (noting the limitations to carrying operating losses forward).

261. I.R.C. § 172(d) (2006).

262. *Id.*

263. Obama & Biden’s Plan, *supra* note 249.

264. See I.R.C. § 1(h) (2006) (detailing the capital gains rate structure). A start-up company, prior to becoming an ongoing trade or business, would most likely not have any capital gains upon which they would pay taxes. See DODGE, FLEMING & GEIER, *supra* note 24, at 725, 728–29 (discussing which assets qualify as capital gains and how these gains are incurred).

265. See *supra* notes 228–29 (noting the low survival rate for start-up businesses).

capital, leading to potential cash flow problems.<sup>266</sup> This is especially problematic if Congress is looking to start-up businesses to spur technological innovation and economic growth.<sup>267</sup> Changing the structure and limits of § 195 will provide immediate incentives to entrepreneurs by allowing them to deduct more expenses upfront.<sup>268</sup> Changing § 172(d) to allow a carryover of NOLs from start-up activities will ensure that entrepreneurs maximize this benefit.<sup>269</sup>

## VI. CONCLUSION

Congress enacted § 195 with the hope that it would encourage small businesses, reduce litigation, and minimize the unequal tax treatment of similar taxpayers.<sup>270</sup> Small businesses produce more than half of the United States gross domestic product and employ over 99% of the workforce.<sup>271</sup> The role of small business in the future stability and “well being of the [United States] economy cannot be overstated.”<sup>272</sup> With this in mind, as well as Congress’s intent in enacting § 195 and President Obama’s own statements regarding start-up businesses as a candidate, Congress should extend and revise § 195.<sup>273</sup>

Increasing the maximum deduction to \$50,000 and the threshold limit to \$400,000 will both encourage small business growth and minimize the discrepancy in tax treatment among

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266. See, e.g., Eric Lipton & Ron Nixon, *A Bank with Its Own Woes Lends Only a Trickle of Bailout*, N.Y. TIMES, Jan. 14, 2009, at A1 (noting banks’ reluctance to extend credit during the current economic crisis); Raymund Flandez, *SBA Offers Aid to Cash-Strapped*, WALL ST. J., June 20, 2009, at B2 (commenting on banks’ weariness to loan money despite the SBA’s program to help existing business owners); see also *supra* notes 209–13 (discussing the costs associated with start-up companies).

267. See *supra* note 252 and accompanying text (noting Congress’s intent behind the stimulus bill).

268. See *supra* notes 225–26 and accompanying text (suggesting changes to the statutory deductions and limitations); see also DODGE, FLEMING & GEIER, *supra* note 24, at 23–28 (discussing the time-value of money).

269. See I.R.C. § 172(d) (2006) (providing limits on nonbusiness taxpayers’ ability to carry over NOLs into future years); see also notes 260–62 and accompanying text (recommending the exclusion of start-up expenses from nonbusiness deductions).

270. See S. REP. NO. 96-1036, at 11 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7293, 7301 (discussing the reasons for changing the current start-up expenditure law); DODGE, FLEMING & GEIER, *supra* note 24, at 121–22 (discussing horizontal equity among similarly situated taxpayers); see also *supra* Part II.B.1 (discussing the congressional intent behind § 195).

271. See Kobe, *supra* note 5, at 11 (tracking the small business percentage of GDP); SBA DATA, *supra* note 5 at Tab us88\_06 (reporting employer and nonemployer statistics).

272. Wise & Miles, *supra* note 23.

273. Obama & Biden’s Plan, *supra* note 249.

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business and nonbusiness taxpayers.<sup>274</sup> Excluding start-up activities from the definition of nonbusiness activity under § 172 will ensure that entrepreneurs receive the full benefit of their expenditures.<sup>275</sup> And, using consistent language in this provision and other related provisions, such as § 162, will simplify application and effectuate Congress's intent.<sup>276</sup>

The American Recovery and Reinvestment Act did not fulfill President Obama's promise to encourage start-up businesses, the creators of "high-wage, high-tech jobs" that will help the economy recover after the financial crisis.<sup>277</sup> With the decrease in available capital, increasing the deductions available to entrepreneurs will help their ability to self-fund.<sup>278</sup> In light of this, Congress should make § 195 as strong as possible to encourage start-up growth and development.

*Andrea Marks*

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274. See *supra* Parts V.A and V.B.

275. See *supra* Part V.C.

276. See *supra* Part V.B.

277. Obama Acceptance Speech, *supra* note 248.

278. See Lipton & Nixon, *supra* note 266, at A1 (noting that banks have been unwilling to lend the funds they have received from the government).