OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

January 12, 1999 CC:DOM:FS:IT&A

UILC: 162.07-30

Number: **199918013**
Release Date: 5/7/1999

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your request, dated October 7, 1998. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=	Parent	=
W	=	X	=
Y	=	Z	=
$	=	$$	=
$$$	=	$$$$	=
$xx	=	10x	=
20x	=	30x	=
1Y	=	2Y	=
Year 1	=	Year 2	=
Year 3	=	Year 4	=
Year 5	=	Year 6	=

ISSUES:

1. Whether certain training expenditures and other associated costs of building a workforce for a new division are capital expenditures and not currently deductible ordinary and necessary business expenses under I.R.C. § 162.

2. Whether the aforementioned costs represent start-up expenses under I.R.C. § 195.

CONCLUSIONS:

1. The expenses in issue were not incurred "in the unusual circumstance where [the] training [was] intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of business;" consequently, since the expenditures do not meet the aforementioned standard set forth in Rev. Rul. 96-62, 1996-2 C.B. 9, the costs need not be capitalized. [1]

2. In light of our determination under ISSUE 1 that the costs involved are generally deductible, as well as the taxpayer's failure to make the appropriate election, any question regarding possible section 195 treatment is rendered moot.

FACTS:

Parent corporation, was the innovator of a certain , X. The subject taxpayer is a wholly-owned subsidiary of Parent. Taxpayer, historically, had a small presence in the United States' markets, primarily in the manufacture and distribution of X and other markets. Through the 1980s, with the exception of only , taxpayer did not share in proprietary products developed by Parent.

By Year 3, management had determined that taxpayer's future growth depended upon moving beyond the market. Its Year 3 marketing plan includes the following:

> There are few new product opportunities in our traditional and narrowly defined niche, . It is then

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[1] The treatment of any other costs, i.e., nontraining expenses incurred by the taxpayer in building a new product division and workforce, should be determined on the relevant facts and circumstances involved as to each expense.

> necessary to consider [taxpayer] as having the expertise to allow for success in the entire U.S. marketplace and, therefore, consider opportunities outside the . The most exciting opportunity for increased sales is the package of products.

That marketing plan goes on to state that an accompanying document details just such an opportunity to bring new proprietary to taxpayer by creating a new sales and marketing organization.

In taxpayer's marketing plan for the following year, the new division is identified as serving as a foothold for the market in the United States. The Year 5 marketing plan describes an "exciting time" at taxpayer as it creates "a new entity heading towards the future." That same plan further describes the new division as follows:

> The [new division] is a reality. It is an organization with over employees. It is a product, Y . . . It is who are working to bring the next generation of products to the U.S. marketplace. It is the embodiment of [Parent's] quality .

Corporate minutes describe two alternative strategies that taxpayer might use to enter the market-- either acquire a business or create one. Taxpayer chose to build the business, and it budgeted the amounts necessary to create an entire new division. The budget included the costs of the launch of Y.

The requirements of the new division were recognized by taxpayer to be distinct from those of the old. The move into the was said to require additional facilities to meet new , marketing, development, and manufacturing needs. Along with new facilities, the new division required an extensive and totally new training program for its new sales force. As stated in the company's Year 6 marketing plan:

> All sales training programs now include more rigorous instruction in knowledge and selling skills. The program has been lengthened to , including two weeks at [a] with faculty instructors. We have worked on introducing new sales techniques to increase the sales performance of every representative.

The new division was a separate profit and cost center with a separate divisional structure, including a separate vice-president heading the division and reporting to taxpayer's president. It had a sales force, , regulatory affairs department, portfolio, and staff separate from those of Taxpayer’s existing division. A new workforce of individuals, almost all from the outside and with no former sales experience, was hired. According to the Year 5 marketing plan, "[d]ifferent marketing skills and styles are needed to be successful in marketplace. It was recognition of this fact which led to the creation of a distinct sales and marketing organization for the [new] [d]ivision."

The new division was to launch Parent’s three new compounds: W, Y, Z. W was to be its product in the future. Each of these had already been successfully launched subsidiaries.

In anticipation of in mid-Year 4, the new division began hiring. By the end of Year 4, the new division had approximately 10x new employees. Most were new sales representatives and district managers in 20x districts and 30x territories across the country. By contrast, the size of the market was only one fifth that of the market, and the "expanded" sales force consisted of only approximately 1Y to 2Y sale representatives.

The new division sustained costs of $$$ with no revenue in Year 4 and costs of $$$$ in Year 5 with sales of Y in the amount of $xx. The majority of the Year 4 and Year 5 expenses related to the recruiting, hiring, relocating and training of sales representatives. Three classes completed extensive , l, product and specialized sales training in Year 4. Each class contained 50 to 80 sales representatives, and the training included with instructors. While in training, sales representatives were lodged in hotels. Taxpayer's in-house personnel acted as instructors and their wages and salaries were allocated between and new division training costs if there were mixed classes.

For Year 4, the Service disallowed a deduction in the amount of $ for building the new division intangible on the ground that those costs represent capital expenses. The Service also made a second adjustment in the amount of $$, unrelated to the workforce expenses at issue. The field concedes that if the taxpayer is found to have been engaged in the expansion of an existing business, a current deduction would also be available for this $$ amount. Taxpayer did not elect section 195 treatment for any start-up expenditures.

LAW AND ANALYSIS:

Section 162, as a general rule, allows the deduction of training expenditures as ordinary and necessary business deductions. Section 263(a) provides that no deduction is allowed for permanent improvements and betterments made to increase the value of property.

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the Supreme Court concluded that certain legal and professional fees incurred by a target corporation to facilitate a merger created significant long-term benefits for the taxpayer and, thus, were capital expenditures. The Court specifically rejected the notion that its earlier decision in Commissioner v. Lincoln Savings and Loan Assn., 403 U.S. 345 (1971), should be read as holding "that only expenditures that create or enhance separate and distinct assets are to be capitalized" under section 263. INDOPCO, at 86-87 (emphasis in original).

The Service has consistently maintained the position that INDOPCO did not change the fundamental legal principles for determining whether a particular expenditure can be deducted or must be capitalized. To that end, the holding in Rev. Rul. 96-62 specifically states that the INDOPCO decision does not affect the treatment of training costs under section 162. Moreover, the revenue ruling makes clear that training expenditures are generally deductible even though they may have some future benefit. As stated in Rev. Rul. 96-62:

> Training costs must be capitalized only in the unusual circumstance where the training is intended primarily to obtain future benefits significantly beyond those traditionally associated with training provided in the ordinary course of a taxpayer's trade or business. [citing as an example, Cleveland Electric Illuminating Co. v. United States, 7 Cl. Ct. 220, at 227-29 (1985) (requiring capitalization of costs for training employees of an electric utility to operate a new nuclear power plant)].

Since it has been determined that the training costs involved in the instant case do not meet this "unusual circumstance" requirement of Rev. Rul. 96-62, the taxpayer should be allowed to deduct those training costs under section 162. The treatment of any other costs, i.e., nontraining expenses incurred by the taxpayer in building its new division and workforce, should be determined on the relevant facts and circumstances involved as to each expenditure.

In light of the determination that the costs in issue are generally deductible, any question regarding sixty-month proration treatment under section 195 is rendered moot. Since the required section 195 election was not made by taxpayer, any "nontraining" costs here--which are not otherwise currently deductible--must be capitalized.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS:

[redacted]

DEBORAH A. BUTLER

By: ______________________________

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cc: