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Why Do the Separate Trade or Business Rules Matter?

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INTRODUCTION

Entrepreneurs and businesses are constantly on the lookout for new business ventures and opportunities. In some cases, these new ventures are viewed as extensions or additions to existing business activities, while other ventures are viewed as entirely new businesses. Whether the activities are viewed as extensions of existing businesses or the establishment of new businesses is often based on economic, marketing, or other business considerations. Very few businesses make this determination based on tax considerations, even though this determination can have significant tax implications. Many taxpayers are unaware that the tax law outlines specific requirements for treating businesses as separate and distinct, and that this determination can have a significant impact on the tax treatment of their new and existing business activities, including the tax accounting methods of the businesses.

In this article, we address the interaction of the separate trade or business rules and the rules governing tax accounting methods. We then review the criteria identified by the Internal Revenue Service (''IRS'') and courts as relevant in determining whether the taxpayer's trades or businesses are separate and distinct. Finally, we address several scenarios in which the separate trade or business issue can arise and the tax implications of the determination in each scenario.

BACKGROUND — TAX ACCOUNTING METHODS

Accounting methods play an important role in the current income tax system in the United States, which is based on the requirement that taxpayers report and pay tax on an annual basis on their income earned during that period.[1] A taxpayer's tax accounting methods will determine when income and expenses are properly reported on the taxpayer's tax return. For example, a taxpayer's accounting method will determine whether a cash payment received from a customer constitutes income in the year the payment is received or in some earlier or later year.

Accounting methods encompass both the taxpayer's overall method of accounting as well as the taxpayer's method of accounting for any ''material item'' of income or expense.[2] Many taxpayers are familiar with the difference between the overall cash method of accounting used by most individual taxpayers and the overall accrual method of accounting used by many businesses, which more closely resembles financial accounting. However, within an overall method of accounting, a taxpayer must adopt and maintain a method of accounting for each ''item'' of income and expense. What constitutes a separate ''item'' of income or expense can be a difficult determination. For our purposes, we will focus on the general rule that an ''item'' is any income or expense that differs in some way that is relevant for tax purposes. For example, the Tax Court has held that late fee income is a separate item from interchange fee income, over-limit fees, finance charges, and cash advance fees because late fee income is earned for different reasons than the other types of income.[3] As a result, most taxpayers will have an overall method of accounting as well as a multitude of other accounting methods covering each income and expense item reported on their tax return.

Taxpayers generally adopt an overall method of accounting with the filing of their first tax return and adopt methods of accounting for each item of income

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[1] *See* §441; Reg. §1.446-1(a)(4). Unless otherwise indicated, references to ''§'' or ''the Code'' are to the Internal Revenue Code of 1986, as amended (the ''Code''), and references to ''Reg. §'' or ''the regulations'' are to the Treasury regulations issued under the Internal Revenue Code.

[2] Reg. §1.446-1(a)(1).

[3] *CapitalOne Fin. Corp. v. Commissioner*, 130 T.C. 147 (2008).

or expense in the first tax year that the item is encountered.[4] Once a taxpayer has adopted an overall method of accounting or a method of accounting for any item of income or expense, the taxpayer cannot change its method of accounting without requesting consent from the IRS.[5] Below, we broadly address the procedures for requesting consent to change a method of accounting, which vary in scope based on the type of change being made.[6] As a result, taxpayers can save considerable time and effort by adopting permissible and favorable methods of accounting in the first applicable year rather than requesting a change from the IRS at a later date.

TAXPAYERS' ABILITY TO USE DIFFERENT ACCOUNTING METHODS FOR DIFFERENT BUSINESSES

Taxpayers are provided with a further level of flexibility (and complexity) in applying accounting methods to their activities where they are engaged in more than one trade or business. The Code provides that taxpayers engaged in more than one trade or business are allowed to use a different method of accounting to determine the income from each separate trade or business.[7] The Treasury regulations clarify that a different method of accounting may be used for different businesses provided that the businesses are separate and distinct and the method of accounting used clearly reflects the taxpayer's income.[8] As a result, each separate trade or business of a taxpayer may adopt methods of accounting for each item of income or expense upon the first occurrence of that item in the taxpayer's trade or business.[9]

To illustrate, assume a taxpayer is engaged in the business of providing computer and technology consulting services to clients. The taxpayer is expanding its business to offer software and other products for sale to its customers in connection with its consulting services. To determine the methods of accounting that will be used by the software sales business, the taxpayer first must consider whether the consulting and software sales businesses will be part of a single business or will be considered separate trades or businesses. If the taxpayer's consulting and software sales businesses are considered a single trade or business, the taxpayer is required to apply the same methods of accounting to both activities. The taxpayer will be required to use the same overall method of accounting for both businesses and will be required to treat items of income and expense consistently for both businesses. However, if the software sales business is considered a separate trade or business, the taxpayer will be allowed to adopt any permissible method of accounting for its software sales business in its first year of operation without regard to the methods used by the consulting business.

In addition to the ability to use different methods of accounting for separate trades or businesses, certain elections and safe harbors are elected or applied at the trade or business level. For example, Rev. Proc. 2015-20[10] allows qualifying small business taxpayers to adopt portions of the tangible property regulations without filing a Form 3115, *Application for Change in Accounting Method* (''Form 3115''), and requesting IRS consent. The revenue procedure defines a small business taxpayer as a taxpayer with one or more separate and distinct trades or businesses under Reg. §1.446-1(d) with assets and gross receipts less than the $10 million threshold. As a result, the $10 million asset and gross receipts thresholds apply at a trade or business level rather than a taxpayer level. To determine whether the safe harbor applies, taxpayers must first determine whether they have separate trades or businesses and then apply the thresholds to each trade or business.

The next obvious question, then, is how does a taxpayer determine whether its trades or businesses are separate and distinct? Whether a taxpayer has separate trades or businesses or one unified business covering multiple activities is a question of fact. As a result, no bright-line standard exists and taxpayers must instead apply the criteria and factors identified in the regulations, case law, and IRS administrative guidance to determine whether its activities constitute separate trades or businesses.

CRITERIA FOR IDENTIFYING SEPARATE TRADES OR BUSINESSES

Regulatory Requirements

One of the central requirements regarding methods of accounting under §446 is that the method(s) of accounting used by the taxpayer must clearly reflect the taxpayer's income. The regulations under §446 outline how the clear reflection requirement applies in the context of separate trades or businesses. Reg. §1.446-1(d)(1) states that taxpayers may use a different method of accounting for each trade or business,

[4] Reg. §1.446-1(e).

[5] Reg. §1.446-1(e)(2).

[6] *See* Rev. Proc. 2015-13, 2015-5 I.R.B. 419.

[7] §446(d).

[8] Reg. §1.446-1(d)(1).

[9] *See id.*

[10] 2015-9 I.R.B. 694.

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"provided that the method for each trade or business clearly reflects the income of that particular trade or business." Reg. §1.446-1(d)(3) provides that a taxpayer's trades or businesses will not be considered separate and distinct if the use of different methods of accounting results in the creation or shifting of profit or loss between the businesses such that the income of the businesses is not clearly reflected. The theme of these two Regulation sections, that the taxpayer must clearly reflect its income and the taxpayer's use of separate trades or businesses cannot distort the income of the businesses, underlies several of the case law and IRS factors discussed below. As a result, taxpayers may find that the factors below are easier to understand and apply if the taxpayer considers the factors in relation to the clear reflection requirement.

Despite the frequent references to "clear reflection of income" in §446, neither the Code nor the Treasury regulations define the term. Courts have defined the clear reflection of income requirement as requiring taxpayers to reflect income with as much accuracy as permitted by standard accounting practices.[11] Clear reflection of income for tax purposes may divert from clear reflection of income for financial accounting purposes due to the differing objectives of tax and financial accounting.[12] Additionally, the IRS has significant discretion in determining whether a taxpayer's method of accounting clearly reflects its income.[13] As a result, a taxpayer bears the burden of demonstrating that its tax method of accounting clearly reflects its income, and the taxpayer cannot rely on its financial accounting practices to support its tax accounting methods.

In addition to the conceptual requirement that the taxpayer's use of different methods of accounting clearly reflect the taxpayer's income, the regulations also identify one specific factual requirement that must be satisfied in order for a taxpayer's trades or businesses to be considered separate and distinct. Reg. §1.446-1(d)(2) provides that a trade or business will not be considered separate and distinct "unless a complete and separable set of books and records is kept for such trade or business." The focus of this requirement appears to be that taxpayers must have separate books for each business so that the economic results (and thus taxable income) of each business can be separately identified. However, the precise level of separation required for the books and records of the businesses is not clear. For example, is the taxpayer required to maintain separate General Ledgers and Trial Balances for each business or can the taxpayer segregate the accounts of each business on a single Trial Balance or General Ledger? This question is further complicated by the impact that a taxpayer's accounting systems and software can have on its ability to consolidate or segregate its accounting records for different businesses.

The IRS and courts have held that the ability of the taxpayer to separate revenues and expenses of the businesses to allow for the preparation of separate profit and loss statements for each business constitutes sufficient separation of books and records.[14] This position would appear to be consistent with the underlying clear reflection requirement in §446. However, in one older case, the Tax Court drew a distinction between "separate" books and records and "separable" books and records and held that the taxpayer's books and records were not sufficiently separate where the general ledger accounts could be physically separated but the books of original entry (i.e., journals) were not separable.[15] Whether the IRS or courts today would look at the taxpayer's accounting records in this level of detail is uncertain. However, taxpayers may need to be prepared to demonstrate that their records were sufficiently separated to support an argument that the income of each business was clearly reflected.

Factors from Case Law and IRS Administrative Guidance

The IRS and courts have expanded on the guidance provided in the Treasury regulations and identified a number of factors to be considered in determining whether a taxpayer's trades or businesses are separate and distinct. The following discussion highlights some of the factors identified by courts and the IRS as relevant in this analysis and how these factors were applied in determining whether the taxpayer's trades or businesses were separate and distinct. The considerations range from substantive economic to administrative factors. Not all factors will be relevant in every situation, and the relative weight assigned to each factor may vary from taxpayer to taxpayer. As a result, taxpayers should consider the potential applicability of these factors based on their unique facts and circumstances.

Similarity and Interdependence of the Businesses

One of the factors considered by courts and the IRS is the similarity in the nature of the businesses being carried on by the taxpayer. Where the character and nature of the taxpayer's businesses differ significantly

[11] *Caldwell v. Commissioner*, 202 F.2d 112 (2d Cir. 1953).

[12] *See Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979).

[13] *Id.*

[14] *See Burgess Poultry Mkt., Inc. v. United States*, 64-2 USTC ¶9515 (E.D. Tex. 1964); PLR 9408003.

[15] *Peterson Produce, Inc. v. United States*, 205 F. Supp. 229 (W.D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

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from one another, taxpayers may have a stronger argument that the businesses should be treated as separate and distinct. For example, a taxpayer engaged in a grocery business and in operating a cattle ranch was found to be engaged in separate businesses and allowed to use different inventory methods for its two businesses.[16] Similarly, a taxpayer engaged in retail merchandising and the buying and selling of land was found to be engaged in separate trades or businesses.[17] However, similarity in the nature of business does not guarantee that the taxpayer will be deemed to have a single trade or business. For example, a taxpayer operating two different hospitals was held to be engaged in two separate trades or businesses.[18]

While the similarity or differences in character of the taxpayer's businesses may appear to be a rather superficial factor to begin the discussion, the level of similarity in the businesses tends to be correlated with the application of the other factors. The more similar the taxpayer's businesses are, the more likely they are to be considered a single trade or business under the factors discussed below.

For example, the interdependence of the businesses and the level of transactions between the businesses relative to transactions with external parties is a relevant factor in determining whether the businesses are separate and distinct. Where the majority of the transactions of one business are executed with the taxpayer's other business, the businesses are less likely to be considered separate and distinct. This factor frequently becomes relevant where a taxpayer's businesses are vertically integrated and one business provides the inputs for the other business. For example, a taxpayer's cattle raising operation was not considered to be a separate trade or business from its slaughtering operation where the majority of the cattle raised by the taxpayer's cattle raising operations were destined for the taxpayer's slaughterhouse.[19] Similarly, a taxpayer's feed and hatchery business was found not to be a separate trade or business from the taxpayer's farming business where the feed and hatchery division transferred the vast majority of its output to the taxpayer's farming business and executed very few transactions with third parties.[20]

In addition to the volume of transactions between the businesses, courts have also considered the economics and other terms of the transactions to determine whether the businesses are separate and distinct. This analysis can be best illustrated by the facts and differing conclusions of the courts in *Burgess Poultry Market v. United States*[21] and *Peterson Produce, Inc. v. United States*.[22] In *Burgess Poultry*, the taxpayer was engaged in a poultry raising business and a poultry processing business. Nearly all of the poultry from the taxpayer's poultry raising division was transferred to the taxpayer's poultry processing division. The taxpayer executed contracts between the divisions outlining the terms at which the poultry would be transferred. The contracts also provided that the chickens were sold from the farming division to the processing division at prevailing market prices. The transactions were executed through the issuance of invoices and checks between the divisions, in the same manner as transactions with third parties. In holding that the taxpayer's divisions were separate and distinct trades or businesses, the court placed significant weight on its conclusion that the taxpayer's use of different methods of accounting under these circumstances did not result in the shifting of income and profits between the divisions.

In contrast, in *Peterson Produce*, the taxpayer was engaged in operating a feed and hatchery business and a farming business. The taxpayer transferred feed and seed from its feed and hatchery business to its farming business at cost with the feed and hatchery business recognizing no income with respect to the items that were transferred to the farming business. The transfers were executed by journal entries with no invoices, checks or other documentation for the transactions. Under these circumstances, the court held that the taxpayer's businesses were not separate and distinct as the taxpayer's method of accounting allowed for the distortion of the taxpayer's income through the transfer of items between its businesses without the recognition of income or gain.

A related factor considered by the courts in *Burgess Poultry* and *Peterson Produce* was whether the taxpayers' businesses were capable of operating as viable, standalone businesses that were independently profitable. In *Burgess Poultry*, the court noted favorably that the taxpayer created the farming division with the intention of realizing a profit and the business had been profitable overall.[23] In contrast, in *Peterson Produce*, the taxpayer transferred feed and items to its farming division at cost with no profit on the transaction and did not execute sufficient transactions with

[16] *Marlin Grocery Co. v. Commissioner*, 15 B.T.A. 1080 (1929).

[17] *Joseph Stern v. Commissioner*, 14 B.T.A. 838 (1928).

[18] *See Nielsen v. Commissioner*, 61 T.C. 311 (1973).

[19] *Gold-Pak Meat Co. v. Commissioner*, T.C. Memo 1971-83.

[20] *Peterson Produce, Inc.*, 205 F. Supp. 229 (W.D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

[21] 64-2 USTC ¶9515 (E.D. Tex. 1964).

[22] 205 F. Supp. 229 (W.D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

[23] *Burgess Poultry Mkt., Inc. v. United States*, 64-2 USTC ¶9515 (E.D. Tex. 1964).

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third parties to independently show a profit.[24] As a result, the court held that the taxpayer's operations were too interdependent and integrated to be considered separate trades or businesses.

Operational Considerations

Courts and the IRS have also identified a number of operational considerations that are relevant in determining whether a taxpayer's trades or businesses are separate and distinct. Some of these considerations are aimed at the public perception of the taxpayer's businesses. For example, where the taxpayer uses a different name or separately identifies its businesses in dealings with the public, the taxpayer's trades or businesses are more likely to be found to be separate and distinct.[25] In contrast, where the taxpayer expanded its existing business and did not change its image in the market, the taxpayer's trades or businesses were held not to be separate and distinct.[26]

The use of different employees to operate its businesses has been considered a relevant factor in this analysis. In this regard, both the IRS and courts appear to draw a distinction between operational employees and management employees. Where the businesses share operational employees, the businesses are less likely to be considered separate and distinct.[27] However, the overlap of management personnel is viewed as less detrimental to the argument that the businesses are separate and distinct.[28]

Whether the businesses are conducted in the same geographical location has also been identified as a relevant consideration in this analysis. Both the courts and IRS have found that trades or businesses conducted in separate locations are capable of being considered separate and distinct, regardless of whether the businesses are similar or dissimilar.[29] Conversely, where the businesses are in the same location and share some of the same physical facilities and resources, the businesses are more likely to be considered a single trade or business.[30] The IRS has informally indicated, however, that they believe the taxpayer can divide its markets using separate trades or businesses that serve different activities or customers, even within the same geographical area. In these circumstances where the businesses are operated in the same geographical area, the taxpayer may bear a higher burden in demonstrating the separation of the businesses, especially if the businesses are engaged in similar activities.

Legal Organization and Regulation of Businesses

The IRS has specifically addressed the impact of the legal and tax status of an entity's businesses on the determination of whether the businesses were separate and distinct. In a 2014 Chief Counsel Advice,[31] the taxpayer corporation conducted a separate business through a corporate subsidiary. The subsidiary converted to a limited liability company (''LLC'') and the taxpayer elected to treat the LLC as a disregarded entity for tax purposes. The IRS Chief Counsel's Office held that the fact that the LLC had not elected to be taxed as a separate entity from the corporation did not mean that the LLC could not be considered a separate trade or business from the corporation. Instead, the Chief Counsel's Office noted that the determination of whether the businesses were separate and distinct was a question of fact and did not depend specifically on the legal or tax status of the businesses. The Chief Counsel's Office then looked to several of the factors discussed above to find that the corporation and LLC were separate and distinct businesses.

Where the taxpayer's businesses are subject to different regulatory regimes and required by law to maintain certain levels of separation, the taxpayer's trades or businesses may be more likely to be considered separate trades or businesses for tax purposes. In Rev. Rul. 74-270,[32] the IRS ruled that a bank operating a commercial banking business and a trust department was engaged in two separate businesses and could use different methods of accounting for each. The trust department was required by law to be separately operated and to hold its assets separately from the general operating assets of the bank. The taxpayer's trust department was fundamentally a different type of business from the bank's commercial activities and was also operated separately with its own management, employees and offices. The IRS ruled that these factors supported the treatment of the taxpayer's businesses as separate and distinct.

Summary

Whether a taxpayer's trades or businesses are separate and distinct under §446(d) is a question of fact, which leaves taxpayers with some uncertainty regarding whether the IRS would view their trades or businesses as separate and distinct or as one unified busi-

[24] *Peterson Produce, Inc.*, 205 F. Supp. 229 (W.D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

[25] *Burgess Poultry Mkt., Inc. v. United States*, 64-2 USTC ¶9515 (E.D. Tex. 1964).

[26] *Peterson Produce, Inc.*, 205 F. Supp. 229 (W.D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

[27] *See* PLR 9408003, PLR 8144001.

[28] *Burgess Poultry Mkt., Inc. v. United States*, 64-2 USTC ¶9515 (E.D. Tex. 1964).

[29] *Id.*; *Nielsen v. Commissioner*, 61 T.C. 311 (1973).

[30] PLR 8144001.

[31] CCA 201430013.

[32] 1974-1 C.B. 109.

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ness. Taxpayers can best support their determination of whether the businesses are separate and distinct by considering the factors outlined above and how those factors would be applied to their specific situation.

Most importantly, taxpayers seeking to treat their trades and businesses as separate and distinct should be prepared to demonstrate that the income from their businesses was clearly reflected and that their books and records were sufficiently separated to support their computation of income from each business. The remaining factors highlighted above, such as the similarity and interdependence of the businesses, the nature of the transactions between the businesses, the overlap of employees and the use of the same business identity and geographical location, should also be considered as they may be relevant in the analysis. Although taxpayers may not be able to achieve certainty regarding the classification of their activities as separate and distinct trades or businesses, they can strengthen their position that the businesses are separate and distinct by aligning their facts, to the extent possible, with the case law and IRS guidance outlined above.

IMPLICATIONS OF SEPARATE TRADE OR BUSINESS DETERMINATION

The determination of whether a trade or business is considered separate or distinct may have significant implications for taxpayers related to a multitude of tax accounting method issues. The following discussion highlights a few of the most common fact patterns in which a determination of separate and distinct trades or businesses may be important.

Accounting Method Changes

As mentioned above, when a taxpayer is engaged in more than one trade or business, it may use different methods of accounting for each separate trade or business, provided the method of accounting used for each trade or business clearly reflects the overall income of the taxpayer as well as that of each particular trade or business. When a taxpayer desires to change a method of accounting, §446(e) requires that the taxpayer obtain the consent of the Commissioner before changing the method of accounting, regardless of whether the taxpayer is changing from one permissible method to another method or from an impermissible method to a permissible method.

Rev. Proc. 2015-13[33] provides the overall procedures under §446(e) and Reg. §1.446-1(e) for taxpayers to obtain IRS consent for both advance (non-automatic) consent and automatic consent[34] method changes. In general, making a taxpayer-initiated (voluntary) accounting method change under Rev. Proc. 2015-13 offers taxpayers several benefits. For instance, most method changes filed under Rev. Proc. 2015-13 provide the taxpayer with audit protection, which prevents the IRS from changing the taxpayer's accounting method for the same item for a taxable year prior to the year of change.[35] Additionally, taxpayers making a method change under Rev. Proc. 2015-13 generally are required to compute a §481(a) adjustment, which is the cumulative ''catch-up'' adjustment necessary to prevent income or expense from being duplicated or omitted when changing from one method of accounting to a different method of accounting.[36] In most instances, taxpayers are allowed a four-year spread of any positive (i.e., an increase to taxable income) §481(a) adjustments that must be recognized as a result of making the method change.

As the taxpayer-favorable terms and conditions mentioned above typically are not available for method changes initiated by the IRS,[37] taxpayers seeking to change their methods of accounting voluntarily must ensure that they properly comply with the procedures and eligibility rules set forth in Rev. Proc. 2015-13. Any material missteps may result in challenge from the IRS upon exam and could possibly render the method change invalid altogether. This issue can be especially critical in situations involving potential exposure to the taxpayer (e.g., if the taxpayer improperly accelerated deductions or deferred income in prior years), as the taxpayer would not receive audit protection from an invalid method change.

Taxpayers are required to prepare and file a Form 3115 during the taxable year for which they desire to make the change in method of accounting. In particular, §6.02(4) of Rev. Proc. 2015-13 provides that if a taxpayer with multiple trades or businesses files a Form 3115 for one or more of those trades or businesses, it must identify, by name, the trades or businesses to which the change relates. Additionally, the taxpayer must identify, by name, all other trades or businesses and explain the method of accounting used by each trade or business for the item that is the subject of the method change.

Among other items of information, Form 3115 requires taxpayers to disclose the name and Employer Identification Number (EIN) of the ''filer'' of the Form 3115, as well as name and EIN of the ''appli-

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[33] 2015-5 I.R.B. 419.

[34] *See* Rev. Proc. 2016-29, 2016-21 I.R.B. 880.

[35] *See* Rev. Proc. 2015-13, 2015-5 I.R.B. 419, §8.

[36] *Id.* at §7.03.

[37] See Rev. Proc. 2002-18, 2002-1 C.B. 678, for details regarding IRS imposed accounting method changes.

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cant,'' if different from the filer. The Instructions[38] to Form 3115 indicate that the ''filer'' of the form is the entity or person required to file Form 3115, whether on its own behalf or on behalf of another entity. Often, the filer of the form is the same entity as the filer of the tax return. In contrast, the ''applicant'' of the Form 3115 is the specific entity, person, or separate and distinct trade or business whose method of accounting is being changed. For instance, if the entity making the method change is considered a disregarded entity for federal income tax purposes and operates as a separate and distinct trade or business from its regarded owner, then the disregarded entity would be listed as the applicant making the change, and the regarded owner as the filer (or, if the owner is part of a consolidated group, the common parent corporation would be listed as the filer).

Typically, each trade or business of a taxpayer making a method change must file its own Form 3115. However, a taxpayer may file a single Form 3115 for multiple trades or businesses if the change in method of accounting is identical for each applicant. It is therefore important for taxpayers to ensure that the correct name of the applicant(s) is clearly disclosed on the Form 3115 to avoid any potential uncertainty related to the specific trade(s) or business(es) making the method change. In particular, taxpayers should ensure that each applicant listed actually has the relevant ''item'' of income or expense subject to the method change, and that each applicant intends to change from the present method of accounting to the proposed method of accounting as described in the Form 3115. For instance, if a taxpayer is filing a method change for advance payments on behalf of multiple trades or businesses, it should not include as an applicant on the Form 3115 a trade or business that has never received advance payments in prior tax years. Doing so may create confusion if that specific trade or business begins receiving advance payments in future years and seeks to adopt a different method of accounting than the proposed method described in the Form 3115. Conversely, if the taxpayer fails to disclose or inadvertently leaves out a trade or business from the Form 3115, the IRS may argue that the trade or business that was excluded from the Form 3115 did not properly make a method change, thereby leaving the taxpayer open to potential exposure with respect to its historical accounting method.

In addition to disclosing the names and EINs of each applicant making the method change, taxpayers must also separately state the §481(a) adjustment for each applicant, including each separate trade or business making the accounting method change. As an example, a corporation filing a method change on behalf of itself and its wholly owned LLC would list two separate §481(a) adjustments in the Form 3115, assuming that the corporation and the LLC are treated as separate trades or businesses. Consistent with the disclosure requirements described above, failure to disclose the §481(a) adjustment for each trade or business making the method change could potentially invalidate the Form 3115. Thus, a taxpayer filing a method change on behalf of one or more trades or businesses should carefully review the Form 3115, along with Rev. Proc. 2015-13 and the instructions to the Form 3115, prior to filing to ensure that all necessary information has been properly disclosed.

Section 381 Transactions

For certain tax-free reorganizations to which §381(a) applies, the separate trade or business determination plays a key role in dictating which methods of accounting may be used post-transaction. Section 381(c)(4) and §381(c)(5) provide rules for determining an acquiring corporation's accounting methods for §381(a) transactions. Generally, §381(a) includes tax-free §368(a)(1)(A), §368(a)(1)(C), §368(a)(1)(D), §368(a)(1)(F), and §368(a)(1)(G) transactions,[39] but not §368(a)(1)(B) and §368(a)(1)(E) transactions. Section 381(a) also applies to a §332 liquidation of a subsidiary into a parent.

Trades or Businesses Operated Separately

The §381(a) regulations provide that the accounting methods to be used post-transaction depend on whether the parties operate as separate trades or businesses after the transaction. For purposes of §381(a), ''separate and distinct trades or businesses'' has the same meaning as provided in Reg. §1.446-1(d).[40] Generally, if the trades or businesses of the parties continue to operate as separate trades or businesses after the §381(a) transaction, the historical accounting methods used by the parties prior to the transaction carry over, unless the methods are impermissible.[41] The carryover method (i.e., the method that each party uses for each separate and distinct trade or business immediately prior to the date of the §381(a) transaction) applies to the overall method of accounting as well to as any special method of accounting used by each trade or business after the §381(a) transaction

[38] Revised Dec. 2015.

[39] Pursuant to §381(a)(2), §368(a)(1)(D), and §381(a)(1)(G), transactions qualify only if the requirements of §354(b)(1) are met.

[40] Reg. §1.381(c)(4)-1(b)(13).

[41] Reg, §1.381(c)(4)-1(a)(2).

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date.[42] If a carryover method is impermissible, or if the acquiring corporation chooses to use a method other than the carryover method, then the method change rules and procedures under §446(e) apply.[43]

Trades or Businesses Combined

On the other hand, if the acquiring corporation integrates the operations of the target into its existing business to form an integrated trade or business after the §381(a) transaction, the acquiring corporation is required to use the ''principal method'' for each of its items.[44] The principal method is typically the accounting method used by the acquiring corporation before the §381(a) transaction, unless the acquiring corporation does not have an accounting method for a particular type of item or good or if the target corporation is larger than the acquiring corporation.[45] Whether the target corporation is larger than the acquiring corporation is based on a comparison of each corporation's adjusted bases of assets and gross receipts. For purposes of §381(c)(4), the target corporation is considered larger if both its assets and its gross receipts are greater than those of the acquiring corporation's trade or business.[46] Thus, if the target corporation is larger than the acquiring corporation, the target corporation's method of accounting is considered to be the principal method; otherwise, the principal method of accounting defaults to the acquiring corporation's method.

Pursuant to Reg. §1.381(c)(4)-1(a)(3), no Form 3115 is necessary to change to the principal method. Any change to a principal method must be reflected on the acquiring corporation's tax return for the taxable year that includes the §381(a) transaction.[47] Further, the taxpayer generally must compute a §481(a) adjustment associated with the change to the principal method; the amount of the §481(a) adjustment and the adjustment period, if any, are determined under Reg. §1.446-1(e) and the administrative procedures that govern voluntary changes in method of accounting.[48] As such, a taxpayer changing to a principal method with an unfavorable §481(a) adjustment generally can spread the adjustment pro-rata over four years, consistent with the procedures outlined in Rev. Proc. 2015-13. However, it is important to note that an acquiring corporation does not receive audit protection when it changes to the principal method of accounting under Reg. §1.381(c)(4)-1(a)(3).

Under Reg. §1.381(c)(4)-1(a)(5), all parties to a §381(a) transaction may request permission to change their accounting methods for the tax year in which the transaction occurs or is expected to occur. However, for trades or businesses that will be combined after the transaction, such method changes will be granted only if the requested method is the method the acquiring corporation will be required to use.[49]

A common question arising in the context of §381(a) transactions and accounting method implications is how quickly the integration must occur post-transaction in order for the operations to be considered an integrated trade or business. Reg. §1.381(c)(4)-1(e)(4)(ii) provides that the determination of whether an acquiring corporation will operate the trades or businesses of the parties as separate and distinct trades or business will be determined as of the date of the transaction, based upon the facts and circumstances. The regulations further point out that intent to combine books and records may be demonstrated by contemporaneous records and documents or by other objective evidence that reflects the acquiring corporation's ultimate plan of operation, even though the actual combination of the books and records may extend beyond the end of the taxable year of the §381(a) transaction. For example, contemporaneous project plans indicating action steps to move the books and records of the two parties onto the same accounting system, or board minutes describing the acquiring company's decision to ultimately combine books and records with the target corporation, may serve as positive evidence of the acquiring corporation's intention to operate as an integrated trade or business.

While the §381(a) regulations provide taxpayers with several helpful examples demonstrating the application of the rules, uncertainty persists in situations where a taxpayer initially intends to integrate the trades or business, but ultimately decides to keep the businesses separate. If the taxpayer changed to the principal method of accounting in the taxable year the §381(a) occurred and did not file a Form 3115, questions may arise in subsequent years as to the propriety of the change if the taxpayer continues to operate the businesses separately. In this case, the IRS may argue that the taxpayer implemented an unauthorized accounting method change as it was not covered by the rules to change to the principal method under Reg. §1.381(c)(4)-1(d)(1) and did not file a Form 3115 or request consent to change its method of accounting. Conversely, a taxpayer that initially intends to operate the businesses as separate trades or businesses but eventually integrates them in a subsequent tax year

[42] *Id.*

[43] Reg. §1.381(c)(4)-1(d)(2).

[44] Reg. §1.381(c)(4)-1(a)(3).

[45] Reg. §1.381(c)(4)-1(c)(1).

[46] *Id.*

[47] Reg. §1.381(c)(4)-1(d)(1).

[48] *Id.*

[49] Reg. §1.381(c)(4)-1(a)(5).

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may also face uncertainty if the acquiring corporation filed a Form 3115 to change to a method other than the principal method of accounting in the taxable year the §381(a) transaction occurred. In this situation, the IRS may argue that the taxpayer was not entitled to file Form 3115 to change its method of accounting to a method other than the principal method and is therefore using an impermissible method of accounting. Thus, it may be prudent for taxpayers that anticipate engaging in a §381(a) transaction to invest considerable thought in evaluating the likelihood of integrating trades or business in the future when assessing what steps, if any, must be undertaken in the year of the transaction with respect to their accounting methods.

Start-Up Expenditures Versus Expansion of Existing Business

Taxpayers often incur costs relating to expanding their business in new or different ways. To build upon the example mentioned earlier in this article, assume that a taxpayer is engaged in the business of providing computer and technology consulting services to clients. It incurs costs related to expanding its business to offer software and other products for sale to its customers, including hiring software engineers to develop the new products and additional salespeople to sell the new offerings. The issue is how to appropriately treat the expenditures — may the taxpayer deduct them, or must they be capitalized? In such situations, the appropriate treatment of the costs as immediately deductible versus capitalizable depends on whether the taxpayer created a new trade or business or merely expanded its existing trade or business.

Under §162(a), a deduction is allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. In contrast, no deduction is allowed for start-up expenditures under §195(a). Start-up expenditures are defined under §195(c) to include amounts paid or incurred in connection with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit in anticipation of such activity becoming an active trade or business. Further, start-up expenditures must be costs which, if paid or incurred in connection with the operation of an existing active trade or business, would otherwise be allowable as a deduction for the taxable year in which paid or incurred.

As an exception to the general rule of §195(a), §195(b) allows taxpayers to elect to treat start-up expenditures as deferred expenses. Specifically, a taxpayer may elect to deduct in the taxable year in which the active conduct of the new trade or business begins an amount equal to the lesser of (a) the amount of start-up expenses, or (b) $5,000 reduced, but not below zero by the amount by which the start-up expenditures exceed $50,000. The remaining start-up expenditures above the deductible amount are amortizable over a period of not less than 180 months, beginning in the month the active trade or business begins.

While the application of §195(a) can be relatively straightforward in situations involving the establishment of a start-up business by a new taxpayer, the issue becomes far more complicated when a taxpayer with an existing trade or business takes steps to expand its operations in new or different directions.

One of the primary distinctions in determining whether an amount is deductible under §162 or required to be capitalized under §195 is whether the amount was paid or incurred in connection with an existing trade or business. Generally, costs incurred in connection with an existing trade or business, including costs to investigate the expansion of an existing business, are deductible under §162. However, expenses incurred by a taxpayer to investigate the creation or acquisition of an unrelated trade or business generally would be subject to §195. Accordingly, in considering whether there is a new business or an expansion of an existing business, the first step in the analysis is determining the nature of the taxpayer's core business. Once this determination is made, the taxpayer must then evaluate whether the core business is being conducted in a new or different way or whether the taxpayer has begun a new business.

Although no formal guidance has been issued to assist in determining whether there is an establishment of a new business or the expansion of an existing business, the issue has been explored in several court cases and IRS rulings. In *Briarcliff Candy Corp. v. Commissioner*,[50] a candy manufacturer that historically sold its products through its own retail stores incurred costs to set up a separate ''franchise'' division to sell its products through third-party operated retail outlets, such as drugstores and card stores. In holding that the costs related to the franchise division were currently deductible, the court pointed out that the product sold through the new division ''was the same, it was also sold and for many years has been sold through the company-owned or leased retail outlets and through long department stores and other business establishment. [The taxpayer] was by long established policy both a wholesaler and retailer.''[51] Further, the court pointed out that the manufacturer's efforts to generate new sales through the franchise division was

[50] 475 F.2d 775 (2d Cir. 1973).

[51] *Id.*

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simply doing no more than attempting to stem the downward course of sales from its existing business.

Similarly, in Rev. Rul. 2000-4,[52] the IRS relied on *Briarcliff Candy* in ruling that costs incurred to obtain, maintain, and renew ISO 9000 international quality standard certification were generally deductible. In comparing the ISO 9000 costs to advertising and advertising expenditures incurred in operating the taxpayer's business and retaining existing customers, the IRS noted that ISO 9000 certification was increasingly becoming a contractual requirement for doing business with many organizations worldwide. Thus, it appears that one of the key factors that may assist taxpayers in determining if an expenditure is deductible under §162 or capitalizable as a start-up cost under §195 is whether the amount was incurred, at least in part, to preserve a taxpayer's market share or allow the taxpayer to remain competitive in its industry.

Due to the lack of formal guidance issued in determining whether a particular activity expands or starts a business, analysis in this area is highly subjective and has resulted in conflicting case law and IRS rulings. For example, in *FMR Corp. & Subsidiaries v. Commissioner*,[53] the Tax Court required a taxpayer providing investment management services to regulated investment companies (''RICs,'' or what are commonly referred to as mutual funds) to capitalize costs of launching new funds. Each RIC advised by the taxpayer provides a distinct investment discipline or service feature; for instance, some RICs invest in equity funds, including corporate stocks, whereas others invest in fixed income funds, which include corporate, government and municipal bonds. During the years in issue, the taxpayer created 82 new RICs, and incurred costs relating to the development of the initial marketing plan and formation of the RIC. In arguing that such costs were properly deductible, the taxpayer cited several cases, including *Briarcliff Candy*, and pointed out that the costs to expand or preserve an existing business in such cases were generally found to be deductible. The Tax Court disagreed, holding that the expenditures were required to be capitalized as they created a significant future benefit. Furthermore, the Tax Court noted that the statutory language of §195 does not require every expenditure incurred in any business expansion to be currently deductible.

The nature and relationship between the old and new activities are important factors in determining whether a taxpayer established a new trade or business or expanded an existing business. In PLR 9310001, the IRS analyzed whether activities undertaken by a taxpayer in the hospitality industry to establish a consulting business constituted a new trade or business or expansion of an existing trade or business for purposes of §162(a) and §195. Noting that ''[w]hether an economic venture constitutes an expansion of an existing business rather than a new activity is essentially a question of fact,'' the letter ruling pointed out if two separate activities are related in such a fashion that the average trade or business in a particular field that includes one of the activities would likely include the other, it would be reasonable to conclude that the other activity would not constitute a new trade or business. On the other hand, if the taxpayer must acquire substantial amounts of new skills or expertise, then it would be reasonable to conclude that the expansion constitutes a new trade or business.

In determining whether a new activity undertaken by a taxpayer is similar enough to be considered an expansion of an existing business, the manner in which the taxpayer conducts the new versus old activities may be a distinguishing factor in the analysis. For instance, in *Cleveland Electric Illuminating Co. v. United States*,[54] the court held that the generation of electricity through a nuclear-powered plant was substantially different from the generation of electricity through a coal-powered plant. Accordingly, the training expenses incurred in connection with the opening of the nuclear plant were required to be capitalized. Despite the fact that the nuclear plant generated the same end product (i.e., electricity) as the coal-powered plant, the court held that the use of a different means of producing electricity was a new trade or business. In another case, *Radio Station WBIR, Inc. v. Commissioner*, the court held that the operation of an FM and AM radio station was not the same business as the operation of a television station, even though each business was engaged in the broadcasting or transmitting of message or signals over the air waves by means of electrical impulses.[55] Although the taxpayer argued that one of the primary reasons it entered the television market was to keep existing radio advertising clients who were expected to switch to television advertising, the court pointed out that the taxpayer previously had no existing facilities for the operation of a television station. As such, the expenditures incurred by the taxpayer for acquiring a television construction permit and television license were required to be capitalized.[56]

To add further uncertainty to the issue, §195, unlike §381(a), does not refer to ''separate and distinct trades

[52] 2000-4 I.R.B. 331.

[53] 110 T.C. 402 (1998).

[54] 7 Cl. Ct. 220, 228–29 (1985).

[55] 31 T.C. 803 (1959).

[56] *Id.*

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or businesses" under Reg. §1.446-1(d). Thus, it is unclear whether §195 could apply to situations where a business is not considered a separate trade or business under §446. For instance, assume that the taxpayer in the business of providing computer and technology consulting services decides to include the operations of its new software and product sales in the books and records of its existing consulting operations. While Reg. §1.446-1(d)(2) would require the taxpayer to treat both operations as a single trade or business for accounting method purposes, it appears possible that the costs incurred to launch the software products could be subject to capitalization under §195, depending on the facts and circumstances. If the costs are subject to §195, isolating the expenditures associated with the taxpayer's software operations could be challenging, particularly if the taxpayer consolidates the operations on a single set of books and records and does not have information readily available to determine the costs associated with software operations only. Accordingly, taxpayers that plan on undertaking activities that may appear to constitute the establishment of a new trade or business should carefully keep track of all related expenditures, regardless of how the operations are accounted for under Reg. §1.446-1(d)(2). In another example of potential divergence in treatments, a taxpayer conducting the exact same business in the exact same manner but in new geographic locations may be able to argue that it is merely expanding an existing business and therefore is not subject to §195.[57] However, if the taxpayer treats the new geographical locations as separate and distinct businesses for purposes of §446 and adopts different methods of accounting than those used for its existing geographical locations, it is possible that the IRS will view that as support for arguing against the deductibility of expansion costs under §162. As such, while consistency between §195 and §446 is not explicitly required, taxpayers should ensure the facts that they rely upon to support a specific tax treatment do not conflict with other Code sections.

As evidenced by the discussion above, taxpayers will continue to face a great deal of uncertainty in attempting to apply conflicting guidance to their specific (and often highly unique) fact patterns. A taxpayer seeking to avoid capitalization of costs under §195 therefore bears a difficult burden of demonstrating that its expenditures were incurred solely to expand an existing business. While the factual nuances and multitude of factors examined in prior guidance make a bright-line test appear impossible, taxpayers can at least familiarize themselves with the most common questions and factors that may be relevant to the analysis. To provide taxpayers with a starting point in their analysis, a few key questions that should be addressed are summarized below:

- Was the new activity undertaken to preserve the taxpayer's existing market share?
- Did the activity simply expand the taxpayer's operations into new geographical regions?
- Did the new activity result in new products or services offered to customers or allow the taxpayer to enter into a new market?
- Did the taxpayer significantly change the manner in which it produces products or provides services?
- Did the new activity require the taxpayer to hire new employees, implement additional training programs, or purchase new facilities/capital equipment?

CONCLUSION

Taxpayers launching, expanding, or acquiring new business ventures face a wide range of issues and considerations, and the potential tax implications of these decisions can easily be overlooked. As discussed above, many important tax issues arise in these situations, including the proper tax treatment of the expansion or start-up costs as well as the tax accounting methods to be used by the new business venture. Failure to address these issues can result in lost tax planning opportunities as well as exposure arising from the improper treatment of costs or use of improper accounting methods. Keeping the issues discussed above in mind when embarking on new ventures will help taxpayers avoid pitfalls and make tax-efficient business operating decisions.

[57] *See* TAM 8141033, TAM 8423005.

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