



Tax Reduction Letter

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Revenue Ruling 77-254

Section 165: Losses

July 1977

Losses; attempted acquisition of business. An individual may deduct, in accordance with section 165 (c) (2) of the Code, expenses incurred in the unsuccessful attempt to acquire a specific business, such as legal expenses incurred in drafting purchase documents. However, expenses incurred in the course of a general search for or preliminary investigation of a business, such as expenses for advertisements and travel to search for a new business, are not deductible. Rev. Rul. 57-418, 1957-2 C.B. 143 amplified.

Advice has been requested whether, under the circumstances described below, a deduction in accordance with section 165 (c) (2) of the Internal Revenue Code of 1954 is allowable to a taxpayer for a loss that was not compensated for by insurance or otherwise.

An individual taxpayer began to search for a business to purchase. The individual placed advertisements in several newspapers and traveled to various locations throughout the country to investigate various businesses that the individual learned were for sale. The individual commissioned audits to evaluate the potential of several of these businesses. Eventually, the individual decided to purchase a specific business and incurred expenses in an attempt to purchase this business. For example, the individual retained a law firm to draft the documents necessary for the purchase. Because of certain disagreements between the individual and the owner of the business that developed after this decision was made, the individual abandoned all attempts to acquire the business.

Section 165 (a) of the Code allows as a deduction any loss sustained during the taxable year that is not compensated for by insurance or otherwise. Section 165 (c) provides that, in the case of individuals, the deduction is limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck or other casualty, or from theft.

Rev. Rul. 57-418, 1957-2 C.B. 143, holds that losses incurred in the search for a business or investment are deductible only when the activities are more than investigatory and the taxpayer has actually entered a transaction for profit and the project is later abandoned.

In *Seed v. Commissioner*, 52 T.C. 880 (1969), acq., 1970-2 C.B. xxi, the United States Tax Court allowed a deduction for expenses incurred by a taxpayer during an unsuccessful attempt to secure a charter to operate a savings and loan association. The court found that the taxpayer's extensive activities in the venture qualified as a transaction entered into for profit. Following the

decision in *Seed* the court has continued to find that a taxpayer has entered a transaction for profit in cases in which the facts indicate that the taxpayer has gone beyond a general search and focused on the acquisition of a specific business or investment. See *Price v. Commissioner*, T.C. Memo. 1971-323; *Domenie v. Commissioner*, T.C. Memo. 1975-94.

In view of the decision in *Seed*, Rev. Rul. 57-418 is amplified to provide that a taxpayer will be considered to have entered a transaction for profit if, based on all the facts and circumstances, the taxpayer has gone beyond a general investigatory search for a new business or investment to focus on the acquisition of a specific business or investment.

Expenses incurred in the course of a general search for or preliminary investigation of a business or investment include those expenses related to the decisions whether to enter a transaction and which transaction to enter. Such expenses are personal and are not deductible under section 165 of the Code. Once the taxpayer has focused on the acquisition of a specific business or investment, expenses that are related to an attempt to acquire such business or investment are capital in nature and, to the extent that the expenses are allocable to an asset the cost of which is amortizable or depreciable, may be amortized as part of the asset's cost if the attempted acquisition is successful. If the attempted acquisition fails, the amount capitalized is deductible in accordance with section 165 (c) (2). The taxpayer need not actually enter the business or purchase the investment in order to obtain the deduction.

Accordingly, in the present case, the individual may deduct as losses incurred in a transaction entered into for profit the expenses incurred in the unsuccessful attempt to acquire a specific business. Thus, the individual's expenses in retaining a law firm to draft the purchase documents and any other expenses incurred in the attempt to complete the purchase of the business are deductible. The expenses for advertisements, travel to search for a new business, and the cost of audits that were designed to help the individual decide whether to attempt an acquisition were investigatory expenses and are not deductible.

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