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Deducting startup and expansion costs

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A corporation can deduct up to $5,000 of business startup costs under Sec. 195. The $5,000 deduction is reduced dollar for dollar (but not below zero) by the cumulative amount of startup costs exceeding $50,000. The remaining startup costs can be deducted ratably over a 15-year period (consistent with the amortization period for Sec. 197 intangibles), beginning with the month in which the active trade or business begins (Sec. 195(b)(1)). Active conduct of a trade or business generally occurs when the corporation has begun the conduct of operations for which it was organized (i.e., is in a position to begin generating revenue).

Startup costs are costs paid or incurred in connection with investigating the creation or acquisition of an active trade or business or creating an active trade or business. Startup costs include amounts paid or incurred in connection with an existing activity engaged in for profit, and for the production of income in anticipation of the activity becoming an active trade or business. To be a startup cost, the expenditure must have otherwise been deductible as an ordinary and necessary business expense under Sec. 162. Expenditures that would have otherwise been capitalized, such as the costs associated with the construction of a capital asset, are not startup costs (Rev. Rul. 81-150).

Expenses of investigating the creation or acquisition of a trade or business are known as investigatory expenses. They are the costs incurred in searching for and analyzing prospective businesses prior to making a final decision whether to acquire an existing business, create a new business, or forgo a business transaction altogether (Rev. Rul. 99-23). These costs may relate to a category of businesses or to a particular business. They may be treated as deductible/amortizable startup costs only if they would be currently deductible by an existing trade or business in the same field. Deductible investigatory expenses include costs incurred for the analysis or survey of potential markets, products, labor supply, and transportation facilities.

Expenses of creating an active business are costs incurred after the investigatory process has determined that a particular business should be acquired or established but before the business actually begins operations. The House report on the Miscellaneous Revenue Act of 1980, P.L. 96-605, which enacted Sec. 195 (H.R. Rep't No. 96-1278, 96th Cong., 2d Sess. 10 and 11 (1980)), lists the following as examples of such costs:

- Advertising costs;
- Salaries and wages paid to trainee employees and their instructors;
- Travel and other expenses incurred in lining up prospective distributors, suppliers, or customers; and
- Salaries or fees paid or incurred for executives, consultants, and professional services.

Other startup expenses might include:

- Business investigation expenses such as surveys, market studies, and consultants' fees;
- Preopening advertising and promotional efforts;
- Travel and entertainment (for efforts to find a location, to secure suppliers or customers, etc.);
- Salaries, employee benefits, insurance, and overhead;
- Preopening repair and maintenance of capital assets to be used in the business;
- Mortgage standby commitment fees to ensure financing for the new venture;

- Accounting and legal fees that are not organizational costs;
- Employee training;
- Rent and utilities for space maintained in the preopening phase; and
- Costs of expanding an existing business or beginning a new business if a new entity is used.

Comparing Sec. 195 to Sec. 263(a)
Sec. 195 requires that a startup cost be "otherwise deductible." Regs. Secs. 1.263(a)-4 and -5 require a taxpayer to capitalize certain amounts that would ordinarily fall under the definition of startup costs. Because these particular startup costs are not otherwise deductible, they cannot be deducted under Sec. 195 as startup costs. However, these amounts could be eligible for depreciation, amortization, or deduction under other tax rules. Examples of startup costs that may fall under Sec. 263(a) include:

- Amounts paid to acquire a lease agreement for a new retail store;
- Transaction costs to create a lease, such as attorney fees to negotiate an agreement;
- Amounts paid to facilitate the formation or organization of a disregarded entity; and
- Prepaid expense items, such as for rent or insurance.

Treating depreciation as a startup cost
Although the cost of depreciable property cannot be treated as a startup expense, no clear guidance exists as to whether depreciation can be calculated and treated as a startup expense. As mentioned previously, Sec. 195 includes in the definition of startup expenses only those expenses that would have been deductible if they had been paid or incurred in the operation of an already existing active trade or business. Sec. 167(a) allows depreciation to be claimed on property used in a trade or business or for the production of income. The startup period of a business does not seem to meet the criteria of Sec. 167(a). During the startup period, it appears that depreciation cannot be deducted or deferred and treated as a startup expense under Sec. 195.

The cost of the depreciable assets can be recovered under Secs. 167 and 168 once active business operations begin (e.g., telephone equipment acquired and used during the startup period is not considered placed in service for depreciation purposes until active business begins). This was the IRS's conclusion in Letter Ruling 9235004. The courts have generally held that the depreciation deduction allowance starts when the intended business begins (*Simonson*, 752 F.2d 341 (8th Cir. 1985); *McManus*, T.C. Memo. 1987-457).

Startup expenses of an investment activity
The capitalization and deduction rules for startup activities also apply to Sec. 212 activities. Sec. 212 activities are those conducted for the production of income as opposed to trade or business activities. Thus, Sec. 212 activities include what are ordinarily considered investment activities.

***Observation*:** Once a taxpayer begins a Sec. 212 income-producing activity, the Sec. 195 startup rules do not preclude deducting ordinary and necessary expenses from the Sec. 212 activity, whether or not that activity is later transformed into a trade or business (*Toth*, 128 T.C. 1 (2007)).

Excluding items not considered startup costs
Interest, taxes, and research and experimental expenditures specifically are excluded from the definition of startup costs (Sec. 195(c)).

Sec. 174(a)(1) allows research and experimental expenditures to be deducted or amortized only if incurred in connection with a trade or business. Many entrepreneurs incur such expenses before they actually form a business and can never deduct or amortize the expenses. Incorporating and starting the business before making the expenditures supports a trade or business connection and shows that business activities have commenced. The definition of research costs is included in Sec. 41 and the regulations issued under that section, including Regs. Sec. 1.41-4.

Deemed election
Under Regs. Sec. 1.195-1, a taxpayer is not required to make a separate election statement to deduct startup costs. Such an election is deemed to be automatically made for the tax year in which the taxpayer begins an active trade or business. The taxpayer can forgo the deemed election by clearly electing to capitalize its startup expenditures on a timely filed return for the year the taxpayer begins business in

accordance with instructions provided with the tax return.

Failure of business

Investigatory and other preopening expenses will be fully deductible by a corporation as a business loss (rather than subject to these amortization provisions) if the business venture or for-profit transaction proves to be unsuccessful and the corporation abandons the search or investigation (Rev. Rul. 56-520). A similar rule applies to noncorporate taxpayers engaged in a trade or business. However, unsuccessful startup costs cannot be deducted by noncorporate taxpayers not engaged in a trade or business when these costs are incurred, unless a specific business or investment has been identified by the time the search is abandoned. Instead, the expenses are treated as nondeductible personal expenses because they do not qualify as ordinary and necessary business expenses or expenses for the production of income (Rev. Ruls. 77-254, 79-346, and 71-191). Therefore, noncorporate taxpayers not in business who anticipate substantial expenditures in investigating (or searching for) a new business should consider incorporating solely to conduct the investigation. If successful, the corporation would conduct the new business. If unsuccessful, the shareholders could take an ordinary loss on the disposition of their small business (i.e., Sec. 1244) stock.

Deducting unamortized startup costs when terminating a business

Unamortized startup costs are deductible as a business loss to the extent allowed by Sec. 165 in the year the related trade or business is terminated (Sec. 195(b)(2)).

Receiving a reimbursement of startup costs

Reimbursements of training costs made before the end of the startup phase by a state as an inducement to locate a plant in its state are nonshareholder capital contributions excludable from the taxpayer's income under the provisions of Sec. 118(a) (Letter Ruling 9238007). The corporation must reduce its startup expenditures by the amount of the reimbursements.

Including startup costs of subsidiaries in a consolidated return

Startup costs of a subsidiary corporation paid by the parent prior to the subsidiary corporation's commencing business operations must be treated as capital contributions to the new subsidiary (*Specialty Restaurants Corp.*, T.C. Memo. 1992-221). A decision can be made to deduct these capitalized costs. Some uncertainty exists as to whether the subsidiary or the parent makes the decision. Based on *Specialty Restaurants*, it appears that as a separate legal entity each subsidiary should make its own election. However, Regs. Sec. 1.1502-77 provides that the parent must make elections for a subsidiary that is included in the consolidated return.

> ***Example 1. Deducting startup costs of subsidiaries:*** In the current year, Oldcorp expands its sales base. For business reasons, it conducts the expansion in a new subsidiary. Oldcorp immediately transfers a portion of its business (either a product line or geographic area of sales) to Newcorp in a Sec. 351 exchange instead of starting a completely new business. Thus, the costs of the expansion might be deductible as Newcorp's ordinary and necessary business expenses because the costs would relate to the expansion of an existing business. Newcorp could deduct up to $5,000, then amortize the remaining expansion costs over 180 months.

Alternatively, Oldcorp can conduct the expansion itself before transferring the new operations to Newcorp. The expansion costs would be related to an existing business and deductible in full as ordinary and necessary business expenses. This alternative may be desirable if Oldcorp has taxable income that it can offset with the startup expenses. Conversely, Newcorp might not have enough taxable income to fully use the deduction in the current year.

Subsidiary classified as a branch or division

Startup costs of a newly formed subsidiary are deductible by the parent if in substance the newly formed subsidiary is merely a branch or division of the parent (*Baltimore Aircoil Co.*,333 F. Supp. 705 (D. Md. 1971)). In *Baltimore Aircoil*, the company formed a wholly owned subsidiary in the state of California and geographically split its operations between the parent and the new subsidiary. The purpose for forming this new entity was to more competitively manufacture, market, and distribute its products on the West Coast. In effect, a new branch was formed, and expenses for travel, moving, training, printing, and telephone were deductible as ordinary and necessary business expenses.

Identifying expansion costs

Costs incurred in expanding an *existing* business are generally deductible under Sec. 162 as ordinary and necessary business expenses. For example, if expansion occurs regularly, such as when new restaurant or store locations are opened more or less continuously, most of the related costs would appear to be recurring ordinary and necessary business expenses.

Example 2. Deducting expansion costs: Goodco operates a chain of automotive service stores. Goodco decides to open a new store in a region outside its traditional service area. In establishing the new store, Goodco incurs preopening costs to recruit and train employees for the new location. In addition, Goodco pays for advertisement of its new store. These costs are deductible Sec. 162 expenses.

Some business expansion costs may need to be permanently capitalized under Sec. 263 if they create a benefit beyond the current year (Field Service Advice 199918013). Regulations issued under Sec. 263(a) contain a list of costs that must be capitalized (Regs. Secs. 1.263(a)-4 and -5).

Example 3. Capitalizing expansion costs: Using the same facts as in Example 2, Goodco also incurs legal fees for its attorney to negotiate a lease agreement for its new service location and prepays a two-year liability insurance policy for its new location. These costs must be capitalized under Sec. 263(a). The attorney's fees can be amortized over the life of the lease. The insurance can be deducted in the periods to which it relates.

Close scrutiny may be required to determine if costs are incurred in the expansion of an existing business as opposed to the acquisition or creation of a new business. For example, the IRS has ruled that a company's expenses of opening restaurants as new corporate entities were considered startup costs, whereas identical costs it incurred for new restaurants operated within the company were considered expansion costs (Letter Ruling 8423005).

Example 4. Expanding versus creating a new business: Using the same facts as in Examples 2 and 3, Goodco establishes a new taxable entity to operate its new store location. The preopening costs for recruiting and training new employees and the advertising costs are now subject to Sec. 195. The legal fees and prepaid insurance costs are still subject to capitalization under Sec. 263(a). In addition, Goodco would have to capitalize costs related to the organization of the new entity, which would fall under the rules of Sec. 248.

Deducting expansion costs

The deduction and amortization of expansion costs are allowed under Sec. 195 to a taxpayer creating or acquiring a trade or business.

In Rev. Rul. 99-23, the IRS set forth three scenarios in which a taxpayer acquired a business unrelated to its existing business. The issue was which costs the taxpayer could amortize under Sec. 195. In all three cases, the IRS concluded that general due-diligence and investigatory expenses incurred to decide whether to enter a new business, and which new business to enter, can be deducted/amortized under Sec. 195. However, such costs incurred after focusing on a specific target or business must be capitalized under Sec. 263 (Rev. Rul. 99-23).

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