

## Writing Off Your Business Start-Up Expenses

### Article Highlights:

- \$5,000 First-year Start-up and Organizational Expense Write-off
- Timely Filing Requirements
- Qualifying Start-up Expenses
- Trade or Business Purchase
- Qualifying Organizational Expenses
- Expense Write-off Limitations
- How to Make the Election
- Other Considerations

Unfortunately, as a result of the COVID pandemic many small firms have gone out of business. However, with the help of vaccines and the waning lethality of the latest versions of the virus, new businesses will be opening as the economy returns to near normal. New business owners, especially those operating small businesses, may be helped by a tax provision allowing them to deduct up to \$5,000 of the start-up expenses and \$5,000 of organizational costs in the first year of the business's operation. These types of expenses not deductible in the first year of the business must be amortized (deducted) over 15 years. If a taxpayer who incurred start-up expenses does not make the election, the start-up costs must be capitalized, meaning that the expenses can only be recovered upon the termination or disposition of the business.

Generally, start-up expenses include all expenses incurred to investigate the formation or acquisition of a business or to engage in a for-profit activity in anticipation of that activity becoming an active business. To be eligible for the election, an expense must also be one that would be deductible if it were incurred after the business actually began. An example of a start-up expense is the cost of analyzing the potential market for a new product.

- **Qualifying Start-Up Costs** – A qualifying start-up cost is one that would be deductible if it were paid or incurred to operate an existing active business in the same field as the new business, and the cost is paid or incurred before the day the active trade or business begins. Not includible are taxes, interest, and research and experimental costs. Examples of qualified start-up costs include:
  - o Surveys/analyses of potential markets, labor supply, products, transportation facilities, etc.;
  - o Wages paid to employees and their instructors while they are being trained;
  - o Advertisements related to opening the business;
  - o Fees and salaries paid to consultants or others for professional services; and
  - o Travel and other related costs to secure prospective customers, distributors, and suppliers.

For the purchase of an active trade or business, only investigative costs incurred while conducting a general search for, or preliminary investigation of, the business (i.e., costs that help the taxpayer decide whether to purchase a new business and which one to purchase) are qualified start-up costs. Costs incurred attempting to buy a specific business are capital expenses that aren't treated as start-up costs.

- **Qualifying Organizational Cost** - include fees for legal services, such as for drafting LLC documents, partnership agreements, corporate charter and by-laws; incorporation fees; temporary directors' fees; and organizational meeting costs.

- **Phaseout** - As with most tax benefits, there is always a catch. Congress put a cap on the amount of expenses that can be claimed as a deduction under this special election. Here's how to determine the deduction: If the expenses are \$50,000 or less, you can elect to deduct up to \$5,000 in the first year, plus you can amortize the balance over 180 months.

*Example: Eligible start-up expenses are \$6,000 and the business began on July 1, 2022. On the business's 2022 tax return, the deduction for start-up expenses will be \$5,033 (\$5,000 + (\$1,000/180 x 6 months)).*

If the expenses are more than \$50,000, then the \$5,000 first-year write-off is reduced dollar-for-dollar for every dollar in start-up expenses that exceeds \$50,000.

For example, if start-up costs were \$54,000, the first-year write-off would be limited to \$1,000 (\$5,000 – (\$54,000 – \$50,000)), plus the remaining \$53,000 of costs would be amortizable over 180 months. These limits are applied separately for the start-up and organizational costs.

The election to deduct start-up and organizational costs is made by claiming the deduction on the return for the year in which the active trade or business begins, and the return must be filed by the extended due date.

The decision to write off these expenses should take into consideration other tax benefits available in the first of year of the business, including bonus depreciation and Sec 179 expensing, the Sec 199A deduction, and the overall result in the first year of the business.

If you are starting a business, it may be appropriate to formulate a business plan in advance. If you have questions or would like an appointment to discuss how to establish your business and the types of business structures that are available, please give this office a call.