



Getting a new business off the ground: How start-up expenses are handled on your tax return

Despite the COVID-19 pandemic, government officials are seeing a large increase in the number of new businesses being launched. From June 2020 through June 2021, the U.S. Census Bureau reports that business applications are up 18.6%. The Bureau measures this by the number of businesses applying for an Employer Identification Number.

Entrepreneurs often don't know that many of the expenses incurred by start-ups can't be currently deducted. You should be aware that the way you handle some of your initial expenses can make a large difference in your federal tax bill.

How to treat expenses for tax purposes

If you're starting or planning to launch a new business, keep these three rules in mind:

1. Start-up costs include those incurred or paid while creating an active trade or business — or investigating the creation or acquisition of one.
2. Under the tax code, taxpayers can elect to deduct up to \$5,000 of business start-up and \$5,000 of organizational costs in the year the business begins. As you know, \$5,000 doesn't go very far these days! And the \$5,000 deduction is reduced dollar-for-dollar by the amount by which your total start-up or organizational costs exceed \$50,000. Any remaining costs must be amortized over 180 months on a straight-line basis.
3. No deductions or amortization deductions are allowed until the year when "active conduct" of your new business begins. Generally, that means the year when the business has all the pieces in place to start earning revenue. To determine if a taxpayer meets this test, the IRS and courts generally ask questions such as: Did the taxpayer undertake the activity intending to earn a profit? Was the taxpayer regularly and actively involved? Did the activity actually begin?

Eligible expenses

In general, start-up expenses are those you make to:

- Investigate the creation or acquisition of a business,
- Create a business, or

- Engage in a for-profit activity in anticipation of that activity becoming an active business.

To qualify for the election, an expense also must be one that would be deductible if it were incurred after a business began. One example is money you spend analyzing potential markets for a new product or service.

To be eligible as an “organization expense,” an expense must be related to establishing a corporation or partnership. Some examples of organization expenses are legal and accounting fees for services related to organizing a new business and filing fees paid to the state of incorporation.

Plan now

If you have start-up expenses that you’d like to deduct this year, you need to decide whether to take the election described above. Recordkeeping is critical.