Start-Up Costs and Organizational Costs

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October 4, 2016

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Business Start-Up and Organizational Costs

- Business start-up and organizational costs are generally capital expenditures
- However, the client can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs paid or incurred after October 22, 2004

Business Start-Up and Organizational Costs

- Start-up costs include any amounts paid or incurred in connection with creating an active trade or business or investigating the creation or acquisition of an active trade or business
- Organizational costs include the costs of creating a corporation or partnership

Business Start-Up Costs

- Start-up costs are amounts paid or incurred for
  - (a) Creating an active trade or business; or
  - (b) Investigating the creation or acquisition of an active trade or business
- Start-up 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

Qualifying Costs

- A start-up cost is amortizable if it meets both of the following tests:
  - It is a cost that could be deducted if paid or incurred to operate an existing active trade or business (in the same field as the one you entered into)
  - It is a cost paid or incur before the day the active trade or business begins

Start Up Costs

- Expenses incurred in preparing to open a new business are deducted over 180 months (amortized), rather than all at once
- Typical costs include:
  - Investigating whether to open a business
  - An analysis or survey of potential markets, products, labor supply, transportation facilities, etc
  - Ordering supplies
  - Training employees
  - The costs of checking out the various factors when selecting a business site
  - Advertising
  - Wages and salaries
  - Professional and consultant fees
  - Logo design
  - Brochures
  - Travel and other necessary costs for securing prospective distributors, suppliers, or customers

What Start-Up Costs Don't Qualify?

- The following costs don't qualify for the first year deduction and 180-month amortization:
  - Incorporation expenses can not be deducted as startup costs
    - However, they may be deductible as incorporation expenses
  - Startup expenditures for interest, real estate taxes, and research and experimental costs that are otherwise allowed as deductions do not qualify for amortization
    - These costs may be deducted when incurred
  - The costs attributable to the acquisition of a specific property that is subject to depreciation or cost recovery do not qualify for amortization
    - Instead, the property should be depreciated under the appropriate rules

Start Up Costs Review

- You incur startup expenses **prior to the time that the business is born**
- If the startup expenditures actually result in an up-and-running business, you can:
  - Deduct a portion of the costs in the first year and amortize the remaining costs over a period of 180 months, beginning with the month in which the business opens
- How much can you deduct in the first year?
  - You are able to deduct up to $5,000 of the qualifying start-up costs, but the first-year deduction starts to phase-out when the expenses reach $50,000

Start Up Costs

- If the start-up efforts end in the creation of an active trade or business, then on the tax return for the year the business commences, the amount of expenses that can be deducted will be the lesser of:
  - The actual expenses with respect to the new business; or
  - $5,000, reduced by the amount by which the start-up expenditures with respect to the active trade or business exceed $50,000
- The remainder of the start-up expenditures are deducted ratably over the 180-month period beginning with the month in which the active trade or business begins
- BizFilings.com

Start-up Costs Incurred by a Partnership

- If the client decides to conduct the business as a partnership, neither the partnership itself nor the client as one of the partners would normally be able to deduct the expenses paid to start the business
- However, the partnership can elect to deduct and amortize the business start-up costs under the same rules as a sole proprietor—except, the election is made by the partnership and reported to the partners on their Schedule K-1’s

Start-up Costs Incurred by a Partnership

- If you decide that the partnership should not make the election, the organizational costs must be added to the tax basis of the partnership interest
- In that case, when the partnership interest is sold or the partnership itself is dissolved, these capitalized expenses will reduce the amount of the capital gain or loss

Partnership

- Some additional costs that will be incurred by a partnership include the legal cost of drafting a partnership agreements and state registration fees

Calculating the Start-up Expense Deduction

- Calculating the first year deduction
- Once you determined the amount of the client's qualifying expenses, you need to determine how much of the expenses can be deducted in the current year

First Year, the Calculation

- Determine the initial year deduction amount
- If you have more than $50,000 in expenses, you must reduce the maximum amount ($5,000) by $1 for each $1 over $50,000 in expenses
- Therefore, if you have more than $55,000 in expenses, all of your expenses must be amortized over the 180-month period

First Year, the Calculation

- Determine the monthly amortization amount
  - Subtract the initial year deduction amount from the total expenses
  - This is the amortizable amount
  - Then divide that amount by 180 to get the monthly deduction
- Determine how many months of amortization can be claimed on the tax return for the first year the business was operating
- The amortization period starts with the month that the client begins operating the business

First Year, the Calculation

- The amount that can be amortize on the return is the number of months that the business operated times the monthly amortization amount
- For the first year, the amortization deduction would be shown on Part VI of Form 4562, Depreciation and Amortization, and then carried over to the appropriate tax form for the business

Schedule C

- For sole proprietors, it would be carried over to the Form 1040, Schedule C as an "other" expense
- After the first year, simply list the amortization amount as an "other" expense on the Schedule C (or the partnership or corporate income tax form)
- However, if the client is filing Form 4562 for some other reason (generally a taxpayer must file this form in the first year they put a capital asset into service), the client would continue to show the amortization costs on Part VI and on the Schedule C

Example: Jeffery

- Jeffery successfully opened a gourmet food business on May 25, 2016
- Before the business opened he had $4,000 of start up expenses
- Jeffery would prepare a Form 4562
- He can deduct a full $4,000 on the first-year Schedule C as "Other Expenses"

Example: Jeffery

- Assume the same facts, but Jeffery incurred $53,000 of start-up costs
- Because the expenses exceed $50,000, he must reduce the initial year deduction by $1 for every $1 over $50,000
- Thus, the $5,000 amount is reduced to $2,000
- He figures the amortization on $51,000 ($53,000 - $2,000)
- His monthly amortization amount is $283 ($51,000/180), so his first year amortization deduction is $850
- The total start-up expense deduction for the first year is only $2,850

Organizational Costs

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Amounts Paid to Organize a Corporation are the Direct Costs of Creating the Corporation

- Qualifying costs
  - To qualify as an organizational cost, it must be
    - For the creation of the corporation
    - Chargeable to a capital account
    - Amortized over the life of the corporation if the corporation had a fixed life, and
    - Incurred before the end of the first tax year in which the corporation is in business

Amounts Paid to Organize a Corporation are the Direct Costs of Creating the Corporation

- A corporation using the cash method of ac-counting can amortize organizational costs incurred within the first tax year, even if it does not pay them in that year

Incorporation Costs Follow Same Rules

- If the client decides to operate their business as a corporation, the corporation can elect to deduct up to $5,000 of its organizational expenditures and amortize the remainder over a period of 180 months
- The $5,000 deducted for organizational expenses must be reduced by the amount by which the expenses exceed $50,000
- Unless the corporation clearly treats the expenditures as capitalized (and, therefore, not recoverable until the corporation is liquidated), the IRS will assume the election to deduct/amortize the expenses has been made

Examples of Organizational Cost for a Corporation

- Temporary directors
- Organizational meetings
- State fees for incorporation privileges
- Accounting service costs incident to organization, and
- Legal service expenditures, such as for drafting of documents, minutes of organizational meetings, and terms of the original stock certificates

Non-Qualifying Costs

- The following items are capital expenses that cannot be amortized
  - Costs for issuing and selling stock or securities, such as commissions, professional fees, and printing costs
  - Costs associated with the transfer of assets to the corporation

It's All in the Planning

- Consider
  - Research expenses
  - Insurance, license and permit fees
  - Equipment and supplies
  - Advertising and promotion
  - Borrowing costs
  - Employee expenses
  - Technological expenses

Steps

- Begin by estimating expenses
- What will it cost to get the business up and running?
- The key to accuracy here is attention to detail
- For each category of expense, draw up a list of everything that will be needed to purchase
- This will include both tangible assets (for example, equipment, inventory) and services (for example, remodeling, insurance)
- Then determine where to purchase the goods or services
- Research more than one vendor; i.e.: comparison shop
- Do not look at price alone; terms of payment, delivery, reliability, and service are also important

Steps

- Contingencies
  - Add a reserve for contingencies
  - Explain how the amount was decided to maintain in reserve

Steps

- Working Capital
  - Determine what is needed in the form of cash and/or financing
  - The client should do an estimated cash flow projection
  - This assists in determining working capital needs
  - The client must determine if financing is needed and what amount is appropriate

SCORE Template

- https://www.score.org/resource/start-expenses
- Download the template to assist the client

Startup Assets

- Typical startup assets are cash
- Sometimes starting inventory
- Current and long-term assets
  - Equipment
  - Office furniture
  - Machinery
  - Other assets needed by the business

Research and Experimental Costs Defined

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Research and Experimental Costs Defined

- Research and experimental costs are reasonable costs incurred in a trade or business for activities intended to provide information that would eliminate uncertainty about the development or improvement of a product
- Uncertainty exists if the information available does not establish how to develop or improve a product or the appropriate design of a product
- Whether costs qualify as research and experimental costs depends on
  - The nature of the activity to which the costs relate rather than
  - The nature of the product or improvement being developed or the level of technological advancement

Research and Experimental Costs

- The costs of research and experimentation are generally capital expenses
- However, the client can elect to deduct these costs as a current business expense
- The election to deduct these costs is binding for the year it is made and for all later years unless the client receives IRS approval to make a change
- If the client meets certain requirements, they may elect to defer and amortize research and experimental costs

Research and Experimental Costs Amortize

- The client can elect to amortize research and experimental costs, deduct them as current business expenses, or write them off over a 10-year period
- If they elect to amortize these costs, deduct them in equal amounts over 60 months or more
- The amortization period begins the month the client first receives an economic benefit from the costs.

Research and Experimental Costs

- The costs of obtaining a patent, including attorneys' fees paid or incurred in making and perfecting a patent application, are research and experimental costs
- However, costs paid or incurred to obtain another's patent are not research and experimental costs

Research and Experimental Costs Product

- The term "product" includes any of the following items:
  - Formula
  - Invention
  - Patent
  - Pilot model
  - Process
  - Technique
  - Property similar to the items listed above
  - It also includes products used by the client in the trade or business or held for sale, lease, or license

Costs not Included in Research and Experimental Costs

- Research and experimental costs do not include expenses for any of the following activities:
  - Advertising or promotions
  - Consumer surveys
  - Efficiency surveys
  - Management studies
  - Quality control testing
  - Research in connection with literary, historical, or similar projects
  - The acquisition of another's patent, model, production, or process

When and How to Elect

- To make the election to deduct research and experimental costs, deduct them on the tax return for the year in which they first pay or incur research and experimental costs
- If you do not make the election to deduct research and experimental costs in the first year in which you pay or incur the costs, you can deduct the costs in a later year only with approval from the IRS

When and How to Elect

IF the Client	THEN
Elect to deduct research and experimental costs as a current business expense	Deduct all research and experimental costs in the first year you pay or incur the costs and all later years
Do not deduct research and experimental costs as a current business expense	If you meet the requirements, amortize them over at least 60 months, starting with the month you first receive an economic benefit from the research

Optional Write-off Method

- Rather than amortize these costs or deduct them as a current expense, the client has the option of deducting (writing off) research and experimental costs ratably over a 10-year period beginning with the tax year in which they incurred the costs
- Costs you can amortize
- The client can amortize costs chargeable to a capital account if they meet both of the following requirements
  - They paid or incurred the costs in the trade or business
  - They are not deducting the costs currently

How to Make the Election

- To elect to amortize research and experimental costs, complete Part VI of Form 4562 and attach it to the income tax return
- Generally, the client must file the return by the due date (including extensions)
- However, if the client timely filed the return for the year without making the election, they can still make the election by filing an amended return within 6 months of the due date of the return (excluding extensions)

How to Make the Election

- Attach Form 4562 to the amended return and write “Filed pursuant to section 301.9100-2” on Form 4562
- File the amended return at the same address that the original return was filed
- The election is binding for the year it is made and for all later years unless the client obtains approval from the IRS to change to a different method

Transferring Personal Assets to Business Assets

- Depending on the business entity the transfer of ownership is handled differently

Corporations

- When setting up a corporation, make sure all property to be used in the corporation has been legally transferred into the corporate name before commencing operations
- Non-corporate property involved in a legal claim may not be covered by corporate liability insurance

Transfer of Ownership

- Bill of Sale: This is used to transfer most anything, except:
  - Real estate
  - Cars
  - Leases
  - Contract rights
- Title Transfer Documents:
  - To transfer a vehicle to a corporation follow the procedures prescribed by the state where the vehicle is registered
  - You will normally have to fill out the back of the Certificate of Title, have it notarized, surrender it to the new owner (the corporation), then, a new Certificate of Title must be obtained in the corporate name

Transfer of Ownership

- Assignments:
  - You can use an Assignment of Lease form to transfer ownership rights in a lease
  - Attach copies of contracts as exhibits to the Assignment
- Deeds:
  - Deeds are used to transfer rights in real property (real estate)
  - Check if your state requires an Affidavit of Property Value to be filed along with the deed
  - Your County Recorders office handles this

Transfer of Ownership

- Leasing and Licensing Property to a Corporation:
  - Property you own may be leased to your corporation
  - You may also license patents and rights to copyrighted works
  - A lease and licensing agreement must be prepared and signed by the appropriate parties

Partnerships

- If your small business is organized as a partnership or a limited liability company, you can transfer your personal property to your company
- There could be tax consequences
- The LLC is a pass-through entity, and therefore does not pay taxes itself, it can pass on higher taxes to LLC members as a result of the property transfer

Partnerships

- You must put the property in the company name to transfer it to a LLC or partnership
- Create a document showing you donated the property to the company
- Record a deed transfer with the county clerk showing the company now owns the property

Depreciation

- The LLC or partnership will depreciate any assets it owns
- This will include property transferred

Transferring Personal Assets

- Determine if transferring ownership or using the property for business purposes furthers the business goals
- Identify the value of the personal property you want to convert to business use by noting the price you paid at the time of purchase (the adjusted basis) and asking around to see what price that property would command if it were sold today (the fair market value)

Transferring Personal Assets

- Transfer ownership of the property to your business by donating it in the case of a sole proprietorship or nonprofit entity, or selling it in the case of a corporation or partnership
- Account for the sale of the personal property by recording a bill of sale that lists the property, the listed value, and the consideration or purchase price paid by the company
- Retain a receipt of donation if you convert personal property to business use by a nonprofit entity

Transferring Personal Assets

- Account for the acquisition of the property by the business

What if the Client Does not Start the Business?

- The portion of costs paid to generally investigate the possibilities of going into business at all, or to purchase a non-specific existing business, are considered personal costs and are not deductible
- However, the total costs that you paid in your attempt to start or purchase a specific business would be considered a capital expense and you can claim it as a capital loss, subject to all the rules that apply to a nonbusiness capital loss
- If the client purchased any business assets along the way (for instance, some bagel-making machinery), they can claim a loss only if and when they sell or dispose of the property

How To Amortize

- Deduct startup and organizational costs in equal amounts over the applicable amortization period
- You can choose an amortization period for start-up costs that is different from the period you choose for organizational costs, as long as both are not less than the applicable amortization period
- Once you choose an amortization period, you cannot change it

Form 4562

Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2016 tax year (see instructions):					
43 Amortization of costs that began before your 2016 tax year				43	
44 **Total.** Add amounts in column (f). See the instructions for where to report				44	

Form **4562** (2016)

Form 4562

- Each year the client can deduct part of certain capital costs over a fixed period
- If they amortize property, the part amortized does not qualify for the § 179 expense deduction or for depreciation
- Attach any information the Code and regulations may require to make a valid election

Form 4562
Start-up and Organizational Costs

- The client can elect to amortize the following costs for setting up the business
- Business start-up costs § 195
- Organizational costs for a corporation § 248
- Organizational costs for a partnership § 709
- For business start-up and organizational costs paid or incurred after September 8, 2008, the client can elect to deduct a limited amount of start-up or organizational costs for the year that the business begins
- A statement is not required to make this election
- Once made, the election is irrevocable
- Any cost not deducted currently must be amortized ratably over a 180-month period
- The amortization period starts with the month you begin business operations
- Regulations § 1.195-1, 1.248-1, and 1.709-1

Form 4562
Watch Your Dates

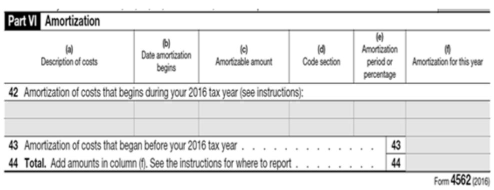
- For business start-up and organizational costs paid or incurred after October 22, 2004, and before September 9, 2008, the client can elect to deduct a limited amount of start-up and organizational costs for the year that the business begins
- If the election is made, they must attach any statement required by Regulations § 1.195-1(b), 1.248-1(c), and 1.709-1(c), as in effect before September 9, 2008
- Any costs not deducted currently can be amortized ratably over a 180-month period, beginning with the month the business begins

Form 4562
Watch Your Dates

- For business start-up and organizational costs paid or incurred before October 23, 2004, they can elect an amortization period of 60 months or more
- Attach any statements required by the appropriate section and related regulations to Form 4562 by the due date, including extensions, of the return for the year in which the active trade or business begins
- If the client has both start-up and organizational costs, attach a separate statement for each type of cost
- If the client timely filed the return without making the election, they can still make the election on an amended return filed within 6 months of the due date, excluding extensions, of the return
- Write "Filed pursuant to section 301.9100-2" on the amended
- return

Form 4562
Column (a) — Description of costs

- Describe the costs the client is amortizing



Part VI Amortization

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2016 tax year (see instructions):					
43 Amortization of costs that began before your 2016 tax year				43	
44 **Total.** Add amounts in column (f). See the instructions for where to report				44	

Form **4562** (2016)

Form 4562

- Column (b) — Date amortization begins
  - Enter the date the amortization period begins under the applicable Code section
- Column (c) — Amortizable amount
  - Enter the total amount the client is amortizing
- Column (d) — Code section
  - Enter the Code section under which they amortize the costs

Planning – It's All In the Planning

Iowa State University CALT Center for Agricultural Law and Taxation

CALT Website

http://www.calt.iastate.edu/

Tour of the CALT Website

Fall Tax Schools

- Though they are named the Farm and Urban Tax Schools the schools cover more than farm issues
- Common return issues for all kinds of returns are covered
- All kinds of business entities
- Problematic issues
- Sometimes we even get into to issues that you many encounter only once or twice a year or tax season
- The Tax Schools are a blend of diverse topics of interest to all tax professionals
- This year: New instructors with diverse backgrounds
- Your adventure awaits at Iowa State's Center for Agricultural Law and Taxation

Farm and Urban Tax Schools 2016

- November 2, 2016 to December 13, 2016
- 8 Locations in Iowa and Online Webinar
- Save the Date for the 2016 Annual Farm and Urban Income Tax Schools
- The program is intended for tax professionals and is designed to provide up-to-date training on current tax law and regulations
  - November 2-3: Maquoketa
  - November 7-8: Red Oak
  - November 9-10: Sheldon
  - November 14-15: Mason City
  - November 17-18: Ottumwa
  - November 21-22: Waterloo
  - December 5-6: Denison
  - December 12-13: Ames and Live Webinar

Winter Webinars

- ACA – 2 Years later Update for the 2017 tax Season
- Tax Research with Limited Resources
- Miscellaneous Income
- New Developments – Tax Update
- Form 8867 Due Diligence
- Learn about Coops – Free webinar

Beginning Tax Preparers Class

- CALT is working on offering a basic class for NEW tax preparers this fall in October
- The week long webinar will cover the basics an individual needs to know such as:
  - Requirement to file and Filing Status
  - Dependents
  - Itemized deductions
  - Child and Dependent care
  - Education Credits
- Other issues a first or second year preparer needs to know as well as a refresher for others who need to brush up on issues
- The class will be a week long or more and will be offered at a special rate

The Scoop

- Throughout the filing season two Scoops will be held on Scoop Dates
  - 8:00 – 8:30 am Central time
  - 12:00 – 12:30 Central time
- This assists with accommodating our west coast practitioners
- The same information will be shared at both sessions
- You have the option of registering for whatever session suits your schedule
- https://www.calt.iastate.edu/calendar-node-field-seminar-date/month

Future Scoop Dates

- October 5, 2016
- October 19, 2016
- November 16, 2016
- December 14, 2016
- http://www.calt.iastate.edu/calendar-node-field-seminar-date/month

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