

# The GIBSON&PERKINS Tax Letter

CIRCULATED TO TAX ADVISORS AND CLIENTS

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## **ELECTIONS REGARDING START-UP EXPENDITURES, CORPORATION ORGANIZATIONAL EXPENDITURES, AND PARTNERSHIP ORGANIZATIONAL EXPENSES**

### ***Background***

The IRS has issued temporary and proposed regulations (T.D. 9411, 07/08/2008) on elections available to amortize or expense certain expenditures under Code Sec. 195, Code Sec. 248, and Code Sec. 709. Code Sec 195 addresses the tax treatment of expenses incurred in exploring a new business. Code Sec 248 addresses the deductibility of expenditures incurred to organize a corporation. Code Sec 709 addresses the treatment of expenses incurred to organize a partnership. Each Code Section provides that, except as otherwise provided, no current deduction was allowed in regard to such expenditures. Under the law prior to October 22, 2004, an election could be made to amortize such expenditures over a period of not less than 60 months. Under the current law, you are allowed to expense some of those expenditures immediately and amortize the rest over time.

### ***The American Jobs Creation Act of 2004***

The American Jobs Creation Act of 2004 (Public Law 108-357, 118 Stat. 1418) (the "Act"), amended the Code to provide that a taxpayer may elect to deduct the relevant expenditures, within limitations, in the year in which the active trade or business to which the expenditures relate begins. The amount that may be deducted in that year is the lesser of (A) the amount of the relevant expenditures or (B) \$5,000, reduced dollar for dollar (but not below zero) by the amount by which the start-up expenditures exceed \$50,000.

All three code sections provide the same type of treatment to the expenses, the only difference between them being the type of expenditure to which they apply. Any start-up expenditures that are not deductible may be deducted by the taxpayer ratably over the 180-month period beginning with the month in which the active trade or business begins. All start-up expenditures incurred by the taxpayer that relate to the active trade or business are considered in determining whether the start-up expenditures exceed \$50,000, including expenditures incurred on or before October 22, 2004.

### ***Definitions***

***Start Up Expenditures.*** The term “start-up expenditure” means any amount: (1) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, creating an active trade or business, or any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business and which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction of the taxable year in which paid or incurred. Examples of start-up expenses include: travel expenses, survey fees, costs of analyses, wages, and consulting fees. Start-up expenses do not include interest, taxes, and research and development costs. Selling expenses in regard to partnership interest (i.e., syndication costs) must be capitalized.

***Organizational Expenses.*** Code Sec. 248(b) defines organizational expenses as “any expenditure which (1) is incident to the creation of the corporation; (2) is chargeable to capital account; and (3) is of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life.” Reg. § 1.248-1(b) specifies that all three criteria must be met before an expense can qualify for Code Sec. 248 treatment. The regulations also give examples of expenses that

qualify and expenses that do not qualify for Code Sec. 248 treatment. Expenses that qualify for Code Sec. 248 treatment are expenses concerned with the initial organization of the corporation. Examples of that type of expenses are legal and accounting services to establish the corporation, cost of drafting the by-laws and establishing stock rights, state incorporation fees, and director or shareholder meeting expenses.

Several different types of expenses are specifically excluded from Code Sec. 248 treatment: expenses incurred to issue or sell securities (these include professional fees, printing costs, and brokers' commissions), expenses incurred to transfer assets to the corporation, and expenses incurred to reorganize a corporation, apart from its initial organization. (Reg. § 1.248-1(b)(3))

### ***Treatment Under the Temporary Regulations.***

Before the temporary regulations were issued, a taxpayer had to affirmatively elect to deduct start up expenditures in the year in which they were occurred. Now, these temporary regulations provide that a taxpayer is deemed to make an election to deduct start-up expenditures for the taxable year in which the active trade or business to which the expenditures relates begins. Therefore, a taxpayer is no longer required to attach a statement to the return or specifically identify the deducted amount as start-up expenditures for the election under section 195(b) to be effective. The election to capitalize start-up expenditures is made by completing Part IV of Form 4562, Depreciation and Amortization, a copy of which is attached.

A taxpayer may choose to forgo the deemed election by clearly electing to capitalize its start-up expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the active trade or business begins. Whichever treatment is applied to the start up expenditures is irrevocable and applies to all start-up expenditures of the taxpayer that are related to the active trade or business.

### ***The Limitation***

The amount that may be deducted under section 195(b)(1)(A) in that year is the lesser of the amount of the start-up expenditures or \$5,000, reduced (but not below zero) by the amount by which the start-up expenditures exceed \$50,000.

*Example.* Corporation X incurs start-up expenditures of \$54,500. Corporation X is deemed to have elected to deduct start-up expenditures under section 195(b) in 2009. Therefore, Corporation X may deduct \$500 ( $\$5,000 - 4,500$ ) and the portion of the remaining \$54,000 that is allocable to July through December of 2009 ( $\$54,000/180 \times 6 = \$1,800$ ) in 2009, the taxable year in which the active trade or business begins.

*Example.* Corporation X incurs start-up expenditures of \$450,000. Corporation X is deemed to have elected to deduct start-up expenditures under section 195(b) in 2009. Therefore, Corporation X may deduct the amounts allocable to July through December of 2009 ( $\$450,000/180 \times 6 = \$15,000$ ) in 2009, the taxable year in which the active trade or business begins.

### **Conclusion**

The new rules make the classification of expenses an important tax planning decision. Attention to detail and some planning can yield significant upfront deductions for start-up and organizational expenses under Code Sec. 195, Code Sec. 248, and Code Sec. 709. These deductions can result in significant tax savings to clients. A good record, as in so many cases, is important.

Regards,



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