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Selected Issues in Tax Reform: The Small Business Start-Up Deduction

Businesses are typically allowed to deduct their start-up costs over a 15-year period. Businesses with low start-up costs are allowed an accelerated deduction for their start-up costs during the year the business begins. Section 195 of the Internal Revenue Code (IRC) allows taxpayers with low start-up costs to deduct up to $5,000 in start-up costs during the business's first year. Businesses with high start-up costs lose this immediate deduction, but can deduct all their start-up costs over a longer period. The start-up deduction was intended to help promote business formation and resolve an area of controversy among taxpayers, the Internal Revenue Service (IRS), and the courts. This In Focus provides a summary of the deduction and its history.

What Are Start-up Costs?

The "start-up expenditures" that may apply toward the deduction are limited. To qualify, the cost must be in one of these three statutory categories:

- investigating the creation or acquisition of an active trade or business (such as a detailed market study);
- creating an active trade or business (such as getting a business license); 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 (such as advertising the business's opening).

In addition to meeting one of these three criteria, the cost must also be for something that would be eligible for deduction under some other provision of the tax code if the business were active. This means that Section 195 does not expand the *types* of expenses that can be deducted, but only the *timing* of when those expenses can be paid or incurred.

Start-up expenditures do not include costs paid or incurred by an active business, even if those costs meet one of the three criteria above. Those costs, however, are likely deductible under other provisions of the tax code.

How Is the Deduction Calculated?

A taxpayer may deduct up to $5,000 in start-up costs in the business's first year. The deduction is reduced, dollar-for-dollar, for start-up costs above $50,000, so that no immediate deduction is available for start-up costs above $55,000. Any start-up costs ineligible for a first-year deduction may be deducted over 180 months (15 years).

IRS regulations at 26 C.F.R. §1.195-1 provide examples of the deduction for businesses with different amounts of start-up expenditures. Those examples are summarized below. Each assumes that the business started on July 1.

- A business with $3,000 in start-up costs may deduct the full $3,000 in the first year of operation.
- A business with $41,000 in start-up costs may deduct $5,000 in start-up costs in the first year of operation. The remaining $36,000 is deducted $200 per month for the next 180 months. The business could deduct an additional $1,200 ($200 * 6 months: July-December) in the first year; $2,400 each year for years 2 through 15; and the remaining $1,200 in year 16.
- A business with $54,500 in start-up costs is in the first-year deduction phaseout range. The business may deduct $500 ($5,000-$4,500) in the first year of operation. The remaining $54,000 is deducted $300 per month for the next 180 months. The business could deduct an additional $1,800 ($300 * 6) in the first year; $3,600 each year for years 2 through 15; and the remaining $1,800 in year 16.
- A business with $450,000 in start-up costs is not eligible for any of the $5,000 first-year benefit. Instead, this business would deduct $2,500 per month for 180 months. The first-year deduction would therefore be $15,000 ($2,500 * 6). For years 2 through 15, the annual deduction would be $30,000. The final $15,000 would be deducted in year 16.

The start-up deduction is available to businesses of all sizes. However, the $5,000 current-year deduction is most likely to be most relevant to small businesses. Larger businesses are likely to have start-up costs above the $55,000 phaseout, and therefore can only use the 180-month deduction method. Because the more generous provision is most relevant to smaller businesses, Section 195 is sometimes called the small business start-up deduction.

Estimated Cost

The Joint Committee on Taxation (JCT) estimated that the business start-up deduction would reduce federal revenue by around $0.2 billion in FY2025. Additionally, JCT estimated that most of the revenue cost would be for pass-through businesses (sole proprietorships, partnerships, and Subchapter S Corporations) instead of Subchapter C Corporations (which are subject to the corporate income tax). Overall, JCT estimated a five-year revenue reduction of $1.4 billion for FY2024-FY2028.

Legislative History

Generally, a business may deduct its costs of production (such as ordinary and necessary business expenses and allowances for depreciation of business property) from gross receipts to calculate taxable income (profit). Additionally, to be a business expense, the business must exist. This creates a chicken-and-egg problem in tax accounting: at start-up, business founders must pay certain costs to create the business. Those costs have no use to the founders independent of enabling the business to exist. However, the business does not exist when those costs were paid or incurred, so the business may not deduct them.

Prior to the enactment of Section 195, the IRS took the position (which courts upheld) that start-up costs were not deductible because businesses did not exist when they were incurred. Instead, those costs were required to be capitalized, or added to a founder's basis in a business. Therefore, a founder would only recover the start-up costs when selling a business (by deducting them from the proceeds of the sale). Businesses that were never sold (either because they were passed within a family, or because they failed) received no tax benefit from their start-up costs.

Separate but related provisions applied specifically to the organization expenses of corporations (Section 248) and partnerships (Section 709). The definition of "organization expenses" is more limited than for Section 195 start-up costs. Organization expenses are expenses incident to the creation of the corporation or partnership and that would otherwise be capitalized into the value of the business. The corporation version was enacted in 1954; the partnership version was enacted in 1976. In these early versions, organizational expenses were to be deducted over a period of at least 60 months (five years).

The Miscellaneous Revenue Act of 1980 (P.L. 96-605) enacted the first version of Section 195. Under this version, all start-up costs were to be amortized over 60 months (five years). In explaining the change, the Senate Committee on Finance identified the potential to "encourage formation of new businesses and decrease controversy and litigation arising under present law" (S. Rept. 96-1036, p. 11).

The American Jobs Creation Act of 2004 (P.L. 108-357) changed the universal five-year amortization for Section 195 (and Sections 248 and 709) to the current $5,000 deduction in the first year, and amounts over that (or all amounts, for businesses past the phaseout) amortized over 180 months (15 years). In proposing the change, the Senate Committee on Finance stated that "allowing a fixed amount of start-up and organizational expenditures to be deductible, rather than requiring their amortization, may help encourage the formation of new businesses that do not require significant start-up or organizational costs to be incurred." Extending the previous 5-year deduction period to 15 years was intended to provide "a consistent amortization period" with Section 197 intangibles (S.Rept. 108-192, pp. 196-197).

Using Section 195 for Economic Stimulus

The Small Business Jobs Act of 2010 (P.L. 111-499) provided a one-year expansion of the start-up deduction. For 2010 only, the maximum one-year deduction was increased to $10,000 (from $5,000) and the beginning of the phaseout range was increased to $60,000 (from $50,000). Taken together, these changes allowed a larger immediate benefit to businesses, and allowed businesses with slightly higher start-up costs to benefit from the first-year deduction.

This change was, like other Section 195 changes, publicly justified by policymakers as promoting business start-ups. For example, then-Secretary of the Treasury Timothy Geithner testified to the Senate Committee on Small Business and Entrepreneurship that the one-year deduction increase would "help innovators turn an idea into a thriving business" (S. Hrg. 112-488).

Comparison With a Tax Credit

A tax credit reduces tax liability dollar-for-dollar, while the value of a tax deduction depends on a taxpayer's marginal tax bracket. For example, imagine a taxpayer with $100 of qualifying expenses. A 20% tax credit would provide a $20 tax benefit. Under current law, the value of a $100 deduction would vary between $0 (if the taxpayer did not have taxable income) and $37 (for taxpayers in the highest tax bracket). The value of business deductions can therefore depend upon the rest of the business owner's tax situation, besides just the business.

The tax credit versus tax deduction comparison may be different for new businesses. New businesses are likely to earn losses in their earliest years, as they incur the costs of starting and growing a business but before they have an established customer base. A business with a loss generally will not have any income tax due. Nearly all business tax credits are nonrefundable, meaning the credits can only offset tax liability, and any amount above liability will not be paid to the taxpayer. Therefore, a start-up business with a loss may not gain an immediate benefit from tax credits—it may need to carry those credits forward to future years, when the business has taxable income.

By comparison, a business with a loss could still receive a benefit from a further deduction, which would increase the business's loss for tax purposes. The business owners may be able to use the business loss to offset other income. However, business loss deductions may be limited by the excess business loss limitation, so the business may need to carry those losses forward to deduct in future years.

Therefore, comparing the value of a tax credit and a tax deduction may be more complicated for start-up businesses. Which is more advantageous depends on the business's and, separately, its owners' tax circumstances, which may differ among owners of the same business. It is possible that, in some situations, start-up business owners may prefer a tax credit, while in others, they may prefer a deduction.

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