Abstract: Government officials monitor the number of new businesses that are launched each year. In the aftermath of the pandemic, government officials saw a large increase of businesses formed. The U.S. Census Bureau measures this by monitoring the number of businesses applying for an Employer Identification Number. This article describes how start-up expenses are handled on the relevant tax return.

Getting a new business off the ground

New businesses are launched every day, as evidenced by the number of Employer Identification Numbers requested, according to the U.S. Census Bureau. In the aftermath of the COVID-19 pandemic, there was a large increase in the number of businesses formed. For 2023, roughly 5.5 million new business applications were filed.

How to treat expenses for tax purposes

Entrepreneurs often don't know that many of the expenses incurred by start-ups can't be currently deducted on their tax returns. Be aware that the way you handle some of your initial expenses can make a large difference in your federal tax bill. Here are three rules to keep in mind if you're starting or planning to launch a new business:

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, including 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 it 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 include 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. Contact us about your start-up plans. We can help with the tax and other aspects of your new business.