Accounting and Tax Treatment for Start-Up/Pre-Opening Expenses

By Michael Helton, CPA and Patrick Goodwin, CPA

At Rivero, Gordimer & Co., some common questions we see among our clients relate to the accounting for organizing a new business and incurring start-up or pre-opening expenses. This is most common among our rent-to-own clients as they break into the industry or continue to expand their store locations. For example:

- What is classified as a start-up/pre-opening expense?
- What is an organizational cost?
- Should these expenses be capitalized?
- If they can be capitalized, how long can they be amortized?

The treatment of these costs differs for GAAP/"book" and tax purposes. For book purposes, the answer to these questions is simple. All organizational, start-up/pre-opening costs are expensed as incurred. The tax treatment of these costs can vary depending on the type of cost, and this can become a cumbersome task for our clients to keep track of.

For tax purposes, the specific breakdown and nature of the cost becomes more important. While for book purposes the character may not matter, for tax purposes both organizational costs and start-up costs are included in two separate sections of the Internal Revenue Code. However, both lead to the same tax treatment and are required to be amortized over a 180-month period beginning with the month in which the entity begins actual business operations.

Organizational Costs

A qualifying organizational cost is any expenditure which is:

- Incident to the creation of the business entity (Corporation, LLC, Partnership, etc.).
- Chargeable to a capital account. This means it's required to be capitalized as opposed to expensed.
- Of a character that, if expended incident to the creation of an entity having a useful life, would be amortizable over that life.

A business entity may "elect" to deduct up to $5,000 of its organizational costs in the tax year in which it begins business. This allowable amount is reduced by the amount by which the organizational expenditures exceed $50,000. The election is made by completing the return and taking the deduction. There is no longer a separate statement that must be attached to the return.

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Start-Up Costs

The same expense election is available for business start-up expenditures. There are three kinds of start-up expenditures that qualify for deduction and amortization:

1. Investigative costs of creating or acquiring an active trade or business.
2. Business start-up costs incurred after a decision to establish a particular business is made but before the business begins.
3. Pre-opening costs of the business that are related to activities engaged in for profit and for the production of income but incurred before the date the active trade or business begins, in anticipation of the activity becoming an active trade or business.

Investigative costs include expenses incurred for the analysis or survey of potential markets, products, labor, supply, transportation, facilities, and similar costs. These costs can be amortized only if the taxpayer does, in fact, enter into or purchase an active trade or business.

Therefore, due diligence performed by a CPA firm or law firm after the Letter of Intent (LOI) is sent may not be amortizable.

Pre-Opening Expenses

Business start-up costs include a variety of pre-opening expenses incurred after a decision has been made to establish or purchase a business but before the business begins. These costs include expenses related to advertising, employee training, professional services, setting up books and records, and lining up distributors, suppliers, or potential customers.

Pre-opening costs are those amounts expended for any activity engaged in for profit and for the production of income. Such activities are engaged in before the day on which the active trade or business begins in anticipation of such activity becoming an active trade or business.

Acquisition Costs

Once the questions of whether to enter into a business or which business to enter have been determined, costs incurred afterward must be capitalized. This dividing line may be determined based off the issuance of a Letter of Intent. Costs to facilitate the acquisition of a specific business, therefore, will not qualify for amortization. Instead, those costs are capitalized as acquisition costs. Acquisition costs are often tacked on to the basis of the asset or capital interest being acquired.

For Partnerships, costs associated with the acquisition of assets, such as brokerage commissions, appraisals, and closing costs, are capitalized and added to the basis of the assets to which they relate. If the assets are depreciable, the capitalized costs are recovered through depreciation. However, syndication costs (incurred to market, promote, and issue the sale of its Partnership interests) must be capitalized and are not amortizable.

Below is a list of some common organizational, start-up/pre-opening costs and how they should be treated for book vs. tax purposes.

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Common Costs & Their Treatment

Type of Expense	Book Treatment	Tax Treatment	Amortizable Life
Accounting and Legal Fees	Expense	Organizational	180 months
Organizational Directors and Meetings of Stockholders	Expense	Organizational	180 months
Articles of Formation	Expense	Organizational	180 months
Promotional Costs to Sell Partnership Interests	Expense	Syndication	None
Employee Training Expenses	Expense	Startup	180 months
Travel Costs Pre-LOI	Expense	Investigatory	180 months
Recruiting Costs	Expense	PreOpening	180 months
Site-Selection Costs	Expense	Investigatory	180 months
Due Diligence Post-LOI	Expense	Capitalize	Depends

When the Business Opens

When does a business begin "business"? Generally, this is answered on a facts-and-circumstances basis. Ordinarily this is when activities have advanced to the extent necessary to establish the nature of its business operations. Accordingly, the acquisition of business operating assets which are necessary to the type of business contemplated may constitute beginning business. Having revenue, while a great indicator of beginning business, is only one factor to consider.

Numerous cases discuss whether a taxpayer is engaged in a trade or business for purposes of deducting expenses as trade or business expenses and offer guidance as to when a business begins for the purposes of amortizing start-up expenditures. These cases generally hold that a taxpayer is engaged in a trade or business only when the business begins to function as a going concern and performs those activities for which it is organized. Another approach adopted in some cases is that activity sufficient to show that the taxpayer is aiming to earn money and that expenses are non-personal is sufficient to establish that a trade or business has begun. Again, most of these are facts-and-circumstances based.

This is only a short list of the various start-up and pre-opening expenses an organization can incur. That being the case, we'd love to assist you with any questions you have related to start-up and pre-opening expenses. Rivero, Gordimer & Company has been assisting clients with their tax and accounting needs for almost 40 years. For any questions or further assistance, reach out to Patrick Goodwin at pgoodwin@rgcocpa.com, or Mike Helton at mhelton@rgcocpa.com. You can also call our office at 813-875-7774 or visit our website at rgcocpa.com.

About the Authors:

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