New Business? First-Year Deduction Strategies

Article Highlights:

- Equipment Depreciation & Expensing Opportunities
- Vehicle Luxury Auto Rules
- Leasehold Improvement Expense Options
- Start-Up Cost Elections
- Organizational Expense Alternatives

If you are planning a new business start-up and are incurring some expenses, you probably anticipate deducting those expenses in the first year of the business's operation. Unfortunately it is a little more complicated than that. Expenses a business incurs in the beginning can include equipment purchases, vehicle purchases and use, leasehold improvements, organizational costs and start-up expenses, and each receives a different tax treatment.

- **Equipment** – The equipment you buy can't be deducted until it is placed in service. For that reason, you can't make any equipment deductions until the business is actually functioning. However, deductions for most equipment purchases are very liberal. For most small businesses, this means the entire cost of equipment and office furnishings can generally be written off in the year of purchase, if that is also the year when the equipment is put into service, using the Sec 179 expensing election. However, the deductible amount is limited to taxable income from all the taxpayer's active trades or businesses (including a spouse's active trades or businesses if married and filing jointly). Income from trades also includes W-2 income.

  Sometimes it may not be appropriate to write off the entire cost in the first year, in which case the equipment can be depreciated over its useful life (according to recovery periods established by the IRS). Most office furniture, fixtures and equipment are assigned a 7 year recovery period, but the depreciable period for computers is 5 years. The recovery period of equipment may vary depending on the type of business activity. There is also a 50% bonus depreciation election for the first year the equipment is placed in service.

- **Vehicles** – Automobiles and small trucks that are purchased for use by the business are treated like equipment, as above, except their recovery period is 5 years and they are subject to the so-called luxury auto rules. These rules limit the depreciation to a maximum of $3,160 ($3,560 for light trucks and vans) for the first year. If bonus depreciation is elected, add $8,000 to the first-year maximum.

- **Leasehold Improvements** – Generally, leasehold improvements are depreciated over 15 years. But through 2019, bonus depreciation may be elected, allowing between 30% and 50% of the cost of interior qualified improvements to non-residential property after the building is placed in service to be deducted in the first year. In addition, the Sec 179 expense deduction is allowed for qualified leasehold property, qualified restaurant property and qualified retail improvements.

- **Start-Up Costs** – Taxpayers can elect to deduct up to $5,000 of start-up costs in the first year of a business. However, the $5,000 amount is reduced by the amount of the start-up costs in excess of $50,000. If the election is made, the start-up costs over and above the first-year deductible amount are amortized over 15 years. If the election is not made, the start-up costs must be capitalized, meaning the expenses can only be recovered upon the termination or disposition of the business. Start-up costs include:
  - Surveys/analyses of potential markets, labor supply, products, transportation, facilities, etc.;
  - Wages paid to employees, and their instructors, while they are being trained;

    - Advertisements related to opening the business;
    - Fees and salaries paid to consultants or others for professional services; and
    - Travel and related costs to secure prospective customers, distributors and suppliers.

- **Organizational Expenses** – If the new business involves a partnership or corporation, the business can elect to deduct up to $5,000 of organization expenses in the first year of a business. This is in addition to the election for start-up expenses. Like start-up expenses, the $5,000 amount is reduced by the amount of the start-up costs in excess of $50,000. If the election is made, the start-up costs over and above the first-year deductible amount are amortized over 15 years. If the election is not made, the start-up costs must be capitalized. Organizational expenses include outlays for legal services, incorporation fees, temporary directors' fees and organizational meeting costs, etc.

The foregoing is an overview of some of the expense issues in a business's first year. As you can see, major decisions and elections need to be made that can have a lasting impact on the new business. You are encouraged to consult with this office for additional details and assistance in preparing a tax plan for your planned new business.