
TUESDAY, JULY 12, 2016, 1:00-2:50 pm Eastern

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Reconciling Book/Tax Treatment of Startup Costs

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Introduction

• New businesses typically incur costs before they begin active conduct of business operations.
• These costs are frequently referred to as “start-up costs” of a business.
• Challenges are involved in trying to identify and calculate book/tax differences.
Introduction

- GAAP – categorized as start-up costs and expensed as incurred.
- Tax – capitalized and broken down into multiple subcategories, such as “start-up costs”, “organizational costs”, and syndication costs.
General Financial Accounting
Treatment of Organization and Start-up Costs
Guidance – Accounting Standards Codification (ASC) Section 720-15

• In practice, various terms are used to refer to start-up costs:
  • pre-opening costs
  • pre-operating costs
  • organization costs
  • start-up costs

• Financial accounting standards refer to these costs only as start-up costs.

• For financial accounting purposes, a business must expense start-up costs as incurred.
ASC Section 720-15-20

• Start-Up Costs include costs of the one-time activities associated with:
  – Organizing a new entity (e.g., legal fees for preparing a charter, partnership agreement, bylaws, original stock certifications, filing fees, etc.)
  – Opening a new facility.
  – Introducing a new product or service.
  – Conducting business in a new territory or with a new class of customer.
  – Initiating a new process in an existing facility.
  – Commencing some new operation.
NOT Start-up Activities:

- Activities related to *routine, ongoing* efforts to refine, enrich, or otherwise improve upon the qualities of an *existing* product, service, process, or facility.
- Activities related to a *merger or acquisition*.
- Activities related to *ongoing* customer acquisition.
Accounting for Costs Not Within the Scope of ASC Section 720-15-20

- An entity should not conclude that these costs are to be capitalized.
- Such costs shall be capitalized if they qualify for capitalization under other generally accepted accounting principles (GAAP).
Example #1

Costs Incurred to Construct Overseas Plant – Initial Entry into Market

- A major U.S. beverage company (the Company) begins construction of a new plant in China.
- This represents the Company’s initial entry into the Chinese market.
- As part of the overall strategy, the Company plans to introduce into China, on a locally produced basis, the Company’s major U.S. beverage brands.
Example #1 - continued

Following are some of the costs that might be incurred in conjunction with start-up activities (EXPENSE AS INCURRED):

- Travel costs, employee salary-related costs, and consulting costs related to feasibility studies, accounting, legal, tax, and governmental affairs
- Training of local employees related to production, maintenance, computer systems, engineering, finance, and operations
- Recruiting, organization, and training related to establishing a distribution network
- Nonrecurring operating losses
- Depreciation, if any, of new computer data terminals and other communication devices
Example #1 - continued

The following costs incurred in conjunction with start-up activities are outside the scope ASC 720-15-55:

- Costs of long-lived asset additions, such as the new plant, production equipment, and packaging lines
- Internal-use computer software systems development costs
- Costs that are capitalizable as inventory
- Deferred financing costs
ASC 720-15-55

- Contains other Implementation Guidance and Illustrations with scenarios and examples of what costs are costs incurred in conjunction with start-up activities.
Sources of Tax Rules Requiring Differences in Book/Tax Treatment
Deferred Tax Assets and Liabilities

- Differences in book/tax treatment of these costs give rise to deferred tax assets and liabilities.

- Temporary – create a deferred tax asset or liability

- Permanent – does not create a deferred tax asset or liability
Internal Revenue Code Section 195

• The basic framework for reporting start-up expenditures defines start-up costs as any amounts incurred to either investigate the potential of creating or acquiring an active trade or business, or in actually creating an active trade or business.

• Start-up expenditures must be capitalized.
Internal Revenue Code Section 197

- Defines certain assets as intangible assets.
- These intangibles must be amortized over a 15 year period.
Internal Revenue Code Section 248

• Provides for a deduction (if elected) of organizational expenditures of up to $5,000.
• Defines organizational expenditures.
Internal Revenue Code Section 709

• Provides for the treatment of organization and syndication fees for a partnership.
IRC § 195(b)

- Deduct up to $5,000 of first $50,000 of start-up costs
- Deduction is phased out dollar-for-dollar as total start-up costs exceed $50,000
- Completely phased out at $55,000
- Costs above and beyond the allowed deduction are amortized over 180 months beginning in the month the active trade or business began.
- Election is deemed made unless the taxpayer affirmatively elects out of this treatment.
Election to expense/amortize start-up expenditures – IRC § 195(b) and IRS Reg. § 1.195-1(b)

- A taxpayer is deemed to have elected to expense/amortize start-up costs under IRC § 195(b) for the tax year in which the active trade or business begins,
- However, 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 tax year in which the active trade or business begins.
- The choice of expensing/amortizing or capitalizing start-up expenditures is irrevocable and applies to all start-up expenditures related to the active trade or business.
Example #1: Expenditures of $5,000 or less

- Corporation X, a calendar year taxpayer, incurs $3,000 of start-up expenditures after October 22, 2004, that relate to an active trade or business that begins on July 1, 2011.
- Under the regulations, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011.
- Therefore, Corporation X may deduct the entire amount of the start-up expenditures in 2011, the taxable year in which the active trade or business begins.
Example # 2: Expenditures of more than $5,000 but less than or equal to $50,000

- The facts are the same as in Example 1 except that Corporation X incurs start-up expenditures of $41,000.
- Under the regulations, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011.
- Therefore, Corporation X may deduct $5,000 and the portion of the remaining $36,000 that is allocable to July through December of 2011 ($36,000/180 x 6 = $1,200) in 2011, the taxable year in which the active trade or business begins.
- Corporation X may amortize the remaining $34,800 ($36,000 - $1,200 = $34,800) ratably over the remaining 174 months.
IRC § 195(c)(2) – Beginning of Trade or Business

- An acquired trade or business shall be treated as beginning when the taxpayer acquires it.
- IRC § 162(a) - a taxpayer is not carrying on a trade or business until the business has begun to function as a going concern and to perform those activities for which it was organized.
Internal Revenue Code Section 197 (Intangibles)

- IRC Code § 197 offers guidance on how to treat intangibles related to business start-ups.
IRC § 197(a)

• Intangibles which are held in connection with the conduct of a trade or business or activity described in IRC § 212.

• Examples include:
  – Goodwill
  – Non-Competes
  – Customer Lists

• Excludes self-created intangibles – IRC § 197(c)(2)
IRC § 197(f)

Section 197 intangibles DO NOT include:

- Financial interests
- Any interest in Land
- Computer software
- Certain interests or rights acquired separately
- Interests under leases and debt instruments
- Mortgage servicing
- Certain transaction costs
- Any self-created intangible
Organizational Expenses

- §248 – Corporate Organizational Costs
- §709 – Partnership Organizational Costs

Defined as expenditures which are:
- Incidental to the creation of the corporation/partnership,
- Chargeable to capital account, and
- Of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life

Include:
- Legal Fees incurred to draft partnership agreement,
- Registration and Filing Fees,
- Other related costs incurred in the formation
Organizational Expenses - Continued

- Election to expense
  - Same rules as those for §195 Start-Up costs
    - $5,000 of first $50,000 of the organization costs can be deducted immediately,
    - Remaining costs amortized ratably over 15 years beginning with the month the partnership begins business – §709(b)(1)(B) / §248(a)(2)
    - $5,000 deduction is reduced for every dollar of costs over $50,000; total phase-out at $55,000
    - Election is automatic, but can elect out of this treatment and treat as a capital expense that is added to the partners’ basis.

- Yes, this can be taken in addition to start-up costs
Reporting Start-up Cost Book/Tax Differences on Schedule M-1 or M-3
Schedule M-1 or M-3

- **Schedule M–1 Requirements – Corporations**
  - Total receipts are $250,000 or more,
  - Total assets at year–end are $250,000 or more,
  - Not filing and not required to file Schedule M–3

- **Schedule M–1 Requirements – Partnership**
  - Total receipts are $250,000 or more,
  - Total assets at year–end are $1,000,000 or more,
  - Schedules K–1 are provided to all members/partners by the return due date, and
  - Not filing and not required to file Schedule M–3
Schedule M-1 or M-3 - Continued

- **Schedule M-3 Requirements – Corporations**
  - $10 million or more in assets at year-end,

- **Schedule M-3 Requirements – Partnership**
  - $10 million or more in assets at year-end,
  - $10 million or more in adjusted total assets at year-end,
  - $35 million or more in receipts, or
  - There is a reportable entity
Schedule M-1 or M-3 - Continued

- **Schedule M–1/M–3 Hybrid**
  - Complete Schedule M–1 and page 1 of Schedule M–3 (related to book income and method)
  - Effective as of tax years ending December 31, 2014,

- **Requirement**
  - At least $10 million, but less than $50 million in total assets
  - For partnerships – they cannot be required to file schedule M–3 for some other reason (i.e. receipts)
### Reporting Start-up Costs

- No specific breakout needed on M-1

#### Schedule M-1

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Net income (loss) per books</td>
<td>500,000</td>
</tr>
<tr>
<td>2</td>
<td>Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Guaranteed payments (other than health insurance)</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Add lines 1 through 4</td>
<td>500,000</td>
</tr>
<tr>
<td>6</td>
<td>Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Add lines 6 and 7</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5.</td>
<td>490,000</td>
</tr>
</tbody>
</table>

#### Note

The partnership may be required to file Schedule M-3 (see instructions).
### Reporting Start-up Costs - Continued

- Grouped together on M–3 Schedule

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>23</td>
<td>Current year acquisition or reorganization investment banking fees</td>
</tr>
<tr>
<td>24</td>
<td>Current year acquisition or reorganization legal and accounting fees</td>
</tr>
<tr>
<td>25</td>
<td>Current year acquisition/reorganization other costs</td>
</tr>
<tr>
<td>26</td>
<td>Amortization/impairment of goodwill</td>
</tr>
<tr>
<td>27</td>
<td>Amortization of acquisition, reorganization, and start-up costs</td>
</tr>
<tr>
<td>28</td>
<td>Other amortization or impairment write-offs</td>
</tr>
</tbody>
</table>
Current Year Acquisition or Reorganization

- Broken into three categories:
  - Investment Banking Fees (Reg 1.263(a)–5(e)(1)),
  - Legal and Accounting Fees
  - Other Costs
    - Note this is not a line on a 1065 M–3

- Applicable to both taxable or tax–free acquisitions of property (stock or assets)

- Applicable to tax–free reorganization

- Temporary differences, generally
Amortization of Goodwill and Start-up Costs

- Amortization/Impairment of Goodwill
  - §197 – Goodwill

- Amortization of acquisition, reorganization, and start-up costs
  - §167 – Depreciation,
  - §195 – Start-Up Expense
  - §248 – Organizational Expenses
    - Partnerships have a specific line on the M-3

- Other Amortization or Impairment Write-Offs
  - §197 – Intangibles

- Temporary differences, generally
Partnership Reporting of Book/Tax Differences Including Syndication Costs
Organizational Expenses - Continued

- Reporting on Schedule M–3
  - Part III, Line 15 – Organizational Expenses as per Reg 1.709–2(a)
    - If electing to deduct and amortize, this will be a temporary difference,
    - If electing to capitalize as nondeductible costs, this will be a permanent difference
Syndication Expenses

- Defined under 1.709–2(b)
  - Expenses connected with issuing and marketing of interests in the partnership.

- Includes:
  - Brokerage Fees,
  - Registration Fees,
  - Legal Fees of Underwriter,
  - Similar costs

- 100% NOT Deductible to tax purposes
 Syndication Expenses - Continued

- Tax Benefit
  - Happens at the earlier of:
    - Partners sell their partnership interest, or
    - Partnership liquidates
  - Decrease capital gain/ increase capital loss on sale or liquidation of their partnership interest
Syndication Expenses - Continued

- Syndication costs are reported to the partner on their final K–1 as a footnote.

- Sample Footnote:
  - “Syndication costs in the amount of $XX,XXX are being reported to you as part of the partnership’s liquidation. Generally, these costs should be included in the tax basis of your partnership interest immediately before the partnership liquidation. Please consult with your tax advisor regarding the proper treatment of these costs.”
Syndication Expenses - Continued

- Reporting on Schedule M–3
  - Part III, Line 16 – Syndication expenses as per Reg 1.709–2(b)
    - This will always be a permanent difference
Disposition of Business Before End of Amortization Period
Disposition of Business

- **Start-Up Costs**
  - Any unamortized start-up will be deducted in full under §165 as losses.

- **Organizational Costs**
  - Any unamortized organizational costs will be deducted in full under §165 as losses.

- **Portion of Business**
  - If only a portion of a business (i.e. distributions) is disposed of then only those start-up and organizational costs associated with that business segment can be deducted.
Disposition of Business - Continued

- §197 Intangibles
  - No loss recognized if:
    - Any other §197 Intangible was acquired in the same transaction or series of transactions, and
    - The Taxpayer still retains any of the other amortizable intangibles acquired in that transaction or series of transactions – §197(f)(1)
    - Basis of the disposed of §197 intangible will be added to the remaining intangibles and continued to be amortized
§197 Intangibles – Continued

- Loss recognized when:
  - The §197 Intangible was the only intangible acquired in a transaction or series of transactions, or
  - The Taxpayer no longer retains any of the other amortizable intangibles acquired in the same transaction or series of transactions – 1.197(2)(g)(1)(ii)

- Deduct the unamortized basis of the intangible on form 4797.
Technical Termination under §708(b)(1)(B)

- Not considered a business disposition for purposes of:
  - §165
  - §197, or
  - §709
    - Syndication costs, and
    - Organizational costs

- Cannot take an immediate deduction
Effect of Tangible Personal Property Regulations on Certain Start-up Costs
If a cost is required to be capitalized under the §263(a) regulations, then it cannot be capitalized under §195.

Items that may have been lumped with start-up costs before, may now need to be capitalized.

Heavily fact and circumstantial – Review of the 263(a) regulations is recommended.
§1.263(a)–4 Capitalize amounts paid to:
- Acquire interest in another entity,
- Create certain intangible assets,
- Facilitate the acquisition or creation of intangible assets

§1.263(a)–5 Capitalize amounts paid to facilitate:
- Acquisition of assets making up a trade or business
- Acquisition of an ownership interest,
- Acquisition of capital
- Formation of a disregarded entity
263(a) is not necessarily a bad thing…
- 1.263(a)-4(d)(6)(v) – $5,000 de minimis rule for certain contract right intangibles,
- 1.263(a)-4(f) – 12-month rule for certain self-created intangibles,
- 1.263(a)-4(e)(4) – Certain de minimis transaction costs,
- 1.263(a)-5(d) – De Minimis rule for costs to facilitate the formation or organization of a disregarded entity
263(a) Regulations - Continued

- Tangible Assets Regulations
  - 263(a)-1, 263(a)-2, and 263(a)-3

- De Minimis Election

- Short recovery periods

- Bonus Depreciation

- 179 Expense
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