According to the Small Business Administration, 60% of small businesses fail within the first five years. A review of the relevant literature revealed limited research on tax issues for small businesses—such as sole proprietorships, partnerships, trusts, estates, and corporations—that had startup costs but subsequently failed to launch. This article aims to provide useful information to small business owners about the tax benefits that might be available after their startup fails.

The IRS estimates that 918,600 taxpayers who did not file a federal income tax return for 2010 could be eligible for refunds totaling $760 million (IR-2014-30, Mar. 19, 2014). This amount does not include states and localities, nor does it include money from taxpayers who failed to report their deductions correctly. Tax deductions pursuant to Internal Revenue Code (IRC) section 162 are of ordinary and necessary expenses paid or incurred during the taxable year. The tax code cannot help a business survive, but it does contain provisions that can soften the blow of failure.

Startup, Organizational, and Syndication Costs

It is very important for small businesses to distinguish startup costs from organizational and syndication costs; these concepts have sometimes been used interchangeably and incorrectly. Under IRC section 195, startup costs are those that the business would have incurred as an ordinary expense if it were actively in business, or operating costs incurred after the entity's formation but before it begins business. Such costs include—but are not limited to—marketing surveys prior to conducting business, preoperational advertising expenses, costs to establish an accounting system, costs to train employees, and salaries paid to executives and employees before the business's launch.

Organizational costs are incurred during a business's formation. Organizational costs relating to corporations are connected directly with the entity's creation, such as legal fees, articles of incorporation and bylaws, accounting costs related to its formation, and directors' and stockholders' meeting costs [Treasury Regulations section 1.248-1(b)(2)]. A partnership's organizational costs include filing fees, legal fees to draft the partnership agreement, and accounting fees to organize the partnership [IRC section 709(b)(3) and Treasury Regulations section 1.709-2(a)].

An entity may capitalize syndication costs; however, it may not amortize them. Such costs include the following: brokerage fees; registration fees; legal fees paid for security advice on the adequacy of tax disclosures in the prospectus or placement memo for securities law purposes; accounting fees related to offering materials; and the printing costs of the prospectus, placement memos, and other sales materials [Treasury Regulations sections 1.248-1(b)(3) and 1.709-2(b)].

Deducting Startup and Organizational Costs

Different rules apply to the deduction of start-up and organizational costs under IRC sections 195, 248, and 709. Expenses incurred in an entity's formation—whether a corporation, partnership, limited liability company, or sole proprietorship—are chargeable to a capital account. An entity may elect to deduct up to $5,000 of start-up costs in the year in which it begins business; however, this amount must be reduced by any startup costs that exceed

$50,000. Expenses not deductible under this provision are amortized over 180 months, commencing with the month in which the entity begins business. For start-up costs incurred before October 23, 2004, the business could elect to amortize those expenses over 60 months, starting with the month the business began. For each set of rules, the election to deduct and amortize start-up costs must be made by the due date (including extension) of the corporation or partnership tax return for the year the business begins. Failure to make the proper election results in no deduction or amortization of the startup costs until the entity is liquidated [Treasury Regulations section 301.9100-2(b)].

According to IRC sections 248(a) and 709(b), the organizational costs of a corporation and partnership are generally not deductible until the entire business is liquidated (*Wolkowitz et al. v. Comm'r*, 8 TCM 754); however, a corporation or partnership may elect to amortize organizational costs over the 180-month period commencing in the month the business begins. For organizational costs incurred on or before October 22, 2004, businesses may elect to amortize organization costs over a period of at least 60 months, beginning with the month they commence. For costs incurred after October 22, 2004, they may elect to deduct up to $5,000 in organizational costs, similar to start-up costs. The remainder of the organizational costs may be amortized over a 180-month period, beginning in the month the active trade or business begins [Treasury Regulations sections 1.248-1 and 1.709-1(b)(2)].

Tax Benefits for Small Businesses

Individual or sole proprietorship. An individual or sole proprietorship whose business failed to start is eligible for certain tax benefits. First, there has to be a determination of the costs or expenses incurred, which may fall into two categories: the costs the taxpayer incurred prior to deciding to start the business, and the costs the taxpayer made in attempting to start the business. If the taxpayer is an individual, the costs made prior to deciding to start the business are deemed personal and nondeductible. It is worth noting that, if an individual conducted an unsuccessful job search in his career, it is not considered a startup cost, but is deductible on Schedule A of Form 1040, "U.S. Individual Tax Return," as miscellaneous deduction subject to the 2% limitation. The costs made in attempting to start the business are deductible and may be treated as capital losses, reported on Schedule D of Form 1040.

Individual taxpayers who incurred net long- or short-term capital losses may only recognize or deduct a maximum of $3,000 of the amount realized from other types of gross income (i.e., ordinary income, passive income, or portfolio income). A joint tax return of husband and wife is treated as that of one person; if they file separately, the loss deduction is limited to half this amount ($1,500).

Capital losses are adjustments to adjusted gross income (AGI), which reduce adjusted income and taxable income before personal exemptions. If a taxpayer does not have any income in a certain year, the capital loss deduction will not be beneficial because it is not a refundable credit; however, it can be applied the following year or in any subsequent year that the taxpayer has income, until the entire amount is used up.

The $3,000 deduction for net capital losses available to individuals is not available to small corporations. Small corporations can only use capital losses to offset capital gains. IRC section 1211 allows capital gains from other investments to be offset by capital losses from startup costs resulting from the attempt to go into business.

Example. Taxpayer Tyler, an individual and sole proprietorship, has $19,000 in startup costs for federal tax purposes from a failed attempt to start a business. He also received gains from the sale of an asset for $10,000. The following items can be used to calculate his tax benefit:

- Gain on sale of assets: $10,000
- Start-up costs: $19,000
- Gain applied to loss: $10,000
- Unapplied loss: $9,000
- IRC section 1211 deduction applied: $3,000
- Eligible loss carried forward: $6,000.

In this example, Tyler did not make the election to expense or deduct the first $5,000 startup cost because his business start-up failed. If the sole proprietorship had acquired an asset for the purpose of the company (e.g., a building) but did not go into business and subsequently sold the asset at a gain, that gain should be recognized and reported on Schedule D of Form 1040. This gain—and, ultimately, the tax on the gain—can be reduced by the losses from the startup costs treated as capital losses.

Corporations. Under the entity concept, a business is treated as separate and distinct from its owners. Theoretically, startup and organizational costs benefit the entire life of a corporation and, for that reason, a case can be made for recording them as intangible assets and amortizing them over the life of the corporation; however, a corporation's life is usually not known, so startup and organization costs are expensed as they are incurred. If the business is a corporation (i.e., a C corporation) that incurred startup costs even though it failed to launch, the costs may be treated as business expenses (operating loss) or capital expenditures. If the corporation elects to treat them as operating costs, they are deductible in the current period. The operating loss will reduce the profitability of the company, thus reducing its tax liability. If the corporation elects to treat the startup costs as capital expenditures, these expenses may be realized at the point of dissolution. Capital losses are allowed only to the extent of gains; this means that the corporation does not have the benefit of the $3,000 capital loss deduction afforded to individual or sole proprietorship (IRC section 1211).

The costs of any assets acquired during the unsuccessful attempt to go into business are a part of the corporation's business assets and should be capitalized (i.e., added to the value of the assets). No deduction is allowed under the tax law. These costs will be recovered after the disposal of the assets or the corporation's liquidation. Gains and losses are taxable or deductible at the corporate level only.

Conduit entities. Under the conduit concept, entities are viewed as extensions of their owners. Partnerships, limited liability companies, and S corporations are treated as flow-through entities because the business owners choose to avoid treating the enterprise as a separate and taxable entity. More than 90% of small businesses are sole proprietorship, partnership, or S corporations (U.S. Census Bureau). The income of such flow-through entities is subject to only a single level of taxation (as compared to a C corporation). Partnerships and S corporations are not taxable entities; taxable income or losses of these entities flows through to their respective partners or shareholders pro rata, respectively.

S corporations. An S corporation is similar, in many ways, to a partnership, and it provides many of the tax benefits that are consistent with partnerships. An S corporation is limited to 100 shareholders. For federal tax purposes, small business S corporation shareholders may be individuals (residents), estates, certain trusts, and certain tax-exempt organizations. S corporations are treated as corporations under state statutes. This means that S corporations operate like C corporations, with similar liability protections (limited liability). For federal income tax purposes, S corporations are similar to partnerships; S corporations are taxed at the shareholder level (IRC sections 1361–1379), which means that all of an S corporation's income, deductions, and tax credits flow through to shareholders, regardless of whether distributions are made.

Under IRC sections 248 and 1363(b), an S corporation's income or losses are determined at the entity level and are divided into income or loss, and separately stated as income, losses, deductions, and tax credits. Although income and losses are determined in a similar fashion to those of partnerships, S corporations amortize organizational expenditures under the corporate rules. Per IRC section 1363(b), gains—but not losses—must be recognized on distribution of appreciated assets to shareholders.

For an S corporation that failed to start, this could be treated as ordinary loss. It would be treated as a separately stated item that retains its tax attributes on the shareholder's tax return and would be reported on Schedule K of Form 1120S, "U.S. Tax Return for an S Corporation." This loss will reduce the shareholder's tax liability and tax basis. If assets such as land or buildings are purchased and subsequently sold at an appreciated value after an S corporation failed to go into business, the gain is passed through to shareholders; however, if the assets are worth less than their basis, the S corporation does not recognize a loss. This loss is postponed until the shareholder sells the S corporation's stock.

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Partnerships. IRC section 701 states that a partnership is not a taxable entity; therefore, it pays no federal taxes. Taxable income or losses flow through to the partners pro rata at the end of the partnership's tax year and are reported on their personal tax returns (IRC section 702). Partnerships income, expenses, gains, and losses normally retain their identity as separately stated items. Because each separately stated item can affect each partners' tax liability differently, each partner must take each item into account separately (IRC section 703). Partners who invested in a business that failed to start are unable to make a valid deduction for the startup costs; however, the partnership (the investors) can elect to deduct or capitalize the business's startup costs under the same rules as a sole proprietor. This would be classified as ordinary loss and treated as an expense on the income statement.

The ordinary income and expenses would be netted to produce a single income or loss amount that is passed through to the partners. If the partnership purchased a business asset, such as land or buildings, in order to launch the failed business, the gains and losses would be reported as separately stated items and flow through to the partners. Importantly, the election is made by the partnership and reported to the partners on their Schedule K-1s.

The income, expenses, gains, and losses affect each partner's basis. The basis is important in determining these separately stated items. Typically, income and gains increase partners' basis, and expenses and losses decrease it. Yet, a partner's basis might be different because of other liabilities. If the partnership did not make the election, the costs must be added to the tax basis of the partnership interest; therefore, in the event that the partnership interest is sold or dissolved, the startup costs that are capitalized will increase the partnership's basis and reduce capital gains (or increase capital losses).

Implications for Small Businesses

The tax consequences for small businesses that fail to launch depends upon the facts and circumstances of each company. This discussion only applies to federal tax provisions. Taxpayers might also qualify for benefits from state and local jurisdictions, depending upon the applicable tax laws.

If the taxpayer is a C corporation and elects to treat these loses as expenses, then the startup costs will reduce taxable income, dividends, and earnings per share. If the taxpayer is an S corporation, it will also reduce taxable income and taxpayer basis when applicable. An individual, however, can only elect to treat the startup cost as a capital loss; this will reduce taxable income or offset capital gains. In addition, it can reduce income tax and self-employment tax.

Finally, taxpayers are required by law to keep the records of failed businesses attempts for a minimum of seven years. Although the statute of limitation expires three years from the due date of the tax return for that year, the time period may extend to six years if the taxpayer underreported income that is more than 25% of the gross income reported on the tax return. ❑