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Introduction

Due to the recent success of high-tech start-ups like Instagram, more and more people are looking into the possibility of being the next success story. The successful start-ups usually began with a few founders who got together with simple ideas to develop apps that are distributed via different platforms. Popular apps like Facebook, Box, and Snapchat were developed and their companies founded by college students. Many colleges now provide entrepreneurship-related programs to assist future start-up founders and innovators. For example, San Jose State University has the *Silicon Valley Center for Entrepreneurship* program to promote entrepreneurship among students by collaborating with investors and entrepreneurs.
[1] The University of California, Berkeley offers accelerator programs for the start-ups which stemmed from the school.[2]

Owning a business requires tax planning. Companies that are fortunate enough to make a profit must pay taxes on their generated income. On the other hand, businesses that are incurring expenses without generating any income may need to find a better way to utilize the tax benefits from their business activities. The purpose of this paper is to discuss tax treatment of high-tech start-ups by analyzing some of the relevant Internal Revenue Code Sections including §162 (trade or business expenses), §195 (start-up expenditures), and §174 (research and experimental expenditures).

§162 Trade or Business Expenses

§162 is pervasive in corporate taxation as it generally allows a deduction for business-related expenses. Although §162 does not clearly define what constitutes a trade or business, it provides

[1] San Jose State University (2017). *14th Annual Silicon Valley Innovation Challenge*. Retrieved from: http://www.sjsu.edu/svic/index.html
[2] University of California, Berkeley (2017). Skydeck is a program of the University of California, Berkeley. Available at: http://skydeck.berkeley.edu/

guidance to determine trade or business expenses and deductions. The question is whether or not start-ups that have not yet produced any income can be considered carrying on a trade or business.

In the 2017 U.S. Tax Court case, *Samuel J. Carrick v. Commissioner*, the taxpayer was denied deductions on the business expenses he claimed on his tax return because the court did not find that he was engaged in a trade or business.[3] Taxpayer Mr. Carrick had a bachelor's degree in electrical engineering and was employed full-time in San Diego. While still employed, he started two business ventures with other individuals. In 2013, he created a website similar to Angie's List, Yelp, and eBay. He spent time collecting data and developing software. He also traveled weekly from San Diego to Los Angeles to meet with his web developer. However, the venture fell apart, and the other members left. He ended the website business before the end of 2013. In 2014, he started another venture and planned to research and develop a device that would prevent swimmers and surfers from being bitten by stingrays. He researched at the beach by interviewing swimmers and surfers, but never actually developed any devices. The IRS disallowed the claimed deductions for meals and entertainment, travel, and car and truck expenses, which were roughly 35% for 2013, and 42% for 2014, of the expenses he claimed, because the taxpayer, according to the IRS, failed to carry on a trade or business. Even if the taxpayer might have carried on a trade or business, any traveling expenses, including meals and entertainment-related activities, must be substantiated to support the deduction.[4] The IRS's decision was based on the premise that the taxpayer's activities were merely preparatory to the beginning of an active trade/business and therefore considered start-up work because true business activity never commenced. The court held that preparatory expenses are not qualified for ordinary and necessary expenses in a trade or business and subsequently denied the claimed §162 deductions.

Two primary requirements must be met in order to claim deductions on business expenses: the expenses must be incurred in a trade or business, and they must be ordinary and necessary.[5] In the U.S. Supreme Court case of *Welch v. Helvering* in 1933, the Court ruled that the business

[3] T.C. Summary Opinion 2017-56.
[4] IRC §274(d)(1) and (2).
[5] IRC §162

expenses must be ordinary and necessary to be deductible.[6] The taxpayer in the case filed for bankruptcy and was discharged from his debts, but later on paid the discharged debts and deducted these payments as ordinary and necessary business expenses. His reasoning was to re-establish his business relations with customers. There was no doubt that the taxpayer, who was the Secretary of the E. L. Welch Company and worked as a commission agent for the company, carried on a trade or business. However, the question was whether or not paying off the discharged debts to restore his customer relations could be considered ordinary and necessary business expenses. The IRS asserted that the payments were capital expenditures rather than qualified expenses because the taxpayer's purposes were to rebuild his reputation and goodwill. The Court agreed with the IRS.

Another often-cited Tax Court case, *Frank v. Commissioner,* showed that it might be difficult to prove that the expenses were ordinary and necessary without carrying on a trade or business.[7] In this case the taxpayers, husband and wife, incurred travel and legal expenses in searching for a new business and claimed the deductions on the expenses. The court denied the deductions by addressing that the taxpayers were not engaged in any trade or business. The expenses of investigating and looking for a new business were preparatory works that could not be deductible as business expenses because there was no trade or business at that time. In 2017, the Tax Court in Mr. Carrick's case made the same argument. Preparatory works were not carrying on a trade or business, so they could not be qualified as ordinary and necessary expenses.

The tax code that the taxpayers in these cases intended to apply to was §162. Per §162(a), all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business are generally allowed as a deduction. However, it may be difficult for taxpayers who do not offer products or services and who do not have customers to prove that they are actually carrying on a trade or business. In spite of these rules, taxpayers can still potentially take advantage of start-up expenditures under §195 and research and experimental expenditures under §174.

[6] *Welch v. Helvering*, 290 U.S. 111, 115 (1933).
[7] *Frank v. Commissioner*, 20 T.C. 511, 513-514 (1953).

§195 Start-Up Expenditures

Tax planning in the first year of a business is very critical. Some of the tax incentives available for a newly-created business must be adopted in the first taxable year. If the start-up misses the first-year window, it may lose some tax benefits unless it files an amended return and requests permission from the IRS. §195 is a good example.

The purpose of §195 is to give a favorable tax treatment to start-ups since start-up costs are not eligible for a deduction under §162. Start-up costs are, by definition, any amount paid or incurred "before the day on which the active trade or business begins."[8] In 1980 Congress enacted §195 as part of Public Law 96-605 to allow taxpayers to amortize start-up costs.[9] Under the original §195 tax law, taxpayers could elect to defer and amortize all start-up expenditures over a 60-month period. The current §195(b), amended by Public Law 108-357, enacted on October 22, 2004, allows taxpayers to elect to potentially deduct some startup business expenses immediately without having to amortize them. Taxpayers may elect to deduct the allowable amount in the year in which the business commences. The limit for the immediately deductible start-up expenses for the taxable year is $5,000, reduced by the amount exceeding $50,000. The remaining start-up expenditures can then be amortized over 180 months, beginning with the month when an active trade or business commences. For example, if a taxpayer starts a business on July 1st and incurs $51,000 of start-up expenditures, the taxpayer can elect to deduct a total of $5,566 ($4,000 for the first-year maximum immediate deduction allowance plus $1,566 (the $261 monthly amortization amount times six months in the first year).

Other qualified start-up business expenses include the investigation cost for looking for an opportunity and the creation cost of establishing a business. It could be difficult for taxpayers to understand what start-up costs consist of and how the costs are treated. It is recommended that taxpayers create a timeline and divide start-up expenditures into two parts:[10]

[8] IRC §195(c)(1)(iii).
[9] U.S. 96th Congress (1979-1980). H.R.7956 - *Miscellaneous Revenue Act of 1980*. Retrieved from: https://www.congress.gov/bill/96th-congress/house-bill/7956/committees
[10] Maples, Larry and Earles, Melanie James. October 31, 2000. *How to Scale the Deduction Barriers*. Journal of Accountancy. Retrieved from: http://www.journalofaccountancy.com/issues/2000/nov/howtoscalethedeductionbarriers.html.

1. Investigation costs – costs incurred before decision to start a business.
2. Creation costs – costs incurred after the decision to start the business but before commencing a business.

In the early stages of a business it is important to distinguish start-up expenses[11] from organizational expenditures.[12] Businesses can potentially currently deduct organizational expenditures up to $5,000 (depending on the total amount of organizational expenditures) and amortize the remainder over a 60-month period beginning with the month when an active trade or business commences if the costs are incidental to the creation of the business and chargeable to the capital account. Start-up expenditures are deducted in the same manner as organizational expenditures, but pertain to expenses incurred after the company has been formed but before it opens up for business.

In the earlier discussed *Carrick* case, although the IRS denied Mr. Carrick's business deductions under §162, the IRS allowed his §195 deductions. As long as start-up expenditures are reasonable, taxpayers should be allowed to use §195 once the active business begins. Taxpayers should keep all documents to support their claim of start-up expenses and deductions.

<u>§174 Research and Experimental Expenditures</u>

High-tech entrepreneurs may be eligible for §174 treatment. The purpose of enacting §174 was to provide an incentive for promoting research and development activities. Taxpayers can either currently deduct or amortize research and experimental expenditures if the expenditures incurred are in connection with a trade or business. If the taxpayer elects to amortize, the amortization period is over a period of not less than 60 months beginning when the expenditures result in a benefit to the taxpayer.

The recently finalized Treas. Reg. §1.174-2 intended to clarify the definitions and eligibilities of expenditures under §174. By definition, research and experimental expenditures are the costs for

[11] IRC §195
[12] IRC §248

research and development in an experimental or laboratory sense. The costs are in connection with a trade or business and include pilot models, which include any model or representation of a product under evaluation or in the process of resolving uncertainty in a product.[13] The success or failure of a product is not a factor in determining the eligibility.[14] Thus, the 2014 final regulation broadens the description of research and experimental expenditures.

Some research and development activities are excluded, such as the ordinary testing or inspections for the quality control, the surveys, management studies, advertising, and research related to literacy or historical projects.[15] Exploration expenditures of natural resources are typically excluded.

An important factor concerning research and development costs is that the expenditures must be reasonable. §174(e) holds that even if the activities are generally qualified as research or experimental expenditures, only reasonable research expenditures are includible. Here is an example: a taxpayer was the CEO and patent holder of the S Corporation called Estech Sytems, Inc. (ESI). He started the company in 1987 and turned it into gross revenues of $38.5 million by 2004.[16] During 2004 to 2007, he claimed flow-through research tax credits due to his company's increasing research activities under §41 (credit for increasing research activities). §41 covers the R&D tax credit, which is a general tax credit available to companies with qualified research and development costs. Per §41, taxpayers may claim a credit equal to 20% of the amount by which taxpayers' qualified research expenses for the taxable year exceed the base amount of the year.[17] The IRS denied his R&D tax credits because his wages were not reasonable under 174(e). Although the taxpayer intended to use §41, the IRS and the court used §174(e) to determine the eligibility of §41. It is worth noting that if a business is eligible to claim the R&D deduction for qualified R&D expenditures, the R&D credit (under §41) can be claimed as well (with a reduction in the normal R&D deduction). Therefore, reasonableness is always an important consideration in determining the qualification of research or experimental expenditures.

[13] Treas. Reg. §1.174-2(a).
[14] *Ibid.*
[15] *Ibid.*
[16] Eric G. Suder, et al. v. Commissioner, T.C. Memo 2014-201.
[17] IRC §41(a)(1).

The use of §174 may be limited because the R&D expenditures must be in connection with a trade or business. Although eligible expenditures include pilot models, the requirement for §174 treatment is to have an active trade or business. Mr. Carrick's ventures in the above-mentioned 2017 U.S. Tax Court case may have qualified as pilot models, but the Court did not conclude that his ventures constituted a trade or business. Even if his ventures were heavily involved in new, innovative product research and development, it was unlikely that he would be qualified under §174 treatment. To seek §174 treatment, the start-ups need to meet the minimum requirement, which is carrying on a trade or business.

Conclusion

A business incurs expenses. Unfortunately, not all expenses are qualified business costs for tax deductions. Also, it is hard to define what constitutes a trade or business. For the high-tech start-ups that do not have sufficient grounds to claim a trade or business deduction under IRC §162, finding other relevant tax codes to provide potential tax benefits can be a challenge. For tax planning purposes, it is recommended to make a timeline and record what expenses will be qualified under what potential tax provisions. Assuming you are starting up a technology business, you may need time to investigate whether your business is a good idea and conduct some market research before officially starting the business. All incurring expenses will be qualified for investigation costs under §195. After you decide to start a business but before business activity takes off, the costs incurred including traveling expenses, wages, and advertising would be qualified for creation costs under §195. If you want to utilize the $5,000 maximum deduction limit, please make sure that organization and start-up expenditures each not to go over $50,000. If your business is involved in research and experimental activities, you may seek §174 treatment and claim a research credit and/or deduction once business status begins, unless your activities are excluded in the code or regulations. Even if you never develop or launch a product, you may be still qualified for the R&D credit and/or deduction as long as your research and development activity is experimental or laboratory in nature.

For owners of single-member follow-through entities or sole proprietorship, start-up entrepreneurs report income and expenses on Schedule C of Form 1040 of their individual returns. The taxpayers can elect to deduct §195 expenses and adopt §174 treatment in Part V ("Other Expenses") on Schedule C. The §195 election is available in the first year in which the taxpayers start a business.

If a start-up is a LLC and has multiple members, the entity is by default a domestic partnership and needs to file partnership tax return (Form 1065) unless the entity elects to file as a corporation. Regardless of the form of the entity you choose, the rules for what constitutes a trade generally remains the same. When you are ready to provide a service or product, or you have customers, you are entitled to §162 business cost deductions. However, not all expenses, even if carrying on a trade or business, are deductible. The expenses have to be ordinary and necessary.