Section 195

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INTRODUCTION

Section 195,[1] enacted in 1980 to address the tax treatment of start-up expenditures,[2] unnecessarily complicates their tax treatment and likely encourages taxpayers to make inappropriate or sub-optimal tax decisions. Recent federal income tax filing data clearly suggest that the vast majority of new partnership and new C corporation taxpayers are not deducting and amortizing their start-up expenditures under section 195 as Congress and the Service expects. The tax implications are that these taxpayers either: (i) distort their income; (ii) increase their tax obligations; (iii) overstate their net operating losses; or, (iv) increase their federal income tax audit risks. This paper therefore suggests several statutory amendments to better align section 195 with its legislative intent, or suggests that Congress use this opportunity for real tax reform in this area and address the real question: whether start-up expenditures are capital or current expenses by analyzing their nature, with the goal of minimizing income distortion.

LEGISLATIVE AND CASE LAW HISTORY

Section 195: Pre-1980

Prior to Congress enacting section 195, start-up and investigatory expenses were deemed nondeductible capital expenses.[3] Courts required new businesses to capitalize these expenses based on the literal language of section 162 and on the clear reflection of income doctrine, collectively known as the "pre-opening expense doctrine" as described in *Richmond Television Corp. v. United States*.[4] The literal language of section 162 requires that businesses must first be "carrying on a trade or business" in order to deduct their ordinary and necessary expenses, and therefore start-up expenditures do not qualify. Under the clear reflection of income doctrine, these expenses were akin to the cost of purchasing an asset, and therefore deducting these expenses under section 162 would distort income as their benefits far outlasted a single tax year. This "future benefits test"[5] ultimately led to the alternative proposition that many deductible expenses may create benefits that last beyond a tax year, and so the Supreme

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[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (hereinafter "I.R.C."). All references and citations to regulations are to Treasury Regulations under the Internal Revenue Code of 1986, as amended, unless otherwise indicated. All references to the "Service" are to the Internal Revenue Service.

[2] The Miscellaneous Revenue Act of 1980, P.L. 96-605, §102.

[3] Madison Gas & Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980).

[4] 345 F.2d 901 (1965).

[5] Hotel Kingkade v. Commissioner, 180 F.2d 310 (10th Cir. 1950).

Court in *Commissioner v. Lincoln Savings & Loan*[6] held that the controlling feature instead should be whether the expenses created or enhanced a separate and distinct additional asset, and were then capital in nature and not an expense.

Given this tax landscape, taxpayers were motivated to either claim an accelerated start date for their new business so as to fall within section 162[7] or to rationalize that *Lincoln Savings & Loan* was misinterpreted and creates *a* test but not *the* test for whether an expense is ordinary or capital.[8] *Richmond Television* and its progeny still provides the test most frequently used by the Service to determine the start date of a business (see Table 1), wherein the court described that date as when "the business has begun to function as a going concern and performed those activities for which it was organized."[9]

Additionally, taxpayers seeking to expand their existing business raised unique issues for the Service with respect to their start-up and investigatory expenses. Here, the issue became whether their additional business activities should be characterized as a new business requiring these expenses to be capitalized under section 263, or whether their additional business activities should instead be characterized as expanding an existing business which permits the deduction of those expenses under section 162.[10] The difference in characterization generally depends on how closely the additional business activities resemble the existing business, and that distinction can be arbitrary depending on the feature the Service emphasizes.[11]

Table 1: Trade or Business Start Dates by Industry

Business Industry	Relevant Start Date of a Trade or Business
Manufacturing	When production begins (not receipt of revenues);[12] having the assets in place for production is not enough[13]
Retail	When doors open and revenue is generated (cash or accrual)[14]
Leasing	When doors open and revenue is generated (cash or accrual)[15]

[6] 403 U.S. 345 (1971).
[7] Frank v. Commissioner, 20 T.C. 511 (1953); Ellis v. Commissioner, 26 T.C.M. 450 (1967).
[8] Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974).
[9] Richmond, 345 F.2d at 907.
[10] Mid-State Products Co. v. Commissioner, 21 T.C. 696 (1954).
[11] Walberg, *Reconsidering the Treatment of Investigatory Costs for Taxpayers with Existing Businesses*, 10 HOUSTON BUSINESS AND TAX JOURNAL 48, 59 n.76 (2010).
[12] McManus v. Commissioner, 54 T.C.M. 475 (1987).
[13] Petrich v. Commissioner, 40 T.C.M. 303 (1980).
[14] Kennedy v. Commissioner, 32 T.C.M. 52 (1973); Walsh v. Commissioner, 55 T.C.M. 994 (1988).
[15] Francis v. Commissioner, 36 T.C.M. 704 (1977); Estate of Miller v. Commissioner, 62 T.C.M. 997 (1991).

Distribution	When assets and licenses are acquired, and the taxpayer begins using them (need not generate income yet)[16]
Publishing (books, films, photographers, music)	Generally, when the work begins[17]
Services	When doors open and services are provided or are ready to be provided[18]

Section 195: Enacted in 1980

Congress enacted section 195 in an effort to "encourage formation of new businesses and decrease controversy and litigation … with respect to the proper income tax classification of start-up expenditures."[19] As originally enacted, section 195[20] provided that taxpayers could elect to amortize their start-up expenditures over a period of not less than 60 months beginning in the month in which the business began. Start-up expenditures were generally defined as any amount paid or incurred in (a) investigating the creation or acquisition of an active trade or business or (b) creating an active trade or business, which would be an allowable deduction if paid or incurred with the expansion of an existing business.

Daniel I. Halperin, former Deputy Assistant Secretary of the U.S. Treasury Department, testified at a hearing before the House of Representatives on April 17, 1980 in support of the bill enacting section 195 that:

> The bill is designed to *reduce the disparity* [emphasis added] in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an existing business.… It is difficult to justify such disparate treatment for similar expenses.
>
> It is our hope that enactment of this bill will induce taxpayers with existing businesses to elect to amortize the start-up costs of a *marginally related business* [emphasis added] thereby reducing the number of controversies in this area. *In the unclear cases, of which there are many, taxpayers should elect to amortize* [emphasis added]; if they fail to elect and the Internal Revenue Service successfully maintains that the costs must be capitalized, the election would not be available and the costs would not be recoverable through amortization. Electing to amortize these expenses over five years would appear for most taxpayers to be a more prudent decision.[21]

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[16] Cabintaxi Corp. v. Commissioner, 63 F.3d 614 (7th Cir. 1995); Jackson v. Commissioner, 864 F.2d 1521 (10th Cir. 1989); Simonson v. Commissioner, 752 F.2d 341 (8th Cir. 1985).

[17] Gestrich v. Commissioner, 74 T.C. 525 (1980); Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982).

[18] Feerick v. Commissioner, 62 T.C.M. 174 (1991).

[19] H.R. Rep. No. 1278, 96th Cong., 2d Sess. 10 (1980) ("House Report"); S. Rep. No. 1036, 96th Cong., 2d Sess. 11 (1980) ("Senate Report").

[20] I.R.C. §195 (1980).

[21] Installment Sales Revision Act of 1980 and Minor Tax Bills: Hearing on H.R. 6883, H.R. 5616, H.R. 5719, H.R. 6039, H.R. 6140, H.R. 6247, H.R. 6824, H.R. 7009 Before the Subcommittee on Select Revenue Measures of the Comm. On

Eligible start-up expenditures therefore fell into two categories: (1) investigatory expenses, and (2) start-up expenses, both of which must have been allowable as a deduction by an existing trade or business when paid or incurred. Investigatory expenses are those "costs incurred in reviewing a prospective business *prior to reaching a final decision* [emphasis added] to acquire or to enter that business. These costs included expenses incurred in analyzing or surveying potential markets, products, labor supply, transportation facilities, etc."[22] Such expenses may relate to businesses generally, or to a category of businesses, or may relate to a particular business.[23] Investigatory expenses paid or incurred after reaching the final decision would be capitalized.[24] Start-up expenses, on the other hand, are those expenses made or incurred after reaching a final decision in the investigatory process, but before the business begins. These expenses include advertising; salaries and wages paid to hire and train employees; travel and other expenses to secure prospective suppliers, distributors, and customers; rent; utilities; insurance; and, executive compensation.[25]

Section 195 as originally enacted was problematic in that it did not mandate capitalizing those start-up expenditures for which an election to amortize was not made and therefore taxpayers were free to argue that those expenses could be deducted. Importantly, section 195 failed to reduce tax controversies as much as the Treasury Department had hoped with respect to start date disputes for new businesses and with respect to claims that the new businesses were in reality simply expansions of existing businesses.[26]

Section 195: Amended in 1984

Congress first amended section 195 in 1984[27] in an attempt to refine the original legislation and resolve its problematic provisions. This amendment was important to the extent that it clarified that taxpayers failing to elect to amortize start-up expenditures under section 195 had no choice other than to capitalize them under section 263. In addition, the amendment carved out deductions relating to interest,[28] taxes,[29] and research and experimentation.[30]

The Service then published guidance in Rev. Rul. 99-23 on applying section 195 to investigatory expenses when acquiring an existing trade or business, as opposed to creating a new trade or business. This ruling provides that ordinary expenses that are investigatory and

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Ways and Means, 96th Cong., 2d Sess. 14 (1980) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy).

[22] House Report at 10; Senate Report at 10.

[23] Senate Finance Committee Report to the Miscellaneous Revenue Act of 1980, P.L. 96-605, 96th Cong., 2d Sess. (1980).

[24] House Report at 12; Senate Report at 13.

[25] House Report at 10-11; Senate Report at 11-12.

[26] Todd F. Maynes et al., "Start-Up Expenditures," 534-4th. Tax Mgmt. (BNA) Income, Deductions, Credits, and Computation of Tax, at A7 (2014).

[27] Deficit Reduction Act of 1984. Pub. L. No. 98-369, 98 Stat. 614 (1984).

[28] I.R.C. §163.

[29] I.R.C. §164.

[30] I.R.C. §174.

paid or incurred to determine whether to enter a new business and which new business to enter qualify as start-up expenditures under section 195; however, once a taxpayer focuses on acquiring a specific business (i.e., makes the final decision) the expenses related to that attempt qualify as capital costs under section 263 as a facilitation cost. Rev. Rul. 99-23 thus provides important and detailed guidance in a fluid decision-making process to determine when investigatory costs can no longer be treated under section 195, and section 263 instead applies.

Section 195: Further Amended in 2004, and in 2010

In order to encourage small business creation[31] Congress further amended section 195 in 2004[32] to provide for a limited current deduction for start-up expenditures: up to $5,000, but then reduced dollar-for-dollar (but not below zero) for amounts greater than $50,000. Any start-up expenditures in excess of $5,000 are amortized over 180 months. The $5,000 and $50,000 thresholds were increased for tax year 2010[33] to $10,000 and $60,000 respectively, as Congress believed the increase could help encourage new business formation not requiring substantial start-up costs. Those threshold amounts then reverted back to the $5,000 and $50,000 amounts in 2011, and for subsequent tax years.

Importantly, in 2008 the Treasury Department published Treas. Reg. §1.195-1(b) which provides that taxpayers are deemed to have made the election to amortize their start-up expenditures and instead have to affirmatively elect to capitalize those expenses. Treasury couched those regulations under electronic filling initiatives acknowledging that a "vast majority" of taxpayers elect to amortize start-up expenditures, and through efforts to reduce the administrative burdens of making those elections.[34]

In retrospect, the legislative evolution of section 195 can be viewed as an attempt at Congress and the Treasury Department inducing taxpayers to compromise – that a rational taxpayer with a marginally related business under highly fact-specific circumstances should choose to apply section 195 to their start-up expenditures rather than risk their permanent capitalization when successfully challenged upon audit, with a limited current deduction used to encourage new business creation being no more than an afterthought. Permanently capitalizing start-up expenditures has the effect of deferring the taxpayer's cost recovery until the sale or disposition of the business, reducing any resulting gain or increasing any resulting loss under sections 1001, and 336.

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[31] HR Rep No. 108-755 108th Congress; Where Congress sought "to remove impediments in such [1986] Code and make our manufacturing, service, and high-technology businesses and workers more competitive and productive both at home and abroad. . ." *House Ways and Means Committee Report on American Jobs Creation Act of 2004 HR 4520.*

[32] The American Jobs Creation Act of 2004, P.L. 108-357, §902.

[33] Small Business Jobs Act of 2010, P.L. 111-240, §2031 (I.R.C. §195(b)(3)).

[34] T.D. 9411, 2008-34 I.R.B. 398.

LITERATURE REVIEW

John W. Lee's (1986) research on section 195 called the original statute (and subsequent amendment in 1984) a "deeply flawed provision and a substantial step backwards from simplicity"[35] in two respects. Firstly, that Congress left section 195 as a bare-bones statute to be fleshed out by regulations using detailed guidance in the legislative history that incorporated by reference then current controversial case law that "fatally [eroded] the certainty sought by the statute."[36] Secondly, that Congress missed the opportunity for true tax reform by failing to address the fundamental concept that the purpose of differentiating capital expenses from ordinary and deductible expenses is to minimize income distortions.[37]

According to Lee (1986), a deep structural analysis of start-up and business expansion costs must begin with "Congress' fundamental policy decision to tax net income calculated annually, with minimum distortion."[38] If currently deducting an expense does not result in more than minimal income distortion, and if the burden of capitalizing and amortizing the expense is heavy, then the expense should be currently deducted.[39] Minimal income distortion occurs when the expense to be deducted (a) is not substantial when compared to the taxpayer's income for the year or has a short useful life, (b) recurs regularly or annually in roughly the same amount, with a short or uncertain future benefit, or (c) cannot be clearly associated with a tax year.[40]

Lee (1986) cites *Cincinnati, New Orleans & Texas Pacific Railway v. United States*[41] as the first decision that uses the distortion of income analysis to allow the current deduction of an expense that benefits future years. The court reasoned "that capitalization, depreciation, and the requirement that the taxpayer's method of accounting clearly reflect income were all so 'inextricably intertwined' that the ultimate question was whether the taxpayer's (tax) accounting method clearly reflected income, and not whether the benefits generated by the expenditures extended beyond the tax year…."[42] The court heavily relied on how insubstantial the expenses were in relation to both taxable income and the taxpayer's balance sheet, as well as the burden of capitalizing and depreciating such amounts. Lee (1986) admitted that the difficulty, of course, lies in determining what was insubstantial with respect to any given taxpayer.[43]

"Managers of a growing business rarely attach much significance to labeling the growth as an expansion of the existing business or a start of a new business. The tax law, however, finds

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[35] J. W. Lee, "Stat-Up Costs, Section 195 and Clear Reflection of Income: A Tale of Talismans, Tacked-on Tax Reform and a Touch of Basics," 6 *VA Tax Rev.* (1986) 1 at 7.
[36] *Id.*
[37] *Id.* at 7-8.
[38] *Id.* at 4.
[39] *Id.* at 13.
[40] *Id.*
[41] 424 F.2d 563 (Ct. Cl. 1970).
[42] Lee, *supra* note 35 at 16.
[43] *Id.* at 17.

such labels critical."[44] So begins Glenn Walberg's (2010) examination of how the investigatory expenses of an existing business are treated under section 195. Walberg (2010) noted that taxpayers, their advisors, and the Service have "devoted substantial resources" to determining and contesting whether an activity rises to the level of a new business activity or whether it is an extension of an existing business activity, which unfortunately subjects taxpayers to "considerable uncertainty" as taxpayers generally consider business opportunities on an ongoing basis, and therefore "can drift into an investigatory phase without realizing or acknowledging its occurrence."[45] He argues that it is difficult to distinguish between routine investigative activities and those that trigger section 195, which adds another layer of tax complexity.[46]

Walberg (2010) believed that taxpayers are ill-equipped to determine if a business activity is a new business for tax purposes. However, in practice the Service looks to whether an average trade or business in a particular field would likely enter into that new activity. If so, then that activity is likely not a new business activity, unless "substantial amounts of new skills and expertise are required to enable the existing trade or business to include the other activity or pursuit . . . ."[47] Walberg (2010) writes that this analysis becomes unwieldly for taxpayers, especially in a dynamic and innovative industry with diverse competitors.[48] He therefore argues that Congress should amend section 195 to reflect that start-up expenditures should be mandatorily amortized, and that investigatory expenses for existing businesses should be fully deductible as their value quickly grows stale and loses their usefulness.[49]

METHODOLOGY

This study compares the total number of new partnerships and new C corporations filing their initial federal income tax return with those new partnerships and new C corporations who utilized section 195. The Service only recently started reporting data on the number of taxpayers filing under section 195 and the gross amounts deducted;[50] however, this data is limited to partnerships (since 2010)[51] and C corporations (since 2008)[52] (see Tables 2 and 3), and does not include tax filing data for S corporations or sole proprietorships.

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[44] G. Walberg, "Reconsidering the treatment of Investigatory Costs for Taxpayers with Existing Businesses," 10 *Houston Business and Tax Journal* 48 (2010) at 48.
[45] *Id.* at 97.
[46] *Id.* at 99.
[47] *Id.* at 59. Quoting I.R.S. Priv. Ltr. Rul. 9310001 (Nov. 4, 1992).
[48] *Id.* at 63.
[49] *Id.* at 108.
[50] Service obtains this tax filing data using line item estimates from a sampling of data from Form 4562.
[51] I.R.S. (June 20, 2018), https://www.irs.gov/statistics/soi-tax-stats-partnership-returns-line-item-estimates-publication-5035.
[52] I.R.S. (June 20, 2018), https://www.irs.gov/statistics/soi-tax-stats-corporation-income-tax-returns-line-item-estimates.

Study Results

Table 2: The table below reflects section 195 tax filing data for partnerships

Taxable Year	Partnerships Initially Filing Form 1065	Partnerships Filing Under Section 195 (Form 4562)	Total Section 195 Deduction Amount (1,000s) (Form 4562)	Average Section 195 Deduction Amount per Form 4562
2010	315,580	20,050	$ 90,401	$ 4,509
2011	311,380	12,166	$ 96,973	$ 7,971
2012	307,763	13,970	$ 49,780	$ 3,563
2013	291,132	16,075	$ 123,942	$ 7,710
2014	308,173	14,820	$ 279,278	$ 18,845
2015	339,513	32,307	$ 95,428	$ 2,954

Table 3: The table below reflects the section 195 tax filing data for C corporations

Taxable Year	C Corporations Initially Filing Form 1120	C Corporations Filing Under Section 195 (Form 4562)	Total Section 195 Deduction Amount (1,000s) (Form 4562)	Average Section 195 Deduction Amount per Form 4562
2008	106,343	25,816	$ 133,862	$ 5,185
2009	103,937	22,571	$ 71,594	$ 3,172
2010	90,196	22,721	$ 106,729	$ 4,697
2011	94,096	16,275	$ 84,572	$ 5,196
2012	96,038	14,944	$ 110,111	$ 7,368
2013	102,151	18,081	$ 136,879	$ 7,570

The tax filing data serving as the source for Tables 2 and 3 does not provide detail on business industries or geographic regions. Importantly, the Service also does not report how many tax filers elect to capitalize their start-up expenditures or their amounts. Notwithstanding these limitations, this data is still useful to the extent of what can be reasonably inferred in regard to how taxpayers are treating these expenses. This study therefore uses the total number of partnerships initially filing Form 1065 and C corporations initially filing Form 1120 as a proxy for the population of taxpayers that would generally be expected to have start-up expenditures and should have utilized section 195.

As section 195 amounts are amortized over 180 months, one expectation for this study was that the number of partnerships and C corporations filing under section 195 in any given tax year would be much greater than the number of those taxpayers initially filing their federal income tax returns, which were expected to fluctuate for any given tax year. Another expectation was that the section 195 deduction amounts would also increase over time due to the cumulative nature of amortization. This pattern was generally expected to follow the tax

filing data for 15-year (180 months) property depreciated amounts for partnerships and C corporations (see Tables 4 and 5).

Table 4: The table below reflects tax filing data for partnerships

	# of Returns Filed for 15-year Property	15-Year Depreciation Amounts in Thousands
2010	113,986	1,280,679
2011	56,313	1,205,622
2012	166,141	1,543,617
2013	156,730	1,888,800
2014	166,482	2,150,967
2015	150,822	2,288,944

Table 5: The table below reflects tax filing data for C corporations

	# of Returns Filed for 15-year Property	15-Year Depreciation Amounts in Thousands
2008	144,147	2,425,850
2009	140,703	2,034,742
2010	113,335	1,483,602
2011	71,957	972,415
2012	150,261	1,504,286
2013	160,985	1,795,333

DISCUSSION AND SUGGESTED SOLUTIONS

Discussion

What is immediately apparent from the study results in Tables 2 and 3 is that the number of partnerships and C corporations filing under section 195 is surprisingly very small when compared to the number of partnerships initially filing (ranging from a low of 3.91 percent in 2011 to a high of 9.52 percent in 2015) and C corporations initially filing (ranging from a low of 15.6 percent in 2012 to a high of 25.2 percent in 2010), with C corporations on average 3.5 times more likely than partnerships to take a section 195 deduction. Also surprising is the almost random nature of the number of partnerships and C corporations filing under section 195 and their deduction amounts over time given the cumulative nature of section 195.

The tax filing data in Tables 2 and 3 therefore suggest that the deduction and amortization provision of section 195 is being ignored by the vast majority of new partnerships and new C corporations, which contradicts the Service's statement that the "vast majority" of taxpayers elect to amortize their start-up expenditures[53] and runs contrary to Congress' stated intent. Its lack of use is problematic given the increased tax complexity section 195 has caused

[53] *Supra*, note 34.

and the likely added risk of the tax treatment of start-up expenditures being challenged on tax audit; therefore, a discussion of possible reasons why start-up expenditures are not being deducted and amortized under section 195 is warranted within the context of the following four options taxpayers have in treating these expenses.

Not Reporting Start-up Expenditures

Failing to report these expenses reflects a lack of taxpayer familiarity with section 195 and suggests that the Service should commit to additional taxpayer outreach and to tax education consistent with their mission mandate. It is very unlikely that partnerships and C corporations of any meaningful size fail to report these expenses as these taxpayers generally have access to tax advisors keen on not wasting an opportunity to recover these expenses as quickly as possible.

Deduct Allowable Start-up Expenditures and Amortize Any Remainder Under Section 195

Tables 2 and 3 clearly suggest that a vast number of partnerships and C corporations initially filing their federal income tax returns are not deducting and amortizing their start-up expenditures under section 195. One of the legislative purposes of section 195 was to encourage new business creation by allowing taxpayers to immediately deduct up to $5,000. Arguably, this limited deduction is too small to be a meaningful incentive and may instead serve to encourage taxpayers to limit their due diligence costs to no more than $5,000 in an effort to immediately recover as much as possible, which may in turn increase their financial risks by self-limiting their information.[54]

The other legislative purpose of section 195 was to reduce tax controversies between the Service and those taxpayers with existing businesses seeking to expand into additional business activities. Where the additional business activity is clearly unrelated to the existing business, the expectation is that taxpayers will apply section 195 to related start-up expenditures. Where the additional business activity is clearly related to the existing business, then the expectation is that taxpayers will deduct those expenses under section 162. In the case of additional business activities that are neither clearly unrelated nor clearly related ("marginally related additional business activities") and can therefore lead to tax controversies, the expectation is that rational taxpayers will apply section 195 to relevant start-up expenditures in order to mitigate their risk that upon audit these expenses will be capitalized. While the Service does not generally publish data on tax controversies, the tax filing data in Tables 2 and 3 suggest that if tax controversies have been reduced in this area, then the reduction is the result of either partnership and C corporation taxpayers refraining from expanding through unrelated or marginally related additional business activities altogether, or they have clearly resolved that their start-up expenditures stemming from additional business activities should be capitalized under section 263 or deducted under section 162—that there is no need to resort to section 195.

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[54] M. F. Wilberding, "An Individual's Business Investigation Expense: An Argument Supporting Deductibility," 26 *Tax Lawyer* 2 (1973).

Arguably, the nature of the business community is such that it is unlikely that those with existing businesses have refrained from expanding through additional business activities (the great recession not withstanding). Moreover, given the complexity and fact specific nature of deciding whether their additional business activities are unrelated, marginally related, or clearly related to an existing business activity, it seems likely that partnerships and C Corporations would have a fair number of business activities whereby section 195 would apply, possibly triggering tax controversies. And yet, Tables 2 and 3 reflect that few partnerships and C Corporations initially filing their federal income tax return avail themselves of the deduction and amortization provisions in section 195. Instead, the vast majority of these taxpayers clearly must then be availing themselves of one or more of the other options discussed in this section.

Elect to Capitalize Start-up Expenditures Under Section 263

Tables 2 and 3 suggest that some partnerships and C corporations initially filing their federal income tax returns may have elected to capitalize their start-up expenditures under Treas. Reg. §1.195-1. While the Service does not provide tax filing data on the number of taxpayers making this election, or their amounts, capitalizing these expenses unnecessarily delays recovering these amounts until the business is sold or otherwise disposed and thus distorts taxpayer income. Those taxpayers affirmatively making this election are no better off than pre-section 195 when taxpayers were required to capitalize their start-up and investigatory expenses, in which case section 195 has needlessly increased the complexity of the tax code in this area by adding an underutilized tax provision.

Deduct Start-up Expenditure Amounts Under Section 162, 248, or 709

Tables 2 and 3 suggest that some partnerships and C corporations initially filing their income tax returns may be deducting their start-up expenditures under section 162. Outside the context of expanding an existing business with clearly related business activities, these taxpayers may be at audit risk caused by misapplying section 162; however, the availability of an immediate deduction of up to $5,000 under section 195 may provide a partial safe harbor for these taxpayers. This immediate deduction not so much makes the case to motivate taxpayers to create new business (which was poorly supported by data) rather than make the case that the immediate deduction partially minimizes income distortion and should be extended by allowing a full deduction of all start-up expenditures. Importantly, the tax data does not support that a material number of partnerships and C corporations initially filing their federal income tax returns may be treating start-up expenditures as organizational costs under section 709 for partnerships or section 248 for C corporations.

Suggested Solutions

If the original legislative intent of section 195 to encourage new business creation and reduce tax litigation and controversies still has merit, then increasing the immediate deduction, decreasing the amortization period, and excluding the investigatory expenses of existing businesses from the definition of start-up expenditures as Walberg (2010) suggests might

individually or collectively make section 195 relevant to taxpayers.[55] All of these options have merit to the extent that they promote minimizing the distortion of income, which is consist with GAAP[56] which also seeks to minimize income distortions. While GAAP is not determinative for tax purposes, Lee (1986) admits that both financial and tax accounting seek to match income with associated costs, and therefore broad accounting concepts are useful in implementing tax policy.[57]

According to Lee (1986), in enacting section 195 Congress missed the opportunity for framing the conversation beneficially: the question should have been whether start-up expenditures are capital or current expenses by analyzing their nature, with the goal of minimizing income distortions. Lee (1986) writes that a mechanical test such as section 195 will most likely fail in making this distinction in all but the most obvious of cases.[58] He believed in currently deducting start-up expenditures that do not result in more than minimal income distortion where the burden of capitalizing and amortizing such expense is heavy.[59] The clear reflection of income test, which is the financial accounting standard and to which section 446 gives preference, may be a good tool to use in this analysis.[60] Lower courts have held that "where a taxpayer has consistently treated certain expenditures in a manner that clearly reflects net income and that also comports with generally accepted accounting principles, the taxpayer's accounting practice should be allowed to dictate tax treatment despite the contrary result arguably required by section 263."[61]

Importantly, Table 6 illustrates the results of a recent PwC survey whereby the United States is in the clear minority of countries (approximately 7 percent) where start-up expenses for corporations are either amortized for a period of greater than 5 years or must be capitalized, with approximately 56 percent of the countries included in the survey either permitting full deduction or amortization of these expenses within five years.**[62]** This survey implies that the United States might want to rethink its position in this tax area.

[55] Walberg, *supra*, note 44.
[56] ASC 720-15; ASC 835-20; ASC360-20; ASC970-10; ASC805.
[57] Lee, *supra* note 35 at 24.
[58] *Id.* at 8.
[59] *Id.* at 13.
[60] R. L. Brown and W. L. Lee, "Federal Income Taxation-Deductibility of Start-Up Expenditures Under Section 162 – The Clear Reflection of Income Test," 61 *Cornell L. Rev.* 618 at 631 (1976).
[61] *Id.* at 635-6.
[62] Any data classified as "Unclear" may be better classified under relevant and regional GAAP principles; PwC, *Worldwide Tax Summaries, Corporate Taxes 2018/9* (1, 2018), https://www.pwc.com/gx/en/services/tax/worldwide-tax-summaries.html#pdf.

Table 6: The table below reflects a PwC survey of how various countries treat start-up expenses

	Africa	Asia Pacific	Central America & Caribbean	Central Asia & Eastern Europe	Europe	Middle East	North America	South America	Total
Fully Deductible	14	9	3	11	22	4	0	4	67
Amortized ≤5 years	6	4	3	1	1	2	0	4	21
Amortized >5 years	0	0	1	1	0	0	2	1	5
Fully Capitalized	0	5	0	0	0	1	0	0	6
Unclear	10	7	11	9	13	5	2	2	59

CONCLUSION

Section 195 was enacted to provide a tax incentive to create new businesses, as well as reduce tax controversy and litigation with respect to start-up expenditures. By those measures, section 195 successfully meets its mandate only when used. After several decades and subsequent statutory amendments, the tax filing data suggest that section 195 is largely being ignored by partnerships and C corporations, which is problematic given the increased complexity this tax provision has caused, and the added risk that the taxpayer's tax treatment of their start-up expenditures will be challenged on tax audit by the Service. This paper suggests amendments that can better align section 195 with its legislative intent, but further suggests that Congress revisit the discussion of fully deducting all start-up expenditures rather than try to fix a flawed tax provision that may encourage taxpayers to make inappropriate or sub-optimal tax decisions with respect to those expenses. This paper further suggests that the Service engage in more comprehensive data gathering on this issue to better direct tax policy efforts.