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Deduction versus Amortization of Start-Up Costs: Kellett v. Commissioner

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A "start-up" typically incurs significant expenses before actually carrying on business activities. Under subsection (a) of Internal Revenue Code (Code) section 162, the deduction of trade or business expenses is limited to "ordinary and necessary expenses paid or incurred during the taxable year *in carrying on a trade or business*" (emphasis added). Thus, only when a trade or business is being carried on may expenses be deducted under that provision. The prohibition against current deduction of start-up expenditures is also stated explicitly in Code section 195, which then goes on to allow an amortization deduction over a 15-year period for such expenditures, beginning when the trade or business is actually commenced.

It is also common for a substantial portion of the expenditures of a start-up, whether incurred before or after business has commenced, to consist of software development costs. Expenditures made to acquire or increase the value of property are, in general, required to be capitalized (see Code section 263(a) and Reg. sec. 1.263(a)-1), absent application of a specific Code provision that may allow more favorable tax treatment. One such provision may be Code section 174, which allows a deduction for certain research and experimental expenditures.

Taking into account the above, two issues commonly confronted by start-up businesses and their tax advisors are (i) when a business has commenced, so that expenses may be deducted immediately under section 162(a), and (ii) whether software development costs incurred by a startup are required to be capitalized or may be deducted currently. In *Kellett v. Commissioner* (TC Memo 2022-62), the Tax Court recently addressed both points. On a point of perhaps greater interest to taxpayers generally, the decision also challenges the ability of a taxpayer to rely on published IRS guidance which is judicially determined not to be supported by any provision of the Code.

Facts in *Kellett*

Gregg Kellett, while employed full-time as a manager by a publisher of business and legal information, began work from home on a venture (not his first) involving creation of a website that would provide a user-friendly interface to access demographic, social, and economic data already available on the internet.

In 2013 Kellett acquired the vizala.com domain name for the website to be created and formed an eponymous limited liability company. He was the sole member of the LLC, and it was disregarded as an entity separate from him for federal tax purposes. Kellett then created certain web pages for the website himself, and he hired engineers to develop interactive features of the website using open-source software.

The website was opened to the public in or around September 2015. Although Kellett envisioned various means of deriving revenue from the website, including selling advertising space or implementing a "paywall" and charging a monthly fee for access, he did not implement any of these strategies in 2015 (the year before the court), and revenue was not derived from the website until 2019.

Kellett's Form 1040 for 2015 included a Schedule C that claimed as deductions the payments made in 2015 to the engineers ("engineer expenses") and other expenses relating to the website activity, including marketing and internet service expenses. All of those deductions were disallowed under a notice of deficiency from the IRS, and Kellett petitioned the Tax Court for review of the deficiency. The discussion below focuses solely on the treatment of the engineer expenses.

In the Tax Court proceedings, the government conceded the business purpose for the expenses, but argued that none were deductible in 2015, on the rationale that the business did not begin before or during that year.

Discussion

Code section 195 addresses the treatment of "start-up expenditures," which are defined to include (subject to specified exceptions) any amount paid (i) in connection with the investigation of an active trade or business (hereafter "ATB"), (ii) to create an ATB, or (iii) otherwise in connection with any activity engaged in for profit before the date on which the ATB begins.

Section 195(a) provides that no deduction will be allowed for start-up expenditures, except as otherwise provided in section 195. Under section 195(b), a deduction is allowed in the year in which the ATB begins, in an amount not in excess of $5,000 (reduced dollar for dollar by the amount by which start-up expenditures exceed $50,000). The remaining start-up expenditures are deductible ratably over a 15-year period beginning with the month in which the ATB begins.

Section 195(c)(2)(A) provides that, in general, the determination of when an ATB begins will be made "in accordance with such regulations as the Secretary may prescribe," but no regulation addressing this point has been issued under section 195.

The court noted that a traditional business, such as a grocery, will start earning revenue once customers arrive. The website developed by Kellett did not fit within this model. He believed that traffic to the website would have to be encouraged for a period of time through free access before any revenue-producing strategy could be implemented -- and, so far as appears from the decision, the government did not introduce any evidence to the contrary. The court concluded, under case law within the Fourth Circuit (the anticipated venue for any appeal), that the business commenced when it began to provide the services for which it was organized. Taking into account Kellett's failure to provide evidence as to the specific date, beyond "September 2015," on which the website became open to the public, the court determined that the business began on September 30, 2015.

The court concluded, on this basis, that engineer expenses paid after September 30, 2015, were deductible in 2015 under section 162 as business expenses. However, engineer expenses paid before that date were determined to be start-up expenditures amortizable under section 195 over a 15-year period beginning with September 2015.

Kellett made additional arguments in support of immediate deduction of expenditures paid before September 30, 2015. He argued that section 174(a), as in effect during 2015, permitted immediate deduction of "research or experimental expenditures which are paid or incurred by him during the taxable year in connection with his trade or business," and that the pre-September 30 engineer expenses were deductible under that provision.

An expenditure may be incurred by a taxpayer "in connection with his trade or business" within the meaning of section 174(a) even if the taxpayer is not yet "carrying on any trade or business" within the meaning of section 162(a) (*Snow v. Commissioner*, 416 U.S. 500 (1974)).

Regulations under section 174 define "research or experimental expenditures" as expenditures intended to discover information that would "eliminate uncertainty" concerning the development or improvement of a product (Reg. sec. 1.174-2(a)(1)). The court concluded, on the basis of cases cited in the opinion, that the expenditures made to develop the website were not research or experimental expenditures as so defined. Kellett knew, before the project began, which software tools could be used to develop the website; similar data aggregation websites already existed with respect to other types of information; and Kellett and the engineers were able to develop the website using generally available open-source software. Therefore, the expenditures were not research or experimental expenditures that could be deducted under section 174 as then in effect.

Kellett then argued that Rev. Proc. 2000-50 authorized the deduction. Section 5.01 of that revenue procedure states that the costs of developing computer software "in many respects so closely resemble the kinds of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment." It concludes on that basis that the IRS "will not disturb" a taxpayer's consistent treatment of costs paid to develop software for a project as current expenses that are "deducted in full in accordance with rules similar to those applicable under section 174(a)."

The government argued that Rev. Proc. 2000-50 was not intended to apply to expenditures paid before an ATB had begun. The court noted that the revenue procedure does not expressly require a current ATB and did not appear to believe that this requirement or a similar requirement was effectively incorporated by the revenue procedure's statement that covered software expenses may be deducted in accordance with rules similar to those applicable to section 174(a), which applies by its terms to expenditures incurred "in connection with" the taxpayer's trade or business.

Nevertheless, the court did not permit Kellett to rely on the revenue procedure. The court further observed that, "[t]o the extent Rev. Proc. 2000-50 purports to establish the taxpayer's entitlement to a deduction," there must be a statutory basis for that deduction, and concluded that such a basis was not established with respect to expenditures paid before an ATB begins. Because there was no statutory authorization for that result, those expenditures of Kellett could not be deducted in 2015.

Kellett argued that the rule of the revenue procedure, in allegedly authorizing a current deduction of software expenditures before an ATB began, should be enforced against the IRS even absent statutory authorization under the rationale of equitable estoppel. The court responded, however, that, even if one assumed (arguendo) that the doctrine of equitable estoppel could ever be applied against the government, such a remedy could only be available in a court of equity. The Tax Court, as a court of law, had no authority to impose equitable estoppel against the government.

Observations

The court's analysis that an ATB may commence under section 162(a) before any revenue is received should be welcomed.

With respect to the court's analysis of Rev. Proc. 2000-50, the government may have been correct that the revenue procedure should be interpreted as only applying to expenditures paid after a taxpayer began an ATB. Under that interpretation, the rule of the Revenue Procedure is at least arguably within the scope of IRS authority under section 162 and related provisions.

The continued vitality of Rev. Proc. 2000-50 is open to question given the substantial changes made to section 174 in 2017, effective for tax years beginning after 2021. As a general proposition, however, it is somewhat concerning that, at least in the Tax Court, a taxpayer has no assurance of being allowed the tax treatment set forth in published guidance of the IRS, if a court concludes that the published guidance lacked statutory authorization.

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