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Valuable Business Tax Deductions

By TurboTax

Valuable Business Tax Deductions

You may be able to take more business deductions than you thought. Below are some of the most common business expenses that you may be able to deduct from earnings, to lower your taxes.

To determine whether a business expense is a business deduction, you should ask yourself: Is this expense both "ordinary" and "necessary". Both elements are required by the IRS for an expense to be a valid business deduction.

- An expense is ordinary if it is common and accepted in your industry.
- A necessary expense is one that is helpful and appropriate for your business.

Automobile Expenses

You can deduct automobile expenses for visits to clients, customers, or a business meeting away from your regular workplace. If you have a home office, a drive from your home to a supplier and back home again is a 100% deductible business expense.

When figuring expenses, you may choose between the standard mileage rate (for 2003, 36 cents per mile, for 2004, 37.5 cents per mile), or your actual expenses, which includes items such as gas, oil changes, tires, repairs, preventative maintenance, insurance, registration. If you choose to deduct your actual expenses in the year you start using your car for business, you are making an "irrevocable election," which means that you can't switch to the standard mileage rate later. If you choose the standard mileage method first, you can switch to actual expenses in a later year.

In most cases, choosing the standard mileage method yields the higher deduction. Your results may differ if you have an inexpensive car or a luxury car, trade your vehicle often, drive infrequently, or drive very short distances. Calculate both methods to see which one gives you the higher deduction.

If you decide to deduct expenses for your car or truck, you must keep a log of your trips noting the date, the miles driven, and the purpose of each trip. Try to log your trips as they occur, when it's easier to keep track of the details. You're also more likely to have an accurate (and usually higher) total of the miles you drove than if you try to recall trips later. Recording information at the time you make the trip is also very helpful if the IRS ever audits you, the IRS requires written documentation to substantiate your deduction.

If you need additional information, see Automobile Write-offs for Business Owners, How to Deduct your Auto Expenses at www.turbotax.com and IRS Publication 463: Travel, Entertainment, and Gift Expenses.

Bad Debts

If you have accounts receivable, you're likely to encounter bad debt. When someone doesn't pay you for work you performed or products you sold, you may take a bad debt deduction against your gross revenue, which reduces both your income tax and your self-employment tax.

Business bad debts aren't limited to accounts receivable. You may incur a bad debt expense if you loaned money to customers, suppliers, or employees who never paid you back.

You must use the accrual method of accounting to get this deduction. If your business uses the cash basis method of accounting, you can't deduct a bad debt expense because with the cash basis method, you don't include an amount in your gross revenues until you receive it.

Depreciation

With an ordinary business expense, you deduct the entire cost of the purchase in that tax year. But if you purchase an asset for your business that you will use beyond the current tax year, you must spread out the deduction over the asset's expected life. This concept of spreading out a deduction over the "life" of an asset is called depreciation. The asset must meet three requirements in order to be depreciated:

1. It must be used in the business or held to produce income.
2. It must be expected to last more than one year.
3. It must be something that wears out, gets used up, or loses its value over time.

The following assets can't be depreciated:

- Property that you place in service and dispose of in the same year
- Inventory
- Land
- Repairs and maintenance that do not increase the value of your asset, make it more useful, or increase its life. (These expenses are generally deductible in full in the year in which you pay them).

If you are eligible, you may deduct the entire cost of the asset in the year it is placed in service in your business instead of spreading the cost out over the life of the asset. This deduction is known by its section in the tax code, as a Section 179 deduction.

While the idea of taking a huge deduction may sound good to you, be careful, because there is a downside to using Section 179. If you dispose of an asset before the end of its useful life, you must recapture the original deduction on Schedule C. "Recapture" means reversing part of the effects of your original deduction, which in turn increases both self-employment tax and your income tax. Before you take the section 179 deduction, be sure that you will use the asset in the business for its entire useful life. Tip: Use tax preparation software such as TurboTax or go to a tax professional when thinking of taking the Section 179 deduction.

Employee Expenses

The wages you pay employees for producing goods or services are deductible, including salaries, fringe benefits, employee benefits, awards, bonuses, sick pay, and vacation pay. You get a deduction regardless of whether you pay wages to employees (to whom you provide a W-2) or use contract labor (independent contractors, to whom you provide Form 1099).

Deductible fringe benefits include:

- Discounts on goods or services
- Flights on airplanes
- Meals and lodging
- Memberships in country clubs
- Tickets to entertainment or sporting events.
- Use of a car

Deductible employee benefit programs include:

- Accident and health plans
- Adoption assistance
- Cafeteria plans
- Dependent care assistance
- Educational assistance
- Group-term life insurance coverage

Report these expenses on your Schedule C, line 14, Employee Benefit Programs.

Home Office Expenses

To take the home office deduction, you must use your home office regularly and exclusively for your business, and your home office must be your principal place of business.

To meet the regular and exclusive test, the area where you work should be a separate room in your home. However, if the area is a common area in your home, it can also qualify as long as you use it exclusively for business. If you have a desk located in a family room, for example, mixing your business correspondence with your personal mail could cause the deduction to be disallowed.

- Exclusive use means that your children cannot use your office computer to do research for school, or to play computer games.
- Regular use does not necessarily mean that you must use the office daily or even weekly, just that you use it on a regular basis. Occasional or incidental use does not qualify for business use, even if the office is used exclusively for business purposes.

To claim that your home office is your principal place of business, you must:

- Perform the most important part of your work there, or
- Use the office for administrative or management activities of a trade or business, and not perform these administrative or management activities at any another location, such as another office off-site. Administrative and management activities include, but are not limited to billing customers, keeping books and records, setting appointments, calling in orders, ordering supplies, and writing reports.

Exceptions: You can claim the home office deduction if you store inventory or product samples there, or if you operate a day-care facility.

If you own your home and are operating your business at a loss, your home office deduction is limited to your direct expenses, which are the deductions normally taken on Schedule A. You can't deduct indirect expenses such as insurance, utilities, and depreciation at all unless your gross income is greater than the sum of your expenses.

Even then, you divide your office's square footage by your home's square footage to obtain the percentage of your home that you use for business purposes. You then apply the resulting percentage to your indirect expenses to determine your deductible home office expenses.

Because the home office deduction is a complex area that has been the subject of much controversy and many court cases, you may want to look at more detailed discussions of this deduction, in Calculating Home Office Expenses, Rules for Taking the Home Office Deduction, Should I Take the Home Office Deduction? at www.turbotax.com and IRS Publication 587: Business Use of Your Home.

Insurance

You can deduct insurance expenses as long as they're determined to be "ordinary and necessary" expenses. Common examples include

- Credit insurance on losses from unpaid debts
- Fire, theft, and flood insurance
- Liability or malpractice insurance
- Medical insurance
- Overhead insurance
- Vehicle insurance

There are a few types of insurance premiums that you may not deduct. These include:

- Insurance for securing a loan. For example, if you take out a policy on your life in order to obtain or protect a business loan, that premium is nondeductible.
- Life insurance policies beginning after June 8th, 1997.
- Loss-of-earnings insurance
- Premiums on most life insurance policies
- Self-insurance reserve funds (a savings account)

For 2003, you can deduct up to 100% of the health insurance and qualified long-term care insurance payments for yourself and your family. If your spouse works in the business with you and you provide a health insurance plan that covers your employees and their dependents as well as your spouse and family, you can deduct 100% of your health insurance expenses.

For more information, see Deducting Long-Term Care Services and Medical Expenses Checklist at www.turbotax.com.

Interest

Generally, you can deduct all of the interest you pay during the tax year on debts related to your business. For example, if you take out a bank loan to help secure additional inventory to increase your business, that interest is deductible.

If you're just starting your business and use a credit card to help with start-up costs, that interest is deductible as well. The source of the interest doesn't matter. If a relative loans you money to start a business, the interest you pay to your relative is also tax deductible.

Watch out for loans that are for both personal and business uses. For example, if you take out a loan for a car that you use in your business and for personal purposes, part of the loan interest won't be deductible. You can only deduct 100% of the loan interest if you can prove that you use the car 100% for your business.

Legal & Professional Fees

Fees that you pay to professionals, attorneys and accountants are considered ordinary and necessary when they relate to your on-going business. If you purchase a new business, the fees paid for professional services are added to the tax basis (or cost) of that business.
Example:

You negotiate the purchase of a pool-cleaning route for $22,500. You hire an attorney to draft a non-competition agreement, and hire an accountant to perform a due diligence review of the books. You pay $2,500 in professional fees. For tax purposes, your cost basis in the pool route is $25,000 ($22,500 + $2,500).

You can deduct tax preparation fees to the extent that the cost is related to your Schedule C business. For example, if all the income on your income tax return is related to your business, you may allocate nearly all of the tax preparation expenses to the Schedule C.

On the other hand, if you have interest and dividend income, numerous donations to charity, a mortgage, a few rental properties, and a Schedule C business, you should allocate the tax preparation expenses throughout the return. Allocate some of the expenses to Schedule A (where it is only deductible when it exceeds 2% of your adjusted gross income – line 35 of Form 1040), some to Schedule C (your small business), and some to Schedule E (where you report rental income and expenses).

Pension Plans

If you set up and maintain a Simplified Employee Pension (SEP) plan, a Savings Incentive Match Plan for Employees (SIMPLE plan), or a Qualified Plan (Keogh or H.R. 10 plan) for yourself and your employees, you can deduct contributions you make to the plan for yourself and your employees. Deduct your contribution on form 1040 and your employees' contributions on Schedule C.

You can also deduct trustee fees incurred to maintain and administer the plan. For more information about the different plans and how to set up a plan for your business, see

- Taxes and Your Retirement Plans
- Retirement Plans for the Self-Employed
- What is a SEP?

- IRS Publication 560: Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)
- IRS Publication 590: Individual Retirement Arrangements

Rent

The IRS defines rent as any amount that you pay to use property you do not own. Most of us are familiar with the concept of paying rent for office space, land, or equipment. But you may not know that you can deduct part of your rent on your home, condo, or apartment if you use part of it as a place of business. (You must meet the requirements for a home office).

If you rent property from your relatives and the IRS deems the rent to be excessive, the IRS will disallow the deduction. To avoid this, make sure the rent is comparable to what you would pay a stranger. Contact a real estate agent and have him or her prepare “comps” (or comparisons) of similar properties in the area to substantiate the rent you are paying to a relative. For the IRS definition of a relative, see IRS Publication 538: Accounting Periods and Methods.

Taxes

There are many taxes that you can deduct when operating a business. For example, if your state taxes are based on the gross income of your business, you can deduct the state income tax. You can also deduct employment taxes such as Social Security, Medicare, federal unemployment taxes, and state unemployment taxes.

Here are some other taxes you can deduct:

- Personal property taxes imposed by your state or local government
- Real estate taxes, which are deductible to the extent that you use the land for your business. If you qualify for the home office deduction, you can deduct a portion of your real estate tax against your gross revenues.
- Sales taxes, which are deductible when paid for business-related purchases or services. Note: you can’t deduct the state and local sales taxes that you charge your customers, because they paid those taxes, and you just passed them along to the state. Also, don’t include the amount of sales tax you collected in the gross receipts you report for your business.
- Excise taxes, which are also deductible to the extent that they are “ordinary and necessary” for the operation of your business.

Fuel taxes that you pay for gasoline, diesel, or other types of motor fuels are already reflected in the cost of the fuel, and therefore aren’t deductible. Note that you may be entitled to a credit or refund for federal excise tax you paid on fuels used for certain purposes – for example, in a farming operation where you don’t use vehicles on maintained roads or highways.

Travel, Meals & Entertainment Expenses

Any payments you deduct for travel, meals, and entertainment must be the ordinary and necessary expenses of carrying on your trade or business. In general, entertainment expenses must be directly related to, or associated with, the conduct of your trade or business.

Travel expenses include those for ordinary and necessary travel away from your home for your business. You must meet two conditions to take the travel expense deduction.

1. Your duties must require you to be away from the general area of your tax home (your regular place of business, regardless of where you maintain your family home) substantially longer than an ordinary day's work.
2. You need sleep or rest to meet the demands of your work while you're away from home.

If your trip meets these requirements, you can deduct a wide variety of travel-related expenses, including:

- Transportation expenses (using a plane, train, bus, or car) between your home and your business destination, including taxi, commuter bus, and limousine fares
- Baggage and shipping expenses for sending samples or display materials
- The costs of operating and maintaining your vehicle if you use your car or truck for business travel. You can choose between actual expenses or the standard mileage rate.
- Tolls and parking fees
- Rental car expenses for the business portion of the usage.
- Meals and overnight lodging. Meals are subject to a 50% deduction limitation.

Other deductions traditionally related to business travel include dry cleaning and laundry care, telephone calls (including those made from a plane), use of fax machines, and tips. For more information on travel, see IRS Publication 463: Travel, Entertainment, Gift and Car Expenses.

Meal expenses include those incurred while traveling away from home or for entertainment of business customers at your place of business, a restaurant, or other location. This deduction may also apply to meals you furnish on your premises to your employees.

Entertainment expenses fall into a broad category and include any activity generally considered to provide entertainment, amusement, or recreation. Some examples include: entertaining guests at social, athletic, or sporting clubs, theaters, yacht trips, hunting, fishing, vacation, and similar trips.

Other Deductible Expenses

There are numerous other business expenses you can deduct. So far, we've discussed the most common expenses that appear on Schedule C. Other deductible expenses include:

- Advertising
- Clean-fuel vehicles
- Donations to business organizations
- Educational expenses
- Environmental cleanup costs
- Licenses and regulatory fees
- Outplacement services
- Penalties and fines you pay for late performance or nonperformance of a contract
- Repayments of income

Expenses You Can't Deduct

Some business expenses are not deductible under any circumstances:

- Demolition expenses and losses. (These costs increase your tax basis in the property, reducing your eventual gain when you sell, thus lowering your capital gains tax in the future.)

- Dues to business, social, athletic, luncheon, sporting, airline, and hotel clubs.
- Lobbying expenses
- Penalties and fines you pay to a governmental agency or instrumentality when you break the law.
- Political contributions

Repairs that add to the value of your property or significantly increase its life. (These costs must be depreciated.)

For More Info

See Miscellaneous Deductions and Maximize Your Deductions at www.turbotax.com.