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RULES ON COMMON BUSINESS DEDUCTIONS

This is a summary of rules on some of the most common business deductions that the IRS frequently examines during an audit. The summary below is a very condensed version of the rules, with details omitted for brevity. Other types of deductions are not discussed. If you have any questions about the deductions, contact us or visit www.irs.gov.

GENERAL RULE

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business.

The law does not provide an exhaustive list of deductible expenses, but the general rule above is a guideline. For example, excessive amounts of expenses (like travel or meals) may call into question whether they are ordinary and necessary. The IRS may evaluate using facts and circumstances, such as the amount of business income and the type of business.

VEHICLE EXPENSES

Miles from one work location to another work location are deductible. Miles from your house to your work place, and vice versa, are not deductible. But if you have a home office (note, there are strict requirements to claim a home office), then miles from your house to another work location are deductible. To claim vehicle expenses, make sure to keep the following records:

1. documentation identifying the vehicle and proving ownership or a lease;
2. mileage log showing date, business purpose, description, location, destination and miles of each trip (you may use a paper log, a phone app, or other software). Certain vehicles are exempt from the mileage log requirement, such as trucks with loaded gross vehicle weight over 14,000 pounds and passenger buses;
3. receipts, invoices and bank statements proving payment for various expenses like gas, parking, toll, repairs, oil, etc.
4. an independent 3rd party mileage reading (like a car repair shop) at the beginning or end of each year (to compute total miles driven for the year)
5. date vehicle is placed in service (i.e. first used for business)
6. cost of vehicle, if owned

Click on this IRS link for more info: Car and Truck Expense Deduction

MEALS AND ENTERTAINMENT

50% of the cost of entertaining a client or employee can qualify as a business expense. This includes the cost of meals, and the cost at nightclubs, social clubs, sports facilities, theaters, vacation or similar trips.

To qualify, the meal or entertainment expense must be EITHER:

1. Directly related to the active conduct of business – the main purpose of the event was business; the taxpayer actually engaged in business during a meal or entertainment activity; and there is more than just a general expectation of receiving income. OR
2. Associated with the active conduct of business – the taxpayer provides the entertainment or meal directly before or after a substantial business discussion.

For each entertainment activity, keep a log of the following information:

1. Name, company, and business relationship of all attendees;

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2. Name and location of the establishment where the event took place;

3. Amount and date of the expense (as proven by bank statements, invoices and receipts); and

4. Description indicating the business purpose of the expenditure.

Click on this IRS link for more info: Entertainment Expense

BUSINESS TRAVEL EXPENSES

Deductible travel expenses consist of transportation and lodging expenses while away from tax home ON BUSINESS. To deduct travel expenses, taxpayers must be away from their tax home longer than an ordinary work day (usually at least overnight). The tax home includes the entire city or general area where the taxpayer regularly conducts business. Taxpayer must maintain an account book, diary, log, trip sheet or similar records, as well as documentary evidence (like receipts and canceled checks) to substantiate the amount, time, place, and business purpose of the expenditures. Examples include plane or bus fare, car rentals, and lodging.

Click on this IRS link for more info: Business Travel Expenses

BUSINESS GIFTS

GIFTS IN GENERAL: You can deduct NO MORE THAN $25 for business gifts you give directly or indirectly to EACH PERSON during your tax year.

Tax Tip: Items that could be considered either a gift or entertainment expense normally are considered entertainment. If you give your business associates tickets to an entertainment activity and you DO NOT attend the event, you can choose which is the most advantageous treatment.

For each gift, keep a detailed record of the name of the recipient, and the occasion.

GIFTS FOR EMPLOYEES: If you give minimal benefits to employees, you can exclude the value from the employees' wages. For example, turkeys, hams, or other items of nominal value given to employees at Christmas or other holidays are deductible business expenses, and not taxable to the employees. But a gift of cash, a gift certificate, or a similar item that can easily be exchanged for cash must be reported as wages of the employee/s regardless of the amount involved.

Click on these IRS links for more info:
- Gift Expenses
- De Minimis (minimal) Benefits for Employees

HOME OFFICE DEDUCTION

To qualify for home office deduction, the area in the home used for business must be used REGULARLY and EXCLUSIVELY:

1. As the principal place of business (including administrative use); or

2. As a place to meet with clients in the normal course of business; or

3. In connection with the business if it is a separate structure not attached to the taxpayer's personal residence.

REGULAR use means the area is used on a continuing basis. Occasional or incidental business use does not meet this test, even if the area is used for no other purpose.

EXCLUSIVE use means a specific part of the home is used ONLY for business purposes. This is a very strict and rigid rule – any indication of personal use, no matter how small, disqualifies the expense.

To document business use, take a picture of the office space, position a calendar in the background, and encode a date on the picture. Do this every tax year.

Click on this IRS link for more info: Home Office Deduction

WORK-RELATED EDUCATION COSTS

To be deductible, the course must be expressly required by an employer, by law or by government regulation. Or it must maintain or improve skills required in performing a PRESENT job. One CANNOT deduct education cost to: (1) return to a job; (2) meet minimal requirements for a trade/business; OR (3) qualify for a new job, trade or business.

If your course qualifies under the above requirements, you can deduct: (1) Tuition and (2) Books, supplies and equipment (if paid to the school as a condition for enrollment)

Click on this IRS link for more info: Work-Related Education

INDEPENDENT CONTRACTORS

If you paid at least $600 in cash, check or by ACH to an independent contractor in one year for rent or services in the course of your trade or business, then you must issue him/her a Form 1099-Misc by January 31 and file a copy with the IRS by February 28 of the following year. Failure to file may result in penalties and/or disallowance of deductions. For your records, ask the independent contractor *at the time of hiring* to fill out a Form W9 so you have a record of his complete name, address and tax ID number.

An independent contractor (IC) is different from an employee. If an employee is misclassified as an independent contractor, the IRS may impose delinquent payroll taxes, late filing penalties, and interest. These basic tests will help you make the proper classification:

1. Behavioral Control - an employer has the right to control how an employee performs the work. An IC usually retains control over how the work is done.

2. Financial Control - an employer has the right to control how the business aspects of an employee's activities are conducted. An IC has the right to control his own business activities.

3. Relationship of the Parties - health insurance, pension plans vacation and sick benefits are paid only to employees. If the worker's services are an integral part of the business operations, the worker is generally an employee.

Click on these IRS links for more info:
Form 1099-Misc Instructions
Independent Contractor or Employee?

CAPITAL EXPENSES

Capital expenses are considered assets and must be capitalized. Instead of an outright deduction, they are deducted through depreciation, amortization or depletion. In general, there are three types of costs you capitalize:

1. Business start-up/organization cost – training wages; analysis or survey of potential markets; costs to create a corporation; business start-up consultants; etc

2. Business assets – computers; furniture and fixtures; equipment (but there may be a way to deduct these outright, subject to limitations)

3. Improvements – office renovations

CHARITABLE CONTRIBUTIONS

A sole proprietorship, partnership or S corporation cannot deduct charitable contributions as a business expense. Instead, they are deductible as an itemized deduction on the proprietor, partner or stockholder's personal taxes, respectively. However, a C corporation may deduct them as business expenses. Substantiation requirements are as follows:

CASH DONATIONS: Regardless of amount, keep bank records or written acknowledgment from the charity stating the amount and date. If it is $250 or more in any one day, provide written substantiation from the organization, not just a bank record.

NONCASH DONATIONS: Regardless of amount, a record of the following is required:

1. name of charitable organization;

2. date and location of contribution;

3. reasonably detailed description of contributed property;

4. fair market value and method of valuing the property.

Though not required, it is advisable to take a picture of the items to prove that they are in "good used condition". The following additional requirements apply, depending on the fair value of the total noncash donations:

Less than $250. A written receipt is required.

$250 to $500. Written acknowledgment from the charitable organization, stating the general

information listed above. It must also state whether any goods or services were provided to the donor in return for the contributions.

$501 to $5,000. Same records required as the $250 to $500 category. In addition, the taxpayer's records must show how the property was acquired, the date acquired and the adjusted basis of the property.

More than $5,000. Same requirements as $501 to $5,000 category. Most contributions over $5,000 require a written appraisal.

Click on these IRS links for more info:

IRS Publication 526: Charitable Contributions

IRS Tips for Year-end Giving

UNIFORMS AND WORK CLOTHES

The cost and upkeep of uniforms and work clothes are deductible if they are required by the nature of the business and the clothes are not suitable for everyday wear. Examples of deductible work clothes: uniforms of athletes, policemen and nurses; shirts with company logo; and protective clothing such as safety boots. Examples of *non*-deductible clothes: business suits, even if purchased specifically for business functions, and any other clothing that is suitable for personal wear.

PERSONAL VERSUS BUSINESS EXPENSES

If you have an expense for something that is used partly for business and partly for personal purposes (like phone, internet and interest expense), divide the total cost between the business and personal parts. You can deduct the business part. For example, if you borrow money and use 70% of it for business and the other 30% for a family vacation, you can deduct 70% of the interest as a business expense. The remaining 30% is personal interest and is not deductible. Likewise, if you use a bank account for both business and personal use, the related bank charges must be allocated. Note, however, that we strongly recommend that you use a separate bank account to be used solely for business.

FAQS ON GOOD RECORD-KEEPING

How long should I keep tax records?

GENERAL RULE: keep copies of your income tax returns and supporting documents for at least 4 years (preferably 6 if space is not critical) from the due date of the return, or from the time you filed your tax return, whichever is later. If you do not file a return, or you file a fraudulent return, the IRS has no time limit to inspect your documents.

After the period runs out, may I throw away tax documents?

You may, but we strongly encourage you to scan all the documents before you shred them.

Do not throw away documents that may have longer/permanent relevance, such as copies of your tax returns, closing statements on the purchase of a house, IRS notice approving an installment agreement, estate and gift tax returns, divorce and property settlement agreements, deeds, title insurance policies, and all trust documents.

How can I substantiate the items on my tax returns?

Specific deductions may require specific documentation requirements. But in general, you need to prove ***all*** of the following for each deduction:

1. the date, amount and description of the expense (*e.g.* invoice, written acknowledgment from payee)
2. proof that taxpayer paid the amount (cancelled check, bank statements, official receipt)

Are there additional record-keeping tips I can use for my business?

1. Use your business bank accounts for all business transactions. Do not use your business bank accounts for personal purposes (or vice-versa). Note, however, that a sole proprietor is allowed to draw money from the business. Likewise, subject to basis limitation rules, an S corporation stockholder may receive nontaxable distributions and a C corporation stockholder may receive taxable dividends.
2. If possible, pay your expenses by credit card or debit card. This automatically provides you with

written documentation via the bank statement's line item description. Keep the receipts as well.

3. Request your bank to print the cancelled check images on the bank statement itself. Usually, the bank charges a minimal monthly fee for this feature. This is very helpful during an audit, since the auditor is able to readily see the check details on the bank statement itself. If the audit goes back to, say, three years prior, it is a challenge for many taxpayers to look for the actual cancelled checks, and ordering extra copies is more expensive.

Click on these IRS links for more info:

Keep Good Records to Reduce Tax-Time Stress
IRS Publication 552: Recordkeeping for Individuals
IRS Publication 583: Starting a Business and Keeping Records

And here is a link from CA FTB: Record Retention