

Small Business Tax Deductions

Stephen Fishman, J.D.

Table of Contents

Chapter 1 – Tax Deduction Basics	1
Learning Objectives	1
Introduction.....	1
How Tax Deductions Work.....	1
Types of Tax Deductions	1
You Only Pay Taxes on Your Business Profits	2
You Must Have a Legal Basis for Your Deductions.....	2
You Must Be in Business to Claim Business Deductions	2
How Businesses Are Taxed	2
Basic Business Forms.....	3
Tax Treatment	4
Spouses Who Co-Own a Business.....	5
The Value of a Tax Deduction.....	7
Federal and State Income Taxes.....	7
Self-Employment Taxes	7
Total Tax Savings	8
What Businesses Can Deduct.....	9
Start-Up Expenses.....	9
Operating Expenses	9
Capital Expenses	9
Inventory.....	11
Businesses That Lose Money	11
Figuring a Net Operating Loss.....	11
Carrying a Loss Back.....	12
Carrying a Loss Forward	12
Review Questions.....	14
Review Answers	15
Chapter 2 – Are You Really in Business	16
Learning Objectives	16
Introduction.....	16
What Is a Business?	16
Profit Test.....	17
Behavior Test	18
Tax Consequences of Being a Hobbyist.....	20
Income-Producing Activities.....	21
Tax Consequences of Income-Producing Activities	21
Types of Income-Producing Activities.....	23
Professional Trading in Stocks.....	24
Real Estate as a Business	25
Review Questions.....	26
Review Answers	27
Chapter 3 – Start-Up Expenses	28
Learning Objectives	28
Introduction.....	28
What Are Start-Up Expenses?	28
Starting a New Business	29
Common Start-Up Expenses.....	29
Costs That Are Not Start-Up Expenses	29
Buying an Existing Business	30
Expanding an Existing Business	31
When Does a Business Begin?.....	31

Table of Contents

Retail Businesses	31
Manufacturers.....	32
Knowledge Workers.....	32
Service Providers.....	32
An Existing Business	32
Claiming the Deduction.....	33
If Your Business Doesn't Last 15 Years	33
Expenses for Businesses That Never Begin.....	34
General Start-Up Costs.....	34
Costs to Start or Acquire a Specific Business.....	34
Organizational Expenses	35
Avoiding the Start-Up Tax Rule's Bite	35
Review Questions.....	36
Review Answers	37
Chapter 4 – Business Operating Expenses.....	38
Learning Objectives	38
Introduction.....	38
Requirements for Deducting Operating Expenses	38
Ordinary and Necessary	38
Current Expense	40
Business-Related.....	41
Reasonable	42
Operating Expenses That Are Not Deductible	44
Tax Reporting.....	44
Review Questions.....	45
Review Answers	46
Chapter 5 – Deducting Long-Term Assets	47
Learning Objectives	47
Introduction.....	47
What is a Long-Term Asset?.....	47
Repairs Versus Improvements	48
Inventory.....	51
Methods for Deducting Business Assets	51
Rules for Deducting Any Long-Term Asset.....	52
What Property Is Eligible.....	52
Real Versus Personal Property	53
Mixed-Use Property	53
Listed Property.....	53
When Depreciation Starts and Ends.....	54
How Much You Can Deduct	54
Disposing of Long-Term Assets	55
Section 179	56
Property You Can Deduct	56
Calculating Your Deduction.....	58
Recapture Under Section 179	61
Bonus Depreciation	62
Property that Qualifies for Bonus Depreciation	63
Placed In Service Date.....	63
Class-Wide Requirement	63
Calculating the Bonus Amount	64
Opting Out of the Bonus.....	64
Regular Depreciation	64
When to Use Regular Depreciation	65
Depreciation Period	66

Table of Contents

First-Year Depreciation	66
Depreciation Methods	67
Depreciation Tables	70
Depreciation Rules for Listed property.....	70
Computer Software	70
Real Property.....	71
Intangible Assets	71
Natural Resources	72
Depreciation Recapture	72
Tax Reporting and Record Keeping	72
Leasing Long-Term Assets	73
Leasing Versus Purchasing.....	74
Leases Versus Installment Purchases.....	74
Review Questions.....	76
Review Answers	77
Chapter 6 – Inventory	79
Learning Objectives	79
Introduction.....	79
What Is Inventory?.....	79
Supplies Are Not Inventory.....	80
Incidental Supplies.....	80
Long-Term Assets.....	80
Deducting Inventory Costs	81
Computing the Cost of Goods Sold	81
IRS Reporting for Cost of Goods Sold.....	82
Maintaining an Inventory.....	83
When You Provide Services and Sell Merchandise	83
Supplies for Providing a Service.....	83
Determining the Value of Inventory	83
Taking Physical Inventory	84
Identifying Inventory Items Sold During the Year	84
Valuing Your Inventory.....	85
Review Questions.....	87
Review Answers	88
Chapter 7 – Office Expenses.....	89
Learning Objectives	89
Introduction.....	89
Qualifying for the Home Office Deduction.....	89
Threshold Requirement: Regular and Exclusive Business Use	90
Additional Requirements	93
Corporation Employees	97
Calculating the Home Office Deduction.....	98
How Much of Your Home Is Used for Business?	98
What Expenses Can You Deduct?	100
New Simplified Home Office Deduction Method	106
How the Simple Method Works	106
Is the Simplified Method a Good Deal?	107
IRS Reporting Requirements	108
Sole Proprietors.....	108
LLCs and Partnerships.....	108
Corporations	108
Filing 1099-MISCs	108
Audit-Proofing Your Home Office Deduction.....	109
Show You’re Following the Rules.....	109

Table of Contents

Keep Good Expense Records.....	109
Deducting an Outside Office or Workplace.....	109
Renting an Outside Workplace.....	110
Buying an Outside Workplace.....	112
Review Questions.....	113
Review Answers.....	114
Chapter 8 – Car and Local Travel Expenses	115
Learning Objectives.....	115
Introduction.....	115
Deductible Local Transportation Expenses	115
Travel Must Be for Business.....	116
Commuting Is Not Deductible.....	116
The Standard Mileage Rate	122
How the Standard Mileage Rate Works.....	122
Requirements to Use the Standard Mileage Rate.....	123
The Actual Expense Method.....	124
How the Actual Expense Method Works.....	124
Record-Keeping Requirements.....	125
Vehicle Depreciation Deductions.....	125
Leasing a Car	132
How to Maximize Your Car Expense Deduction	133
Use the Method That Gives the Largest Deduction.....	133
Keep Good Records	133
Other Local Transportation Expenses	133
When Clients or Customers Reimburse You	134
Reporting Transportation Expenses on Schedule C	134
Corporations, LLCs, and Partnerships.....	135
Using Your Own Car.....	135
Using a Company Car.....	136
Review Questions.....	138
Review Answers.....	139
Chapter 9 – Business Travel.....	141
Learning Objectives.....	141
Introduction.....	141
What Is Business Travel?.....	141
Where Is Your Tax Home?.....	142
Your Trip Must Be for Business.....	144
What Travel Expenses Are Deductible.....	146
Traveling First Class or Steerage	146
Taking People With You.....	146
How Much You Can Deduct.....	147
Travel Within the United States.....	147
Travel Outside the United States.....	148
Conventions.....	150
Travel by Ship.....	151
Calculating Time Spent on Business	151
50% Limit on Meal Expenses	152
Maximizing Your Business Travel Deductions.....	154
Plan Ahead.....	154
Make a Paper Trail.....	154
Maximize Your Business Days	155
Take Advantage of the Sandwich Day Rule.....	155
How to Deduct Travel Expenses	155
Sole Proprietors.....	155

Table of Contents

Partnerships and LLCs.....	155
Corporations.....	156
Travel Expenses Reimbursed by Clients or Customers.....	157
Review Questions.....	158
Review Answers.....	159
Chapter 10 – Meal and Entertainment Expenses.....	160
Learning Objectives.....	160
Introduction.....	160
What Is Business Entertainment?.....	160
Activities That Aren't Entertainment.....	160
Meals Can Be Travel or Entertainment.....	161
Who You Can Entertain.....	161
Deducting Entertainment Expenses.....	161
Business Discussions Before or After Entertainment.....	162
Business Discussions During Meals.....	162
Entertaining at Home.....	163
Entertainment in Clear Business Settings.....	164
Calculating Your Deduction.....	164
Expenses Must Be Reasonable.....	164
Going "Dutch".....	165
Expenses You Can't Deduct.....	165
Entertainment Tickets.....	166
Reimbursed Expenses.....	166
Meals for Employees.....	167
Reporting Entertainment Expenses on Your Tax Return.....	167
Sole Proprietors.....	167
Partnerships, LLCs, and LLPs.....	168
Corporations.....	168
Review Questions.....	169
Review Answers.....	170
Chapter 11 – Hiring Workers.....	171
Learning Objectives.....	171
Introduction.....	171
Employees Versus Independent Contractors.....	171
Tax Deductions for Employee Pay and Benefits.....	173
Employee Pay.....	173
Payroll Taxes.....	175
Employee Fringe Benefits.....	177
Reimbursing Employees for Business-Related Expenditures.....	179
Accountable Plans.....	179
Unaccountable Plans.....	181
Unreimbursed Employee Expenses.....	181
Employing Your Family or Yourself.....	182
Employing Your Children.....	182
Employing Your Spouse.....	184
Rules to Follow When Employing Your Family.....	185
Employing Yourself.....	187
Tax Deductions When You Hire Independent Contractors.....	188
No Deductions for ICs Taxes.....	189
Paying Independent Contractors' Expenses.....	189
Review Questions.....	191
Review Answers.....	192

Table of Contents

Chapter 12 – Retirement Deductions	193
Learning Objectives	193
Introduction.....	193
Why You Need a Retirement Plan (or Plans).....	194
Tax Deduction	194
Tax Deferral.....	194
Individual Retirement Accounts—IRAs	196
Traditional IRAs	197
Roth IRAs.....	198
Employer IRAs.....	199
SEP-IRAs	199
SIMPLE IRAs.....	199
Keogh Plans.....	200
Types of Keogh Plans.....	200
Setting Up a Keogh Plan.....	200
Solo 401(k) Plans	201
Review Questions.....	203
Review Answers	204
Chapter 13 – Medical Expenses	205
Learning Objectives	205
Introduction.....	205
The Health Care Reform Act.....	205
Health Insurance Mandate	206
What Is Required Under the New Law.....	207
State Health Insurance Exchanges	208
Health Insurance Premium Tax Credits.....	208
The Personal Deduction for Medical Expenses	210
Deducting Health Insurance Costs	211
Personal Income Tax Deduction for the Self-Employed	211
Deducting Health Insurance as a Business Expense	212
Tax Credits for Employee Health Insurance	215
Requirement #1: You Must Have Employees	216
Requirement #2: Employee Compensation Must Average Less Than \$50,000	216
Requirement #3: You Must Pay at Least 50% of Employee Health Insurance Premiums	216
Amount of the Credit.....	217
Adopting a Health Reimbursement Arrangement.....	217
What Is a Health Reimbursement Arrangement?.....	217
Impact of Obamacare on HRAs.....	219
What Expenses May Be Reimbursed?	219
How to Establish an HRA.....	219
Sample HRA.....	221
Complying with Annual Reporting and Fee Requirements	221
Health Savings Accounts	222
What Are Health Savings Accounts?	222
Establishing Your HSA.....	222
Making Contributions to Your HSA	224
Deducting HSA Contributions.....	224
Withdrawing HSA Funds	225
Are HSAs a Good Deal?	226
HSAs for Employees.....	227
Tax Reporting for HSAs	227
Review Questions.....	228
Review Answers	229

Table of Contents

Chapter 14 – Additional Deductions	230
Learning Objectives	230
Introduction.....	230
Advertising.....	230
Goodwill Advertising	230
Giveaway Items	231
Website Development and Maintenance	231
Permanent Signs	231
Business Bad Debts	232
Three Requirements to Deduct Bad Debts	232
Types of Bad Debts	233
Casualty Losses	235
Amount of Deduction	235
Damage to Your Home Office	237
Tax Reporting	237
Charitable Contributions	237
Contributions by Proprietors, LLCs, Partnerships, and S Corporations.....	237
Clothing.....	238
Dues and Subscriptions.....	239
Education Expenses	239
Starting a New Business	240
Minimum Educational Requirements	240
Traveling for Education	241
Gifts.....	241
Insurance for Your Business	241
Homeowners’ Insurance for Your Home Office.....	242
Car Insurance	242
Interest on Business Loans.....	242
Home Offices.....	243
Car Loans.....	243
Loans to Buy a Business.....	243
Loans From Relatives and Friends.....	243
Interest You Can’t Deduct.....	244
Deducting Investment Interest.....	244
Keeping Track of Borrowed Money	244
Legal and Professional Services	245
Buying Long-Term Property	245
Starting a Business	245
Accounting Fees	246
Taxes and Licenses.....	246
Income Taxes	246
Self-Employment Taxes	246
Employment Taxes	246
Sales Taxes.....	247
Real Property Taxes	247
Other Taxes.....	248
License Fees	248
Domestic Production Activities.....	248
Activities That Qualify for the Deduction	248
Excluded Activities	249
Tangible Personal Property Mixed With Services	249
Amount of Deduction	249
Limits on the Deduction.....	249
Review Questions.....	251
Review Answers	252

Table of Contents

Chapter 15 – Record Keeping and Accounting	253
Learning Objectives	253
Introduction.....	253
What Records Do You Need?.....	253
Business Checkbook and Credit Cards	254
Calendar or Appointment Book	255
Records of Your Business Income and Expenses	256
Tracking Your Business Expenses	258
Supporting Documents.....	260
Records Required for Specific Expenses	262
Automobile Mileage and Expense Records	263
Entertainment, Meal, Travel, and Gift Expenses	266
Listed Property.....	270
How Long to Keep Records	271
What If You Don't Have Proper Tax Records?	271
Accounting Methods	272
Cash Method	272
Accrual Method.....	274
Which Is Better: Accrual or Cash Method Accounting?	275
Tax Years	276
Review Questions.....	277
Review Answers	278
Chapter 16 – Claiming Tax Deductions for Prior Years	279
Learning Objectives	279
Introduction.....	279
Reasons for Amending Your Tax Return.....	279
Net Operating Losses	279
Retroactive Tax Laws	280
Casualty Losses	280
Time Limits for Filing Amended Returns.....	280
Three-Year Amendment Period.....	280
Section 179 Deductions	281
Net Operating Losses	281
Bad Debts.....	281
Business Start-Up Expenses.....	281
How to Amend Your Return	282
How the IRS Processes Refund Claims	282
Review Questions.....	284
Review Answers	285
Chapter 17 – Staying Out of Trouble With the IRS	286
Learning Objectives	286
Introduction.....	286
What Every Business Owner Needs to Know About the IRS	286
Anatomy of an Audit.....	286
The IRS: Clear and Present Danger or Phantom Menace?.....	287
You Are a Prime IRS Target.....	288
How Tax Returns Are Selected for Audits.....	288
Ten Tips for Avoiding an Audit	290
Tip #1: Be Neat, Thorough, and Exact.....	290
Tip #2: Mail Your Return by Certified Mail	290
Tip #3: Don't File Early.....	290
Tip #4: Don't File Electronically	290
Tip #5: Form a Business Entity.....	291
Tip #6: Explain Items the IRS Will Question.....	291

Table of Contents

Tip #7: Avoid Ambiguous or General Expenses.....	291
Tip #8: Report All of Your Income.....	291
Tip #9: Watch Your Income-to-Deduction Ratio.....	291
Tip #10: Beware of Abnormally Large Deductions	292
Review Questions.....	293
Review Answers	294
Chapter 18 – Help Beyond This Book.....	295
Secondary Sources of Tax Information	295
Information From the IRS.....	295
Other Online Tax Resources.....	297
Tax Publications	297
Tax Software	299
The Tax Law.....	299
Internal Revenue Code	299
IRS Regulations.....	300
Court Cases.....	300
IRS Rulings, Interpretations, and Tax Advice.....	301
Consulting a Tax Professional.....	303
Types of Tax Pros.....	303
Review Questions.....	305
Review Answers	306
Glossary.....	307
Index	311