

# **Tax Deductions for Professionals**

---

9<sup>th</sup> Edition

Stephen Fishman, J.D.

# Table of Contents

---

<b>Chapter 1 – Tax Deduction Basics</b> .....	<b>1</b>
Learning Objectives .....	1
Introduction.....	1
How Tax Deductions Work.....	1
Types of Tax Deductions .....	1
You Pay Taxes Only on Your Profits .....	2
You Must Have a Legal Basis for Your Deductions.....	2
The Value of a Tax Deduction.....	2
Federal and State Income Taxes.....	3
Social Security and Medicare Taxes .....	3
Total Tax Savings .....	4
What Professionals Can Deduct.....	5
Start-Up Expenses.....	5
Operating Expenses .....	5
Capital Expenses .....	5
Inventory.....	6
Review Questions.....	7
Review Answers .....	8
<b>Chapter 2 – Choice of Business Entity</b> .....	<b>9</b>
Learning Objectives .....	9
Introduction.....	9
Types of Business Entities .....	9
Sole Proprietorship .....	9
Limited Liability Company (LLC).....	10
Limited Liability Partnership (LLP).....	11
Corporation.....	11
Partnership .....	12
Limiting Your Liability .....	13
What Is Liability?.....	13
Liability for Professional Malpractice .....	14
Liability for Business Debts .....	15
Other Types of Liability .....	16
The Role of Insurance.....	16
The Four Ways Business Entities Are Taxed.....	17
Tax Treatment Choices.....	17
Sole Proprietorship Taxation .....	18
Partnership Taxation.....	18
S Corporation Taxation .....	19
C Corporation Taxation.....	19
Comparing Tax Treatments.....	20
Tax Deductions.....	20
Tax Rates.....	21
Owners' Employment Status .....	25
Fringe Benefits.....	27
Allocating Profits and Losses .....	28
Deducting Business Losses .....	29
Retaining Earnings in Your Business.....	30
State Taxes .....	32
IRS Audit Rates .....	32
Should You Change Your Business Entity or Tax Treatment? .....	33
The Cost of Converting to Another Business Form .....	34
Changing Your Tax Treatment .....	35
Automatic Conversion of Your Business Entity .....	36

## Table of Contents

Review Questions.....	37
Review Answers .....	38
<b>Chapter 3 –Operating Expenses .....</b>	<b>39</b>
Learning Objectives .....	39
Introduction.....	39
Requirements for Deducting Operating Expenses .....	39
Ordinary and Necessary .....	39
Current Expense .....	40
Business Related.....	41
Reasonable .....	42
Operating Expenses That Are Not Deductible .....	42
Tax Reporting.....	42
Review Questions.....	44
Review Answers .....	45
<b>Chapter 4 – Meal and Entertainment Expenses .....</b>	<b>46</b>
Learning Objectives .....	46
Introduction.....	46
What Is Business Entertainment? .....	46
Activities That Aren't Entertainment.....	46
Meals Can Be Travel or Entertainment.....	47
Who Can Be Entertained? .....	47
Deducting Entertainment Expenses .....	47
Business Discussions Before or After Entertainment .....	48
Business Discussions During Meals.....	48
Entertaining at Home .....	49
Entertainment in Clear Business Settings.....	49
Calculating Your Deduction.....	50
Expenses Must Be Reasonable .....	50
Going "Dutch" .....	50
Expenses You Can't Deduct .....	50
Entertainment Tickets .....	51
Meals for Employees .....	52
Expenses Reimbursed by Clients.....	52
Review Questions.....	54
Review Answers .....	55
<b>Chapter 5 – Car and Local Travel Expenses .....</b>	<b>56</b>
Learning Objectives .....	56
Introduction.....	56
Deductible Local Transportation Expenses.....	56
Travel Must Be for Business .....	56
Commuting Is Not Deductible.....	57
The Standard Mileage Rate .....	59
How the Standard Mileage Rate Works.....	59
When You Can Use the Standard Mileage Rate.....	60
The Actual Expense Method .....	60
How the Actual Expense Method Works.....	60
Record-Keeping Requirements .....	61
Vehicle Depreciation Deductions.....	61
Leasing a Car .....	67
Other Local Transportation Expenses .....	68
Reporting Transportation Expenses on Schedule C .....	68
When Clients Reimburse You .....	69
Professionals With Business Entities.....	69
Using Your Own Car .....	69

## Table of Contents

Using a Company Car.....	70
Review Questions.....	72
Review Answers.....	74
<b>Chapter 6 – Long-Distance Travel Expenses.....</b>	<b>76</b>
Learning Objectives.....	76
Introduction.....	76
What Is Business Travel?.....	76
Where Is Your Tax Home?.....	77
Your Trip Must Be for Business.....	78
What Travel Expenses Are Deductible.....	79
Traveling First Class or Steerage.....	80
Taking People With You.....	80
How Much You Can Deduct.....	80
Travel Within the United States.....	81
Travel Outside the United States.....	81
Conventions.....	83
Travel by Ship.....	83
Calculating Time Spent on Business.....	84
50% Limit on Meal Expenses.....	84
Maximizing Your Business Travel Deductions.....	86
Plan Ahead.....	86
Make a Paper Trail.....	86
Maximize Your Business Days.....	86
Take Advantage of the Sandwich Day Rule.....	87
Travel Expenses Reimbursed by Clients.....	88
Review Questions.....	89
Review Answers.....	90
<b>Chapter 7 – The Home Office Deduction.....</b>	<b>91</b>
Learning Objectives.....	91
Introduction.....	91
Qualifying for the Home Office Deduction.....	91
Three Threshold Requirements.....	91
One of Five Additional Requirements.....	94
Special Requirement for Employees.....	98
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.....	104
How the Simple Method Works.....	104
Is the Simplified Method a Good Deal?.....	105
How to Deduct Home Office Expenses.....	106
Sole Proprietors.....	106
LLCs, LLPs, and Partnerships.....	106
Corporations.....	107
Audit-Proofing Your Home Office Deduction.....	108
Prove That You Are Following the Rules.....	108
Keep Good Expense Records.....	108
Review Questions.....	109
Review Answers.....	110
<b>Chapter 8 – Deductions for Outside Offices.....</b>	<b>111</b>
Learning Objectives.....	111
Introduction.....	111
If You Rent Your Office.....	111
Timing of Deductions.....	112

## Table of Contents

Improvements and Repairs .....	112
Cost of Modifying a Lease .....	113
Cost of Canceling a Lease .....	113
If You Own Your Office .....	113
Operating Expenses .....	113
Improvements and Repairs .....	113
Section 179 Expensing .....	114
Depreciation Deductions .....	114
Loss for Replaced Structural Components .....	116
Interest Deductions .....	117
Property Taxes .....	117
Tax Incentives for Improving Access for the Disabled .....	117
Energy Efficiency Deduction .....	118
If You Lease a Building to Your Practice .....	119
Review Questions .....	120
Review Answers .....	121
<b>Chapter 9 – Deducting Long-Term Assets .....</b>	<b>122</b>
Learning Objectives .....	122
Introduction .....	122
What Is a Long-Term Asset? .....	122
Repairs Versus Improvements .....	123
Inventory .....	126
Methods for Deducting Business Assets .....	126
Rules for Deducting Any Long-Term Asset .....	127
What Property Is Eligible .....	127
Real Versus Personal Property .....	127
Mixed-Use Property .....	127
Listed Property .....	128
When Depreciation Starts and Ends .....	128
How Much You Can Deduct .....	128
Disposing of Long-Term Assets .....	129
Sale of Long-Term Assets .....	129
Trade-In of Long-Term Assets .....	130
Abandonment of Long-Term Assets .....	130
Section 179 Deductions .....	130
Property You Can Deduct .....	131
Calculating Your Deduction .....	131
Recapture Under Section 179 .....	134
Bonus Depreciation .....	135
Property That Qualifies for Bonus Depreciation .....	135
Place-in-Service Date .....	136
Class-Wide Requirement .....	136
Calculating the Bonus Amount .....	136
Opting Out of the Bonus .....	137
Regular Depreciation .....	137
When to Use Regular Depreciation .....	137
When You Can't Use Section 179 .....	137
When You Can't Use Bonus Depreciation .....	138
Depreciation Period .....	138
First-Year Depreciation .....	138
Depreciation Methods .....	139
How to Deduct Listed Property .....	142
Computer Software .....	142
Real Property .....	143
Intangible Assets .....	144
Depreciation Recapture .....	145

## Table of Contents

Tax Reporting and Record Keeping for Section 179 and Depreciation .....	145
Leasing Long-Term Assets .....	146
Leasing Versus Purchasing .....	146
Leases Versus Installment Purchases .....	147
Review Questions .....	149
Review Answers .....	150
<b>Chapter 10 – Start-Up Expenses .....</b>	<b>151</b>
Learning Objectives .....	151
Introduction .....	151
What Are Start-Up Expenses? .....	151
Starting a New Practice .....	151
Common Start-Up Expenses .....	151
Costs That Are Not Start-Up Expenses .....	152
Buying an Existing Practice .....	153
Expanding an Existing Practice .....	154
When Does a Professional Practice Begin? .....	154
How to Deduct Start-Up Expenses .....	155
Who Gets Start-Up Deductions .....	155
If Your Practice Doesn't Last 15 Years .....	155
Organizational Expenses .....	156
Review Questions .....	157
Review Answers .....	158
<b>Chapter 11 – Medical Expenses .....</b>	<b>159</b>
Learning Objectives .....	159
Introduction .....	159
The Health Care Reform Act (“Obamacare”) .....	159
Health Insurance Mandate .....	160
What Is Required Under the New Law .....	161
State Health Insurance Exchanges .....	161
Health Insurance Premium Tax Credits .....	162
The Personal Deduction for Medical Expenses .....	162
Self-Employed Health Insurance Deduction .....	163
Business Income Limitation .....	164
Designating Your Plan Sponsor .....	164
No Other Health Insurance Coverage .....	164
Tax Reporting .....	165
Deducting Health Insurance as an Employee Fringe Benefit .....	165
Deducting Health Insurance Costs Paid on Behalf of Employees .....	165
Sole Proprietors, LLCs, S Corporations, Partnerships, and LLPs .....	166
C Corporations .....	166
Employing Your Spouse .....	167
Tax Credits for Employee Health Insurance .....	167
Requirement #1: You Must Have Employees .....	168
Requirement #2: Your Employee Compensation Must Average Less Than \$50,000 .....	168
Requirement #3: You Must Pay at Least 50% of Employee Health Insurance Premiums .....	169
Amount of the Credit .....	169
Unused Credit Amounts .....	169
Adopting a Health Reimbursement Arrangement (HRA) .....	169
What Is a Health Reimbursement Arrangement? .....	170
Impact of Obamacare on HRAs .....	171
What Expenses May Be Reimbursed? .....	171
How to Establish a Plan .....	171
Sample Plan .....	172
Complying with Annual Reporting and Fee Requirements .....	173
Health Savings Accounts .....	173

## Table of Contents

What Are Health Savings Accounts? .....	173
Establishing an HSA .....	173
Making Contributions to Your HSA .....	175
Deducting HSA Contributions .....	175
Withdrawing HSA Funds .....	176
Are HSAs a Good Deal? .....	177
HSAs for Employees .....	178
Tax Reporting for HSAs .....	178
Review Questions .....	179
Review Answers .....	180
<b>Chapter 12 – Retirement Deductions .....</b>	<b>181</b>
Learning Objectives .....	181
Introduction .....	181
Why You Need a Retirement Plan (or Plans) .....	181
Tax Deduction .....	182
Tax Deferral .....	182
Types of Retirement Plans .....	184
Individual IRAs .....	184
Employer IRAs .....	185
Tax-Qualified Plans .....	185
Nonqualified Plans .....	185
Individual Retirement Accounts—IRAs .....	185
Roth IRAs .....	186
IRAs for Businesses .....	187
SEP-IRAs .....	188
SIMPLE IRAs .....	189
Qualified Retirement Plans .....	189
Defined Benefit Plans .....	190
Defined Contribution Plans .....	190
Keogh Plans .....	191
Setting Up a Keogh Plan .....	191
Profit Sharing Plans .....	191
Money Purchase Plans .....	191
Withdrawing Your Money .....	191
Solo 401(k) Plans .....	192
Roth 401(k) Plans .....	192
Review Questions .....	193
Review Answers .....	194
<b>Chapter 13 – Inventory .....</b>	<b>195</b>
Learning Objectives .....	195
Introduction .....	195
What Is Inventory? .....	195
Supplies Are Not Inventory .....	196
Incidental Supplies .....	196
Do You Have to Carry an Inventory? .....	197
Deducting Inventory Costs .....	197
Computing the Cost of Goods Sold .....	197
Determining the Value of Inventory .....	198
IRS Reporting .....	198
Review Questions .....	200
Review Answers .....	201
<b>Chapter 14 – More Deductions .....</b>	<b>202</b>
Learning Objectives .....	202
Introduction .....	202

## Table of Contents

Advertising.....	202
Goodwill Advertising .....	202
Giveaway Items .....	203
Website Development and Maintenance .....	203
Permanent Signs .....	203
Business Bad Debts.....	203
Three Requirements for Deduction.....	204
Applying the Rules.....	205
Casualty Losses .....	207
Amount of Deduction .....	207
Special Rules for Losses Related to Federally Declared Disasters .....	208
Charitable Contributions.....	208
Contributions of Money .....	208
Contributions of Property .....	209
Contributions of Services .....	209
Clothing.....	210
Disabled Access Tax Credit.....	210
Use of Credit by Health Care Providers.....	210
Amount of Credit.....	210
License Fees, Dues, and Subscriptions.....	211
Education Expenses .....	211
Entering a New Profession.....	212
Minimum Educational Requirements .....	212
Traveling for Education .....	212
Gifts.....	212
Insurance for Your Practice.....	213
Homeowner’s Insurance for Your Home Office.....	213
Car Insurance .....	213
Interest on Business Loans.....	214
Home Offices.....	214
Car Loans.....	214
Loans to Buy a Practice .....	214
Loans From Relatives and Friends.....	214
Interest You Can’t Deduct.....	215
Keeping Track of Borrowed Money .....	215
Legal and Professional Services .....	215
Buying Long-Term Property .....	215
Starting a Practice.....	215
Accounting Fees .....	216
Taxes .....	216
Income Taxes .....	216
Self-Employment Taxes .....	216
Employment Taxes .....	216
Sales Taxes.....	216
Real Property Taxes .....	217
Other Taxes.....	217
Domestic Production Activities .....	217
Activities That Qualify for the Deduction .....	218
Amount of Deduction .....	218
Limits on the Deduction.....	218
Review Questions.....	220
Review Answers .....	221
<b>Chapter 15 – Hiring Employees and Independent Contractors .....</b>	<b>222</b>
Learning Objectives .....	222
Introduction.....	222
Employees Versus Independent Contractors.....	222



## Table of Contents

Tax Deductions for Employee Pay and Benefits .....	223
Employee Pay .....	224
Payroll Taxes .....	225
State Payroll Taxes .....	226
Employee Fringe Benefits .....	227
Reimbursing Employees .....	228
Reimbursement Under an Accountable Plan .....	228
Unreimbursed Employee Expenses .....	228
Employing Your Family .....	229
Employing Your Children .....	229
Employing Your Spouse .....	230
Rules to Follow When Employing Your Family .....	231
Tax Deductions When You Hire Independent Contractors .....	233
No Deductions for IC's Taxes .....	234
Paying Independent Contractor's Expenses .....	234
Review Questions .....	236
Review Answers .....	237
<b>Chapter 16 – Professionals Who Incorporate .....</b>	<b>238</b>
Learning Objectives .....	238
Introduction .....	238
Automatic Employee Status .....	238
Paying Yourself .....	239
The Tax Treatment of Compensation Versus Distributions .....	239
C Corporations and the Advantages of Employee Compensation .....	240
S Corporations and the Advantages of Corporate Distributions .....	244
Employee Fringe Benefits .....	245
Qualified Fringe Benefits .....	245
Types of Fringe Benefits .....	247
Benefits That Are Not Tax Deductible .....	249
Shareholder Loans .....	250
Only Bona Fide Loans Are Recognized by the IRS .....	250
Below Market Loans .....	250
Review Questions .....	252
Review Answers .....	253
<b>Chapter 17 – How You Pay Business Expenses .....</b>	<b>254</b>
Learning Objectives .....	254
Introduction .....	254
Your Practice Pays .....	254
Tax Treatment .....	254
Documentation Requirements .....	255
Using Personal Funds to Pay for Business Expenses .....	255
LLCs, Partnerships, and LLPs .....	255
Corporations .....	257
Your Client Reimburses You .....	259
Accountable Plans .....	260
What Is an Accountable Plan? .....	260
Time Limit to Make Adequate Accounting .....	261
Payments Not Made Under an Accountable Plan .....	261
Review Questions .....	263
Review Answers .....	264
<b>Chapter 18 – Staying Out of Trouble With the IRS .....</b>	<b>265</b>
Learning Objectives .....	265
Introduction .....	265
Anatomy of an Audit .....	265

## Table of Contents

How Small Business Owners Get in Trouble With the IRS .....	265
Records Available to Auditors .....	265
The IRS: Clear and Present Danger or Phantom Menace?.....	266
How Tax Returns Are Selected for Audits.....	266
DIF Scores.....	266
IRS Income Matching Program .....	267
Groups Targeted for Audit.....	268
Tips and Referrals.....	268
Tax Shelters, Scams, and Schemes.....	268
Tax Shelters .....	268
Tax Scams and Schemes .....	269
Ten Tips for Avoiding an Audit .....	270
Review Questions.....	273
Review Answers .....	274
<b>Chapter 19 – Record Keeping and Accounting.....</b>	<b>275</b>
Learning Objectives .....	275
Introduction.....	275
Recording Your Expenses .....	275
Your Accounting System.....	275
Documenting Your Deductions.....	276
What Supporting Documents Do You Need?.....	276
Automobile Mileage and Expense Records .....	278
Entertainment, Meal, Travel, and Gift Expenses .....	281
Listed Property.....	285
How Long to Keep Your Records .....	286
What If You Don't Have Proper Tax Records?.....	286
Accounting Methods .....	287
Cash Method .....	287
Accrual Method.....	289
Tax Years.....	290
Review Questions.....	292
Review Answers .....	293
<b>Chapter 20 – Help Beyond This Book.....</b>	<b>294</b>
Learning Objectives .....	294
Introduction.....	294
Information From the IRS.....	294
IRS Website.....	294
IRS Booklets and CD-ROM.....	294
IRS Telephone Information .....	294
Free IRS Programs.....	294
Other Online Tax Resources.....	295
Publications for the Nonexpert .....	295
Tax Software .....	296
The Tax Law.....	296
Internal Revenue Code .....	296
IRS Regulations.....	297
Court Cases.....	297
IRS Rulings, Interpretations, and Tax Advice.....	298
Review Questions.....	300
Review Answers .....	301
<b>Glossary.....</b>	<b>303</b>
<b>Index .....</b>	<b>307</b>