Common Business Tax Deductions

Here are some common deductions for small business

Sure, you pay tax on your business profits. But there's good news, too. You can potentially reduce your taxable income significantly by taking all the deductions you're entitled to as business expenses.

It is important to know which expenses are deductible. If you are a shareholder or partner in the 25% tax bracket, for example, every one hundred dollars of deductions saves twenty five dollars of taxes. If you are located in a state that imposes an income tax, each write-off is worth even more because it will save you state taxes, as well.

To determine whether you can deduct an expense, ask yourself: Is this expense both ordinary and necessary to the business? The IRS requires both elements.

An expense is ordinary if it is common and accepted in your industry.

An expense is necessary if it is helpful and appropriate for your business.

Common small business deductions include costs for:

Automobiles, Bad debts, Depreciation, Employee compensation, Home office, Insurance, Interest , Legal and professional fees, Pension plans, Rent, Taxes, Travel, meals and entertainment

Automobiles

As a small business owner, you can deduct automobile expenses for visits to clients, customers or travel to business meetings 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 percent deductible business expense.

When figuring expenses, you may choose between taking the standard mileage rate (which is 50 cents per mile for 2010), or deducting your actual expenses for items such as gas, oil changes, tires, repairs, preventive maintenance, insurance and registration. If you choose to deduct your actual expenses in the year you start using your car for business, 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 choosing the method that yields the higher deduction, the number of miles you drive each year is probably the most important factor. If you do a lot of driving, then the standard mileage rate method may work better for you. However, automobiles that consume more gas may let you claim a higher deduction using the actual expense method. If you decide to deduct your actual expenses, 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. Keep a record of your gas purchases, insurance and registration payments, and repairs and maintenance costs. If the IRS ever audits you, you will need to provide written documentation to substantiate your deduction.

If you're self employed, you can also deduct the business part of interest on your car loan, state and local property taxes, parking fees and tolls, even if you claim the standard mileage rate.

Bad debts

How can something bad be good for you? Easy: If you loaned money to customers, suppliers or employees who never paid you back, you may be able to claim a bad-debt deduction to offset part of your loss. This type of debt must have the following characteristics:

- **Debtor-creditor relationship** -- There must be a legal obligation for a debtor to pay a creditor a specified sum of money. The best way to establish this relationship is with a written document stating the amount of the loan, interest rate, repayment schedule, etc. This is particularly important if you lend your corporation money. Without written documentation of the loan, the IRS may treat the advance as a contribution of capital to the business and it will not be deductible.
- **Worthlessness** -- You must prove that the debt is uncollectible and that you attempted to collect it.
- **Loss** -- You must have sustained a loss because of the debt.

It's also possible to claim a bad-debt deduction if someone doesn't pay you for work you performed or products you sold. To qualify for this tax-saving deduction, though, you must use the accrual method of accounting, which entails booking income when a product or service is sold, for example. If your business uses the cash-basis method, you can't deduct a worthless receivable as a bad-debt expense because, with this accounting method, you don't count income until it is received. So you don't need a deduction to offset the amount not paid because you never include that amount in income.

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. It must be:

1. Used in the business or held to produce income
2. Expected to last more than one year
3. 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

Repair and maintenance expenditures that do not increase the value of your asset, make it more useful, or increase its life. (These outlays are generally deductible in full in the year you pay them.)

Of course, there are always exceptions. Small businesses may be able to deduct the entire cost of a depreciable asset in the year it is placed in service instead of spreading the cost out over the life of the asset. This is known as a Section 179 deduction, after the section of the tax code that authorizes it. It also goes by the alias "expensing," because you get to deduct the full cost at once—just like you do for business expenses—rather than depreciating the capital asset over time.

For assets placed in service in 2010, you can expense a maximum of $500,000—a higher-than-normal amount—which Congress approved to help the struggling economy. This limit applies in 2011 as well. The amount you can expense in 2010 is reduced if you purchase more than $2 million in eligible property during the year. The same limit applies in 2011.

While the idea of taking a huge deduction right away may sound good to you, be careful, because there is a downside. If you sell an asset, you may have to recapture all or part of the depreciation deductions. (Recapture means reversing all or part of your earlier deductions by adding them back as income.)

Employee compensation

Compensation you pay employees is deductible, including salaries, awards, bonuses and fringe benefits such as health insurance, sick pay and vacation pay. You get a deduction whether you pay wages to employees, to whom you provide a W-2, or use independent contractors, to whom you issue Form 1099.

You can also write off the cost of benefits such as group-term life insurance, adoption assistance, dependent-care assistance and educational assistance. Other 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

Home office

You can work out of your home and save on taxes at the same time. Sound impossible? It’s not, but the home office deduction is a bit tricky, so you need to know all the ins-and-outs. To take the home office deduction, you must use your home office regularly and exclusively for your business. Generally, your home office must be your principal place of business, or you must use it to meet clients or customers on a regular basis.

Exclusive use means that you've got a specific area of your home that you use only for your trade or business. For example, if the den in your home is used only as your office, you can take the deduction. But if the kids also play there or you watch sports on TV in your den, you can't. So do yourself a favor and move the toys and that big-screen TV to another room in your house.

Regular use means that you use the space as an office on an ongoing 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, and not perform these activities at any other fixed location, such as another office off-site. Administrative and management activities include billing customers, keeping books and records, setting appointments, ordering supplies and writing reports. For example, if your business involves repairing clients' computers in their homes, you can deduct your home office if you use it to set up appointments and bill customers, even though you don't repair the computers in your office.

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

The size of your deduction depends on the percentage of your home that is used for business. If your total business expenses exceed gross income from business use of your home, your deduction will be limited.

The two most common methods of calculating business percentage are:

- Dividing your home office's square footage by that of the entire house
- Dividing the number of rooms used for business by the home's total number of rooms, if all rooms are about the same size

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 IRS Publication 587: Business Use of Your Home.

Insurance

You can deduct insurance expenses for your business as long as they're ordinary and necessary. Common examples include:

- Coverage for losses from unpaid debts
- Casualty and theft insurance
- Professional liability or malpractice insurance
- Accident and health insurance
- Overhead insurance
- Coverage for vehicles used in your business

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

- Life insurance where you are directly or indirectly the beneficiary. This includes policies you take out on yourself to secure a loan for your business
- Loss-of-earnings insurance (also called business interruption insurance)

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 buy business equipment, that interest is deductible.

If you're just starting your business and you use a credit card to help with start-up costs, or if a relative loans you money, such interest costs are also tax-deductible.

A corporation can deduct the interest it pays on loans from its shareholders. There should be a valid business purpose for such a borrowing arrangement and written documentation in place detailing the amount of the loan, interest rate and maturity date. Since these types of arrangements may receive increased scrutiny from the IRS, you should have evidence that the transaction is a loan and not an investment.

Watch out for loans that are for both personal and business uses, because personal use will limit your deduction. For example, if you take out a car loan on a vehicle that you use for both business and personal reasons, part of the loan interest won't be deductible.

Legal and professional fees

Fees that you pay to professionals, such as attorneys and accountants, are deductible when they relate to your ongoing business. If you purchase business assets, the fees paid for professional services are not deducted, but are added to the tax basis (or cost) of your business.

Example

You negotiate the purchase of a pool-cleaning route for $22,500. You hire an attorney to draft a non-compete agreement with the seller 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).
If you began the business this year, legal fees to incorporate or to organize your business as a partnership may also be deductible. In 2010, you can deduct up to $10,000 of such expenses in the year you begin business. Additional expenses must be amortized over 15 years.
If you are a sole proprietor, you can deduct accounting and tax preparation fees on Schedule C, to the extent that they are related to your business. Tax preparation costs for the personal portion of your return may be deductible on Schedule A if you itemize deductions.

Pension plans

If you set up and maintain a retirement plan such as a Simplified Employee Pension (SEP) plan or a Savings Incentive Match Plan for Employees (SIMPLE) plan, you can deduct contributions you make for yourself and your employees. (If you have no full-time employees, except your spouse, you may find that an individual 401(k) plan may offer an even better deal than a SEP or SIMPLE plan.)
You can also deduct trustee fees incurred to maintain and administer the plan if contributions to the plan don't cover those fees. To learn more about different plans and how to set them up, see

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

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. (To do so, you must meet the requirements for a home office. See Home Office Expenses.)
If you rent property from your relatives or a related company 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 ask him or her to prepare comparisons of similar properties in the area to substantiate the rent you are paying to a related party.
Rents are usually deductible in the year they are paid. For rent paid in advance, you can only take a deduction for the portion that applies to your use of the property during the tax year. For example, on January 1, 2010 Jim signed a three-year lease for office space, agreeing to pay a total of $30,000 in rent. He paid the entire cost up front. Jim can deduct $10,000 in 2010 and another $10,000 in each of the next two years.

Taxes

There are many taxes that you can deduct when operating a business. For example, if your state taxes the gross income of your business, you can deduct that tax on your federal return. As an employer, you can also deduct your share of your workers' employment 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 revenue.
- Sales and excise taxes, which are deductible when paid for business-related purchases or services. But if the tax is on a depreciable asset, add the tax to the basis of the asset.

Fuel taxes that you pay for gasoline, diesel or other types of motor fuels are already reflected in the cost of the fuel, so you can't deduct these taxes as a separate item. Note that you may be entitled to a credit or refund for federal excise tax you paid on fuels used, for example, in a farming operation where your vehicles are used off-road.

Travel, meals and entertainment

Go out on the town with your clients, pick up the bill and get a tax deduction. What could be easier? Just make sure that the outing is business-related. In other words, any payments you deduct for travel, meals and entertainment must be ordinary and necessary in 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 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 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.

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

- Transportation (using a plane, train, bus or car) between your home and your business destination, including taxi, commuter bus and limousine fares
- Shipping items such as samples or display materials
- Maintaining your own vehicle if you use your car or truck for business travel. You can choose between deducting actual expenses or taking the standard mileage rate.
- Tolls and parking
- Rental cars
- Meals and overnight lodging. You may deduct only 50% of the cost of business meals.

Other deductible expenses include costs for dry cleaning and laundry care, telephone calls, 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 amusement or recreation. Some examples include hosting clients at social, athletic or sporting clubs, theaters, yacht trips, hunting or fishing, vacations and the like.

Other

So far, we've discussed the most common small business deductions.
Other deductible expenses include:

- Advertising
- Educational expenses
- Licenses and regulatory fees
- Dues and subscriptions for professional organizations or business publications
- Outplacement services for your employees
- Penalties and fines you pay for late performance or nonperformance of a contract

Expenses you can't deduct

Sorry, the news on write-offs isn't all good: Some business expenses are not deductible under any circumstances:

- While the cost of entertainment at social, athletic, luncheon, sporting, airline and hotel clubs is deductible, the dues you pay to be a member are not, even if your membership is for business.
- Federal income tax payments
- Lobbying expenses
- Penalties and fines you pay when you break the law
- Political contributions