Business Expense Deductions--Getting It Right

The expenses that business owners incur in operating their businesses provide one of the most important types of deductions allowed by the Internal Revenue Code (IRC). However, like almost everything else concerning the IRC, the rules governing trade or business expenses are fairly complex.

These rules involve several basic considerations. The first consideration is whether the expenditure is a "trade or business expense" or a "capital expense." The distinction is crucial. The amount of your trade or business expenses may be fully deductible in the year in which you incur them. In contrast, capital expenses may, at best, entitle you to a deduction that you take in installments over several years. This difference can significantly affect the amount of your taxable income.

What Are Capital Expenditures?

In general, capital expenditures are amounts you pay to acquire new property that you intend to resell (inventory, for example) or keep for one or more years. Capital expenditures also include amounts you pay to improve property you already own. Under the IRC, property is considered to be improved if the expenditure restores or increases its value, prolongs its life, or adapts the property to a new or different use.

The concept of capital expenditures may best be explained through examples. One classic example is the start-up expenses incurred to acquire or create a new trade or business. These expenses are considered capital expenditures because the owner incurs them to acquire property that she or he intends to keep. While start-up expenses may not be fully deducted in the year in which they are incurred, they can be amortized (deducted in installments) over a five-year period.

An attorney's fee paid in connection with the purchase of business property is another typical capital expenditure. Again, this is a capital expense because it is incurred to acquire property. If the property is the kind for which depreciation deductions are permitted (another form of deduction through installments), these fees might be deducted over time.

All is not irrevocably lost, however, if you have a capital expense for which you cannot take partial deductions through amortization or depreciation. In such cases, the amount of your capital expenditure will reduce the amount of your taxable gain when you sell the asset. For example, you may deduct the cost of inventory from the sale price [when you sell your business?].

What Is a Trade or Business Expense?

Business expenses that are not within the definition of capital expenditures may constitute trade or business expenses. However, these expenses are deductible only if they pass two tests under the IRC. First, the activity for which you incurred the expense must be for a trade or business**.** Next, the expense must be ordinary and necessary.

A trade or business is regular activity engaged in with a profit motive. In order to have a profit motive, you must enter into an activity with the bona fide, primary purpose of making a profit. If your primary purpose is recreation or pleasure, your activity will be considered a hobby, and your expenses will not be deductible.

Even if you have a profit motive and are therefore engaged in a trade or business, your noncapital business expenditures will only be deductible if they are ordinary and necessary. An ordinary expense is one that is customary or usual. This does not mean customary or usual within your experience, but rather, customary or usual within the experience of your particular trade, industry, or business community. Therefore, a business expense may qualify as ordinary even though it is the first and only time you have incurred it. Conversely, business expenses that you usually incur may not be ordinary under the IRC if they are not customarily or usually incurred by your competitors or business neighbors.

A necessary expense need only be appropriate and helpful, rather than essential to your business. Generally, your judgment as to what is a necessary expenditure in your trade or business will be accepted by the courts. This is particularly true when the expense is reasonable in amount in relation to its business purpose.

Like capital expenditures, deductible trade or business expenses may be best explained through examples. Classic examples include the purchase of consumable supplies such as paper, pens, and computer disks. Other typical examples include legal services (other than to acquire or sell property), rent, utilities, insurance, advertising, salaries, and postage.

The deduction of transportation costs can be tricky because they may reflect both business and personal expenses. Transportation expenses, including the cost of operating and maintaining a car, that are directly attributable to the conduct of your trade or business are deductible. If you work at two or more locations, the cost to travel between those locations is a business expense. Commuting expenses (the cost to travel from your home to your workplace) are nondeductible personal expenses. However, if you have a home office and a second business location, the cost to travel from your home to your second location will be deductible.

Like transportation, entertainment expenses also may involve both business and personal activity. Thus, these expenses are subject to special rules under the IRC. They must be ordinary and necessary, and must also be directly related to or associated with the active conduct of your trade or business. In other words, if you take your clients to a Bulls game, and you want to deduct the expense, you must actually conduct business during the game! Furthermore, starting in 1994, the amount allowable as a deduction for entertainment expenses is limited to 50 percent of the expenditure. (Starting in 1994, you will only be allowed to deduct 50 percent of your entertainment expenses.)

Particularly during the holiday season, business owners often make gifts to their customers, business associates, clients, and professional advisors. Expenses for gifts can be deductible if they meet the ordinary and necessary test. However, Congress has played Scrooge and limits the deduction to $25 a year per recipient.

The distinction between your capital expenses and your trade or business expenses is often fuzzy. A typical example arises when considering expenses incurred to repair property. The expenditure may be a capital expense if it significantly increases the value of the property or prolongs its life beyond what existed before the expenditure. On the other hand, the expenditure may be a trade or business expense if it instead merely keeps the property in an ordinary, efficient operating condition.

Deducting, amortizing, and depreciating business expenses can be complicated. If a potential deduction could influence your decision to incur an expense, you should first consult an experienced attorney or accountant.