Chapter 5
Business Expenses

Key Concepts

- Trade or business expenses must be ordinary, necessary, and reasonable in amount to be deductible.
- Accrual-basis taxpayers deduct their expenses when the all-events test is met and there is economic performance. Cash-basis taxpayers generally deduct expenses when paid; however, prepaid expenses that benefit future years may have to be capitalized.
- Business travel expenses are only deductible when the taxpayer is away from home. Deductible transportation expense does not include commuting to and from work.
- Deductions for business expenses require proper documentation and the deductions for certain expenses may be limited.
- The income tax expense reported on financial statements is based on financial statement income, which can differ from income shown on the tax return. Temporary book/tax differences are accounted for as deferred tax assets or deferred tax liabilities.

1. Criteria for deductibility

a. General provisions for trade/business expenses
Section 162 of IRC
Activity must be entered into with expectation of making a profit
TP must be involved on a regular and continuous basis

Investment activity vs. business activity

Section 212 of the IRC

b. Ordinary and necessary and reasonable

c. Contrary to public policy
Only direct lobbying expenses at the local level are deductible. TP must have a direct interest in specific legislation affecting their businesses.

d. Related to tax-exempt income

e. Accrued to a related party

f. Obligation of another taxpayer

g. Substantiation – receipts, canceled checks, paid bills
Substantiation for travel, entertainment, gifts and auto expense:

Amount of expense	Diaries
Time and place	Trip sheets
Business purpose	Travel logs
Business relationship	Receipts
	Expense reports
	Witnesses

2. Timing of deductions

a. Accrual method
All events test is met
Economic performance – reserves for estimated expenses are not deductible

b. Cash Method
Check, credit card, borrowing, property, services
Early payment for their expenses at year-end
If sell merchandise, must use accrual for purchases and sales of inventory; business with average annual gross receipts of $10 M or less may account for the cost of MI at year-end as an asset, but are permitted to account for their other expenses on the cash basis.
Corporations with average annual gross receipts of more than $5 M cannot use the cash method for tax.
PSC may use cash method.

c. Restrictions on prepaid expenses
Payments for assets to be consumed by the close of the following year are fully deductible in year of payment.

Prepaid rent is deductible in period paid if the prepaid period does not exceed one year and the TP has a contractual obligation to prepay rent beyond the current tax year.

Prepaid interest must be allocated to the time period over which the interest accrues. Prepaid interest is deductible in the same period for both cash and accrual taxpayers.

OID(principal minus proceeds) is a form of prepaid interest and must be amortized over the term of the loan.

Points are loan origination fees and are treated like OID, except on home mortgages.

3. Costs of starting a business

a. TP investigating a new business of the same nature as the TP's existing business may deduct all business investigation expenses in the current period, whether or not the new business is actually acquired.

   If a TP has no current business, or is investigating a new business different in nature from existing business, then

      If new business is acquired, all investigation expenses are capitalized and amortized over 60 months beginning in month operations begin.
      If new business is not acquired, expenses cannot be deducted.

b. Start-up expenses (employee training, advertising, professional services, development of distributors, and customers) incurred after decision to proceed with a new business and before beginning operations are capitalized and amortized over 60 months.

c. Organization costs (legal and accounting fees, state fees, meetings of boards of directors and shareholders) – capitalize and amortize costs incurred before the end of the tax year in which the corporation begins the business operations. Organization costs incurred after operations begin must be capitalized and will be recovered when the corporation is liquidated.

4. Operating Expenses

a. Business meals and entertainment
50 % deductible by whoever ultimately pays
Exceptions to 50 % rule – page 172

Directly related entertainment of current or potential clients/customers must include an active discussion related to that business in a clear business setting.

Associated with – event precedes or follows a meaningful discussion of business. Must be a clear business purpose for the discussion, it must be substantial in relation to the entertainment, and the TP must expect a clear business benefit.

No deduction is allowed for the costs of owning and maintaining recreation facilities.

No deduction is allowed for membership dues & fees paid to social, athletic or sporting clubs.

Business gifts are deductible up to $25/donee/year.

Gifts costing $4 or less with company's name on them are not counted in the $25 limit.

b. Travel (meals and lodging) and transportation
Travel away from home (Is sleep or rest required?)

A tax home is the TP's principal place of employment, regardless of where the family residence is maintained.

Temporary assignments – if employment away from home in a single location is expected to last (and does in fact last) for no more than one year, it is temporary.

Transportation expenses when not away from home (No food costs allowed)

Automobile, tolls, parking, taxi fare
Auto-actual. Depreciation or lease payments, gas and oil, tires, repairs, insurance, registration fees, parking and tolls
Auto-standard mileage allowance of 37.5 cents per mile plus parking and tolls.

Costs of commuting to and from work are not deductible.

Combining business and pleasure travel

If primary purpose is business, transportation is deductible.
If primary purpose is pleasure, no transportation is deductible.
If number of days on business exceeds pleasure, then primary purpose is business.
Travel days are considered business days.
Meals and lodging are deductible for business days

- Saturdays
- Friday and Monday business
- Convention, seminar or meetings related to TP's business are deductible.

Travel outside the United States

If all business, all deductible.

If business and personal, transportation must be allocated unless 1) the travel does not exceed one week or 2) less than 25% of time is spent for personal purposes.

If primarily pleasure, travel expenses to and from are not deductible.

Cruise ship must be registered in the United States. Even then, only $2000/year/individual is deductible.

c. Bad debts expenses
Only specific charge – off method is allowed for tax.
No deduction is allowed for a bad debt unless the receivable was included in income.
Nonbusiness bad debt is treated as a STCL.
Investment and personal loans made by the TP are considered nonbusiness.

d. Insurance premiums
Premiums for fire, casualty & theft on business property are deductible.
Only actual losses are deductible by self-insurers.
Life insurance premiums paid by a business as employee fringe benefits are deductible.
Premiums paid on key-person life insurance policies are not deductible if the business is the beneficiary.

e. Legal expenses

Are deductible if origin and character of the claim are directly related to a trade/business.
Legal fees incurred to defend title to property are added to the asset's basis.
Legal fees in connection with a criminal charge are deductible if has a direct relationship to a profit-seeking activity.
Martha Stewart- no
Arthur Andersen- yes

f. Taxes

Real property (state, local, foreign)
Personal property (state and local)
Foreign, state & local income taxes
Employer's payroll taxes (FICA and unemployment taxes)
Other federal, state, local, and foreign taxes that are incurred in a business or other income-producing activity

Sales taxes
Sale of real estate during the year
Assessments to fund improvements increase the cost basis of property
Assessments for maintenance, repairs, or current interest on financed improvements are deductible.

g. UNICAP rules and inventory

Purchase cost includes invoice price, less discounts, plus shipping and handling.

UNICAP rules require indirect costs to be capitalized by businesses whose average annual gross receipts for the preceding three years exceed $10 M.

UNICAP rules require the value of inventory to include all direct costs of manufacturing, purchasing, or storing inventory and the following overhead items:

- Factory repairs, maintenance, utilities, insurance, rent,and depreciation (including the excess of tax depreciation over financial depreciation)
- Rework, scrap, and spoilage
- Factory administration and officers' salaries related to production
- Taxes (other than income tax)
- Quality control and inspection
- Profit sharing and pension plans, for both current and past service costs
- Service support such as payroll, purchasing, and warehousing

Nonmanufacturing costs (research, selling, advertising and distribution expenses) are not required to be included in inventory.

Allocating between COGS and EI can be done by FIFO, LIFO, specific identification or weighted average.

TP who wants to use LIFO for tax purposes must also use LIFO for any report or statement to owners or to obtain credit.

LIMITED EXPENSE DEDUCTIONS: rental of residential property, home office expenses, and hobby expenses

h. Residential rental property
Renting real estate is usually considered a Trade/Business.
Converting a principal residence to rental property

Expenses for a vacation home must be allocated between rental use and the owner's personal use.

1. Primarily personal – the rental period is less than 15 days. The use of the vacation home is considered purely personal. The taxpayer can ignore all income but is allowed no deduction for any expenses associated with the rental (except property taxes and mortgage interest expense).

2. Primarily rental – the rental period is greater than 14 days; personal use is less than the greater of 15 days or 10 percent of the rental days. The property is considered primarily rental property. The rental income less rental expenses from the property is included in income. The expenses related to the personal use of the home are not deductible (except for interest and taxes).

3. Mixed personal/rental use – rented for more than 14 days; personal use is more than the greater of 14 days or 10 percent of the rental use. Expenses must be allocated between personal and rental use, and the reporting follows rules similar to those for hobbies; that is, rental expenses are deductible only to the extent of rental income.

Expenses are allocated based on the following formula:

$$\frac{\text{Number of rental days}}{\text{Total number of days used}} \times \text{Total expense} = \text{Rental-use expense}$$

i. Home office expenses

Exclusively and on a regular basis and
Be the principal place of business for any business of the taxpayer or
Be used as a place to meet clients/customers in normal course of business or
Is located in a structure separate from the home.

Home office of employee
Allocate based on square footage
Deductible only to the extent income is generated
Deductible in the following order:

1. Expenses directly related to the business other than home office expenses (such as supplies)
2. The allocated portion of expenses that would otherwise be deductible as itemized deductions (mortgage interest and property taxes)
3. Operating expenses including utilities, insurance, and maintenance
4. Depreciation

If a home office qualifies as the individual's principal place of business, daily transportation expenses incurred in traveling between the taxpayer's residence and other work sites are deductible.

Self-employed files form 8829: Expenses for Business Use of Your Home.
Employee's home office expenses are a miscellaneous itemized deduction.

j. Hobby expense

Hobby or business, consider

The manner in which the TP carries on the activity
The expertise of the TP
The time and effort spent by the TP in the activity
The actual profits earned in one or more years
The elements of pleasure or recreation that are part of the activity

If show a profit in 3 out of 5 years of operation, burden of proof shifts to IRS. If activity is a hobby, income is included in GI and expenses are deductible to extent of hobby income as miscellaneous itemized deductions in the following order:

1. Expenses that would otherwise be deductible as itemized deductions (home mortgage interest, property taxes, and casualty losses)
2. Other business-type expenses (advertising, insurance, utilities, and maintenance)
3. Depreciation and amortization expense

Expenses in category 2 and 3 in excess of income are lost because there are no carryover provisions for any nondeductible expenses.

5. Accounting for income tax expense

Permanent differences have no deferred tax consequences

Temporary differences result in a deferred tax account

SFAS 109 Accounting for Income Taxes requires basing the income tax expense reported on financial statements on the current year financial statement income so tax expense matches the transactions reported on the financial statements, regardless of when the tax is actually paid.

Deferred tax asset is a prepayment of tax that will be refunded in a future year when temporary differences reverse.

Deferred tax liability is a current tax savings that will have to be paid in a future year when temporary differences reverse.