Top Small Business Tax Deductions

The tax burdens that come with owning a business can be discouraging, especially for first-time business owners. However, these additional taxes come hand-in-hand with additional tax deductions. Understanding and correctly using these deductions can be crucial to the success of your business, while using them incorrectly can lead to unwanted attention from the IRS. Small businesses are three times more likely to be audited than individuals are, but this is more often due to genuine mistakes than deliberate fraud. Before filing taxes for your business, it's important to understand what qualifies as a business expense and what qualifies as a personal expense so that you only file for legal business deductions.

You may be able to deduct many of the costs involved with running a business, including the following:

- **Auto expenses**
- **Home office deduction**
- **Travel**
- **Entertainment**
- **Equipment and operating costs**
- **Taxes and insurance**
- **Other deductions**

Before considering the different types of business expenses, you should first familiarize yourself with the broad definition of a business expense as it applies to taxes. When determining whether an expense is business or personal, consider the IRS definition that a business expense must be both ordinary and necessary in order to be deductible: "An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business." By considering these two qualifications, you can decide whether your deduction can truly be classified as a business expense.

Auto expenses

Certain professions require a fair amount of driving on the job. While commuting to and from the office doesn't count as a deductible business expense, other job-related driving does. There are two ways to deduct your mileage:

- **Actual expense method:** Using this method, you would be responsible for tracking all of your business-related driving expenses for the year, including gas, maintenance and repair costs, car insurance and your vehicle's depreciation. Record keeping for this method is easier if

Busine LLC
4225 Executive Square
La Jolla, CA 92037

www.businewealth.com
858.255.4274

you have a designated business vehicle. Using one vehicle for both business and personal matters complicates your calculations, but it may be worth it if it saves you money.

- **Standard mileage rate:** Instead of keeping track of all of your auto expenses, you'll only need to record your mileage (again, only that related to business activities). At the end of the year, multiply your mileage by the standard mileage rate, which is 56 cents per mile in 2014, and the product is your deduction. This rate takes gas, insurance, auto repairs, depreciation and other auto expenses into account, so there is no need to track anything other than business mileage.

Deciding which method to use is not as simple as choosing the bigger deduction. In your first year of business, choosing the actual expense method will preclude you from using the standard mileage rate in future years. On the other hand, if you use the standard mileage rate in the first year, you can switch back and forth between the two methods in future years. It's probably a good idea to use the standard mileage rate in the first year and then calculate both to find the largest deduction for your business in the future.

Home office deduction

Many small business owners are hesitant to claim the home office deduction because they fear it is an audit red flag. However, as long as you define "home office" correctly, you're not increasing your risk for an audit. Keep in mind that a home office must only be used for business purposes in order to be completely deductible. For instance, if your office doubles as a guest room, you cannot deduct it. That said, you can deduct a partial room if only part of your office is used for business. To claim the deduction, you must also show that you use your home as your principal place of business.

The home office deduction takes all home costs into account for your office or partial office, including utilities, homeowners or rental insurance, mortgage interest or rent payments and more. There are two ways to calculate your home office deduction:

- **Actual expense method:** This method involves taking the square footage of your office (either the whole room or the part devoted solely to business activities) and dividing it by the total square footage of your house. The percentage you get is the percentage of home expenses that you can deduct for your home office. This method will require you to calculate all home expenses, which can be a cumbersome process.

- **Safe harbor method:** The second option, available for the first time for the 2013 tax year, provides a standard deduction of $5 per square foot of the home used for business, up to 300 square feet. While this eliminates the need for tricky calculations on the taxpayer's part, it also eliminates certain deductions as well. Specifically, the depreciation of any home office space cannot be deducted under this method.

Choosing between these two methods may depend on the size of deduction you expect; as the safe harbor method has a maximum of 300 square feet, the total maximum deduction will be $1,500. If you expect to yield a much higher deduction with the actual expenses method, it may be worth the extra work it takes to calculate your home expenses.

Travel

For legitimate business travel, airfare, hotels and other travel expenses can be deducted. Almost any cost related to business travel is 100 percent deductible, but it's important to make sure you can prove that your trip was for business purposes. You can mix business with pleasure to some degree—for instance, if you take your family with you and stay in a hotel together, the cost of the hotel is deductible. Calculating deductions for business trips that are over a week long or part of vacation travel can be difficult and may require some tax research to do correctly.

Entertainment

Entertaining clients, customers, prospective business partners, etc. is deductible at 50 percent. This means you can deduct restaurant bills, theater tickets, sports events and more, as long as you can prove that the entertaining happened immediately before, after or during business activities. Proper documentation is important for this deduction. You should note on each receipt who was present and what business discussions or activities took place.

Equipment and Operating Costs

Running a business and spending money go hand in hand. You'll have to buy equipment and supplies and pay regular bills to run your business—anything from furniture and computers to Internet service and advertising costs are deductible. Not all business purchases can be deducted the same way, however, and there are limits to how much you can claim.

- **Business assets:** When you purchase something for your business that you intend to use for longer than a year (such as a computer, office furniture or specialized tools and equipment), you must either depreciate it over a number of years or deduct the entire expense under Section 179 of the Internal Revenue Code. Under Section 179, you can deduct up to $500,000 in 2014, with phase-outs beginning after $2 million of assets are purchased. Real estate, assets above the $500,000 limit and other exceptions must be depreciated yearly instead. Inventory purchased for resale is not deductible.

- **Bonus depreciation:** In 2014, business owners can take an additional 50 percent deduction on qualified assets that exceed the Section 179 limits, if placed into service for the first time that year. This means that if you write off $500,000 in business assets in 2014, you can also write off 50 percent of the remaining expenses you had in 2014.

- **Capital expenses:** The costs associated with going into business also have their own tax deduction. You can deduct up to $5,000 in capital expenses before going into business.

- **Current expenses:** Any expenses you incur for the daily operations of your business—office utilities, phone and Internet service, advertising costs, etc.—are considered current expenses. Subtract these expenses from your gross income at the end of the year.

Taxes and Insurance

As a business owner, even your taxes are tax deductible to a certain extent. The following taxes qualify:

- State income tax

- Employment taxes

- Sales tax on equipment and supplies (deducted with the cost of the items)

- Property tax for business real estate

Various insurance expenses are also deductible for business owners:

- Auto insurance for a vehicle used in business activities is deductible if you use the actual expense method. Insurance premiums are not deductible if you use the standard mileage rate to calculate your car expenses.

- Homeowners or rental insurance can be deducted as part of the home office deduction. You can also deduct insurance for business real estate not attached to your home.

- If you are self-employed, your health insurance costs are 100 percent deductible, provided you don't have access to insurance through a spouse's plan.

- Business liability insurance and other ordinary and necessary insurance are also 100 percent deductible.

Other Deductions

There are many other tax deductions you can take if you qualify. A tax professional can help you maximize your deductions. Here are some common business deductions:

- **Employees' pay:** You can deduct your employees' paychecks as a business expense.

- **Retirement plans:** Contributions you make to your own and your employees' retirement plans are deductible.

- **Interest:** Interest you pay on loans used for financing your business is deductible.

- **Charity:** Donations of equipment and supplies are fully deductible unless they've already been depreciated.

- **Moving:** Under certain circumstances, you can deduct the costs of moving. To qualify, you must move at least 50 miles and be able to prove that the move was necessary for your business.

- **Bad debt:** You can deduct the cost of goods that you sell but aren't paid for, but you cannot deduct unpaid services.

- **Social events:** Parties, picnics, etc. for employees are 100 percent deductible.

Owning and operating a business comes with a variety of expenses and often a hefty tax bill. However, by taking advantage of the numerous tax deductions available to small business owners, you can greatly reduce your tax burden and improve your business's odds of success. The IRS won't remind you to take your applicable deductions, so it's important to learn which ones apply to you.

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