BUSINESS EXPENSE BASICS

WHAT ARE DEDUCTIBLE BUSINESS EXPENSES?

Every business has expenses. These expenses offset the income your business generates, and you either pay tax on the profit or can use the loss to offset your other income. For an expense to be deductible against your income, it must be **ordinary** and **necessary** for your business.

An **ordinary** expense is one that is common and accepted in your industry. This requirement boils down to if your expense fits your business. A karaoke machine generally fits a party planner business, but probably doesn't fit a laundromat.

A **necessary** expense is one that is helpful and appropriate for your trade or business. This does not mean the expense must be indispensable for your business. It just must have a reasonable relationship with how your business plans to make money.

There are many rules related to how much of a business expense is immediately deductible, such as with depreciation or inventory, but whether or not the expense will be deductible follows the principles above.

NON-DEDUCTIBLE BUSINESS EXPENSES

Personal and job-related expenses are not deductible as business expenses. In general, job-related expenses you have as an employee aren't deductible on your personal income taxes. However, if your employer reimburses you for the expense, you generally don't have to report that reimbursement as income.

Most personal expenses are not tax deductible. However, it is common for a self-employed worker to have expenses for things that are used both for business and personally. If you have an expense like this, you may deduct the portion of the expense used for business but not the portion used personally.

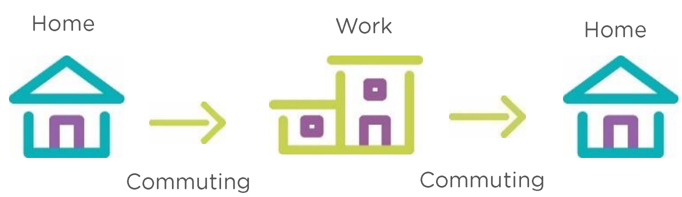
A common example of a mixed personal and business expense is a cellphone. If you use the same cellphone both personally and for your self-employment, you can deduct the portion of the expense used for your business. If you use your cellphone 50% for business, you can deduct 50% of your plan costs.

Another example is your car; you are likely to use your personal car as part of your business. You are allowed to deduct expenses related to miles you drove the car for business, but not any expenses for any miles you drove the car for personal use. See the next page for more details on determining business miles.

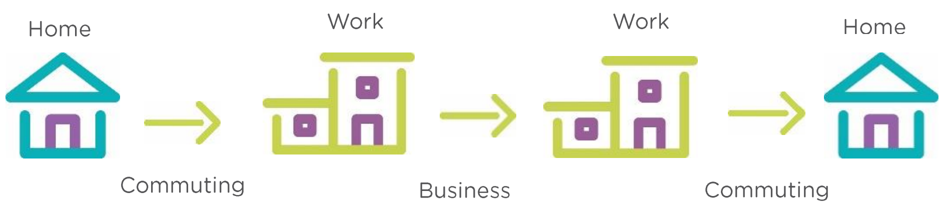
PERSONAL OR BUSINESS CAR EXPENSES

If you use a car both personally and for self-employment, you are allowed a deduction based on the miles you drove your car for business. To claim this deduction, you need to track how many of your miles were for business and how many were personal and commuting; personal and commuting miles are not deductible. Business miles are the miles from one work site to another. Here are some other examples of business mileage.

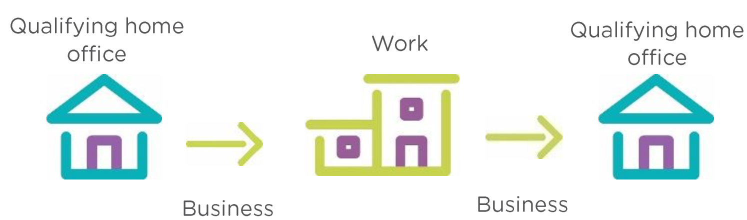
1. A self-employed taxpayer without a home office leaves home to go to a work site then returns back home. Both trips are commuting miles and not deductible.



2. A self-employed taxpayer without a home office leaves home for a work site then visits a second work site before returning home. The trip between work sites is deductible business mileage. The trips between home and work sites are commuting mileage and are not deductible. If you stop at a store to pick up job supplies before traveling to a work site, the trip from the store to the work site is considered business mileage.



3. The third scenario shows business mileage for a self-employed taxpayer with a qualifying home office. The taxpayer leaves home to go to a work site then returns back home. All trips are business mileage because the home office is considered a work site.



HOME OFFICE

You may be able to deduct a portion of your home expenses if you have a home office. The space must be an area of your home you use regularly and exclusively for business. It does not need to be an entire room, but the business space cannot be used for personal activities. The deduction is based on either a standardized rate or a percentage of the actual expenses.

DEPRECIATION

Depreciation is a method to deduct a portion of a large purchase over many years instead of taking an immediate tax deduction in the year you purchase it. This is to help shift the cost to offset future income the purchase generates. Some large purchases must be depreciated, but with some purchases you will have a choice to depreciate them or take them as a current year expense.

INVENTORY

In general, when you sell property, you deduct the cost of the property when you sell it instead of when you purchase it. Inventory is an accounting tool to record the value of the merchandise you purchase until you sell it and can take the deduction. You have an inventory if you sell merchandise. Tracking your inventory is important because you may buy and sell the merchandise in different tax years.

You do not have an inventory if you aren't selling merchandise to customers. For example, a masseuse may have oils and lotions used during massages, but those are considered supplies rather than inventory.

Contract sales is another common example of a business that does not have inventory. These sellers don't hold any goods, but instead they sell for another company and generally order merchandise for a customer.

INVENTORY VALUATION

Inventories need to be valued at the start and end of the year to report on your tax return. There are multiple methods to value an inventory, but the simplest and default is the Cost Method. Under the Cost Method, the value of your inventory is what you paid for each item in it. You just add up the cost you paid for each item to get your inventory valuation.

LEARN MORE

The IRS has additional information about what expenses are deductible and how much can be deducted as part of their online Small Business and Self-Employed Tax Center: www.irs.gov/businesses/small-businesses-self-employed.

If you have additional questions about business expenses, you can call the Prepare + Prosper Self-Employment line at 651-262-2169.