

Determining Your Business Deductions

What the IRS says counts



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What is deductible for business taxes? That is the question on everyone's lips this time of year. Essentially the Internal Revenue Service (IRS) has four basic rules for deductions, which are:

Rule 1: Expenses must be incurred in connection with your trade or business

Rule 2: Expense must be "ordinary"

Rule 3: Expense must be "necessary"

Rule 4: Expense must not be lavish or extravagant under the circumstances

If you cannot meet all four of the basic rules regarding deductions, you cannot deduct it.

When the IRS says that the expense must be incurred in connection with your trade, business or profession, they are referring to an activity that is carried on with a reasonable attempt to make a profit and the expenses incurred during that attempt. You must actually be in business in order to write off your expenses or they are considered start-up costs. Partly



personal and partly business expenses can be prorated, taking the portion that is business as a write off. Assets originally purchased for personal use and then turned into business use items can be deducted.

Sole-proprietors do not have to worry about who pays a business expense in order for it to be deductible. This is because the business is not separate from the individual. All other entities should have the business pay the invoice, if not, then business should pay the individual back through the use of an expense form.

Ordinary expenses are ones that are common and acceptable to your type of business. For example a restaurant will likely have a large amount of expense for dishes. The IRS considers expenses for dishes "ordinary" to the restaurant business, so the expense doesn't draw the IRS's attention. However, an accounting firm with the same amount of expense for dishes raises a red flag. It seems simple enough but many small businesses try to write off absolutely everything as an expense to the business. They rationalize it by saying, "I am the business and I am always doing business, therefore everything I do is deductible." That is where the next rule comes into play.

The expenses your business has must be necessary. This means that the expenses are actually anything that is appropriate and helpful to you so that you can make a profit. The IRS can rationalize that while advertising is necessary and helpful for you to grow your business, it is not necessary or helpful for you to have box seats at the hockey arena for entertaining your clients. If you have such

expenses, you will really have to prove that the use of those expenses really does increase your ability to make a profit. You may decide to use those tickets as rewards for your employees and therefore it is motivational and helps your business in that manner. If an expense seems like it could be questionable, a note in the books at the time of purchase is the best way to make sure your bases are covered if you should be audited.

Finally, if you are questioning an expense as seeming lavish and extraordinary, it probably is. If it sticks out like a hairy leg in a chorus line, then don't deduct it. I had a client that took a trip down to the Dominican Republic with her entire family and wanted to write it off as a business expense. She was trying every way in the world to rationalize it as a business expense but the reality was that it just wasn't business at all. Most of the time, you know if you really did business or didn't. If the trip was truly partially for business but you had some fun and you got to bring your family along, then the portion that is for business is deductible and the portion that is fun, family time is not. If you account for it right when it occurs, you shouldn't have any questions at year-end.

Remember, you have to meet all four of the basic rules regarding deductions or you cannot deduct it. It must be necessary, ordinary and incurred in connection with your trade or business and it must not be extraordinary or lavish.

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