Understanding Allowable Business Expenses

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It's crucial for business owners to understand exactly what expenses can be deducted from total revenues and reported to shareholders, employees and taxing authorities. Some expenses are obvious: wages, salaries, and benefits you pay employees, for example. Allowable expenses also can vary according to activity, and thus can be a challenge to fully understand.

What You Need to Know

Where do I start?

Keep accurate, detailed records, receipts and cancelled checks of all expenses! That's the cardinal rule, and a business must be diligent about obeying it. Even "little" expenses add up over a year's time. Recording and calculating categories of expenses on a computer spreadsheet is virtually essential now, and numerous business software packages are available at office supply stores and online. The more details a business has about its expenses, and the better organized they are, the better and more effectively run that business will be.

Is there a standard definition of allowable expenses?

Yes, but it is broad. Any "ordinary and reasonable expense" that helps a business generate revenue and earn income is deductible. Buying a new machine that assembles a product is one obvious example. Gasoline and tires for a delivery truck is another. Other examples include:

- employee wages, salaries, commissions, and benefits, including those paid to the owners;
- materials and supplies used to produce goods and/or deliver services;
- rent for the space a business occupies, or a mortgage payment if a business owns its own property;
- costs for electricity, natural gas, and other fuels;
- costs incurred in transporting goods, including vehicle fuel, and the cost of operating vehicles the business uses;
- advertising, marketing, and promotional costs;
- the value assigned to equipment as it ages, known as depreciation;
- various taxes businesses are required to pay.

Many expenses incurred in meeting with and entertaining customers and clients are allowable, too, but the rules governing them are open to interpretation. This is where good record keeping and common sense are paramount. Along with travel costs, entertainment expenses (“T&E,” as the category is dubbed) are ones that the IRS and other taxing authorities tend to scrutinize carefully.

Nonallowable expenses vary widely, too, such as any costs incurred for nonbusiness purposes, personal expenses, and expenses that can be reimbursed under insurance policies.

What is depreciation?

It is a noncash or theoretical expense that reduces the value of an asset over time, due to normal wear and tear, age and/or obsolescence (a five-year delivery van is not as efficient or reliable as a new one). Most assets lose much of their value over time, i.e. they “depreciate.” Accounting methods write off the value of the asset over its useful life, be it five years, seven years, or longer. Because depreciation, too, is an allowable expense, a business needs to understand it.

How important is outside advice?

In a word: essential! No business should try to operate without at least the occasional advice and counsel of an accountant, tax attorney, or both, depending on the business and its activities. Firms and individuals that provide such services abound, and many specialize in helping specific sectors, such as restaurants or small retail businesses. Select an accountant by first conferring with friends and acquaintances or business organizations such as a chamber of commerce. Members of service clubs like Rotary International can recommend good accountants, too. The fees these professionals charge are deductible expenses.

What to Do

Set Up Record Keeping

A typical and oft-suggested first step is simply putting *all* receipts in an envelope or folder, then dutifully recording the expenses on a computer spreadsheet, according to categories: payroll, office expenses, taxes, supplies, marketing, professional services, and so forth. It can be a tedious process, especially for an eager, visionary entrepreneur launching a new business. But it can save countless headaches. Spending time on this task early on will also save countless hours at the end of the business year. By organizing and tabulating expenses as you incur them, you are able to report aggregate totals and deduct them with relative ease.

Receipts, in particular, can be critical. The troubles that beset businesses during a tax audit usually are caused by poor record-keeping, not deliberate dishonesty. Receipts for travel, entertainment, and vehicle use often are the most important of all, because those are the expenses that usually draw the most critical review.

Find and Rely on an Accountant

Just one glance at a typical tax form illustrates why professional accounting assistance is so highly recommended. To begin with, these professionals will save you untold hours by allowing you to concentrate on running and growing your business. More important, accountants are fountains of knowledge. They know the applicable rules governing allowable expenses. They know what the IRS and other taxing authorities are paying special attention to at a given time. Finally, they keep up with changes, interpretations, and nuances in the tax codes. For example, a good accountant can explain the advantages and drawbacks of incorporating a business, or the best way to establish a consulting business. The best of these professionals will also help you set up your ledgers to track expenses efficiently, which will reduce the time they will need to spend preparing your business's tax returns—and, in turn, reduce their fees, which are allowable expenses, too.

Understand the Rules and Be Aware of Changes

Many accounting firms routinely provide information about any changes in how taxing authorities treat allowable expenses. Pay attention to these directives, which often are sent toward the end of a given year, or are made available on the Internet. For example, a change in the standard deduction for business miles driven (44.5 cents per mile for 2007), could be substantial, so a business needs to be aware of it. Knowing about other changes, and/or whether or not to incur specific expenses in a current year or postpone them can have a meaningful impact a business's overall performance.

In addition, specific types of business have allowable expenses that are unique to their particular sector. You need to be aware of these nuances, which can be significant. Years ago, for instance, General Motors Corporation and the IRS sparred for months over how the automaker deducted the cost of maintenance equipment, included cleaning rags.

Use Credit Cards, but with Care

Making purchases with specific credit cards designated for business use is a popular and recommended means of tracking and verifying expenses, since monthly credit card statements list specific purchases, prices, and transaction dates. That, too, eases record-keeping. A number of credit cards companies, American Express, for example, offer special services to smaller businesses, including modest discounts on purchases made with their respective cards. At year-end, these companies also provide statements that arrange purchases in specific categories.

Keep in Touch

Similarly, it is simply good business to confer with your accountant in the latter months of a business year, especially if you have had unusual expenses, or expect to incur them before the year ends. You are apt to learn, for example, if it is better to deduct the full expense of, say, an office copier in one year or spread out its cost over two or three years. Tax treatments can vary, depending on the expense.

If In Doubt, Ask

The language governing business expenses can be tricky, and even IRS agents can offer different interpretations. For example, standard instructions refer to a “tax home.” For most organizations, it is the regular place of business. Yet, for a small home-based business, the owner’s residence is considered its “tax home.” And, if there is no designation, the business could be considered “itinerant,” and thus “away from home,”which, in the extreme, might prompt a conclusion that no travel deductions are allowable!

By the same token, deducting a portion of rent or mortgage payments that a home office represents is allowable. Yet some accountants advise against doing so, for when it comes time to sell the residence, the portion of net proceeds that the home office represents might then be considered “income” due to capital gains, and therefore, be subject to taxation.

What to Avoid

You Are Careless!

Expenses profoundly impact any business’s yearly performance and earnings. Not keeping good records can be disastrous. So recording every transaction as it occurs is ideal. If that’s not practical, do it as often as it is practical but at least monthly.

You Spend Too Much Time Analyzing the Books

On the other hand, you are in business to provide a service or manufacture a product, not to study each and every expense down to the last dime to weigh its impact on profitability. There *is* a limit to sound record-keeping and analysis, lest a business devote so much time to the procedure that it forgets why it went into business in the first place and winds up having to go out of business.

You Fail to Call “Employees” “Employees”

A business might well want to declare that everyone working for it is an “independent contractor” in order to avoid payroll taxes and all the related reporting procedures. But if these workers are working exclusively for the business on a continuing basis, the taxman will see if differently and penalize accordingly. Generally, independent contractors are persons who have their own businesses and offer services to several firms. An example would be a graphic artist who designs Web Sites, or a writer hired to prepare material for a specific brochure.

You Take Chances

As the saying goes, “Don’t mess with IRS.” Take, for example, a business owner who plans a sales trip in conjunction with a family vacation. The owner can only deduct the actual expenses he or she incurs in pursuing sales. Allowable deductions can include the cost of the hotel room used by the business owner, since he or she would still need a standard hotel room if traveling alone. But additional charges or more expensive accommodations for the family are not allowable. Nor are the family’s meals or airfares. Logical? Absolutely. Yet too many individuals still try to deduct more expenses than they have a right to.

Where to Learn More

Books:

Daily, Frederic W., and Diana Fitzpatrick, Tax Savvy for Small Business: Year-round Tax Strategies to Save You Money, 10th Ed. 2006.

Fishman, Stephen, Deduct it! Lower You Small Business Taxes, 3rd Ed. Nolo, 2006.

Estill, Scott M., Tax This! An Insider’s Guide to Standing Up to the IRS, 4th Ed. Self-Counsel Press, 2007.

Harvey, Greg, Ph.D., Microsoft Excel 2007 for Dummies.Hoboken, NJ: Wiley, 2007.

Web Sites:

U.S. Internal Revenue Service: www.irs.gov/businesses/index.html

Tax and Accounting Sites Directory: www.taxsites.com

American Institute of Certified Public Accountants: www.aicpa.org