Business Tax Deductions

Accountable plan. Employer reimbursements for an employee's business expenses are deductible by the employer and not included in the employee's income. The expenses must have a business purpose and be substantiated by the employee, and the employee must return any excess reimbursements within a reasonable period of time. See Tab 9 of the *1040 Quickfinder® Handbook* for more information.

Awards and bonuses. Bonuses paid to employees are deductible if intended as additional pay for services. Gifts to employees or customers are limited to $25 per year, per individual [IRC §274(b)]. Cash or gift certificates given to employees must be treated as taxable wages. Also see *Employee Achievement Awards* in Tab K.

Advertising. Advertising costs that relate to business activities are deductible as current operating expenses. Advertising is not capitalized under UNICAP. Advertising to influence legislation is not deductible. Prepaid advertising costs are deductible in the year to which they apply.

Amortization. See Tab J.

Auto expenses. Passenger automobiles rated at or below an unloaded gross vehicle weight of 6,000 pounds are considered listed property. Deduction limits and substantiation requirements apply.

The value of an employer-provided vehicle must generally be included in the employee's wages. See Tab K for more information about employer-provided autos.

Self-employed individuals, including partners in a partnership, and employees who do not use more than four vehicles at a time for business are allowed to compute their deduction using the standard mileage rate (40.5¢ per mile from January 1, 2005, through August 31, 2005, and 48.5¢ per mile from September 1, 2005, through December 31, 2005). Generally, a corporation can deduct 100% of the costs associated with the auto. The business portion of the employee's use is deductible as a transportation expense while the personal use is deductible either as additional compensation or as a taxable fringe benefit.

Bad debts—Business. See *Business Bad Debts*.

Barrier removal for disabled or elderly. Up to $15,000 of the cost of removing barriers to make a facility more accessible for disabled or elderly individuals may qualify for a current deduction, as opposed to capitalizing the cost. Qualifying costs include those paid for grading, walks, parking lots, ramps, entrances, doors and doorways, stairs, floors, restrooms, water fountains, public telephones, elevators, and often-used controls such as lights and heat. The choice to deduct rather than capitalize the costs must generally be made by the due date of the return, but an amended return claiming the deduction may be filed within six months of the return due date. Some barrier removal costs may also qualify for the disabled access credit (Form 8826). See *Disabled Access Credit (Form 8826, IRC §44)* for more information.

Bribes or kickbacks. Payments made directly or indirectly to a government official or employee are not deductible if made in violation of the law. Payments are not deductible if made to any person in violation of a federal or state law that provides a criminal penalty for loss of license or privilege to engage in a trade or business.

Capital expenses. Regulation Section 1.162-4 states:

> "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition may be deducted as an expense… Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with Section 167 or charged against the depreciation reserve if such an account is kept."

Facts and circumstances determine whether an expense must be capitalized. Often there is no bright line and the issue ends up in court. In *INDOPCO*, 69 AFTR 2d 92-694 (Sup. Ct. 1992), the Court required capitalization of investment banking, legal and other fees associated with a change of ownership, even though a separate and distinct asset had not been created. The decision stated that "benefits beyond the year in which the expenditure is incurred" were sufficient to require capitalization. In subsequent litigation the IRS has relied heavily on *INDOPCO,* with mixed results.

Cinergy Corp, 91 AFTR 2d 2003-1229 (Fed. Cl. 2003). In 1972 the taxpayer used asbestos as a fireproofing material in constructing a building. In 1990 the taxpayer deducted the cost of removing the asbestos because it was deteriorating and previously unknown health threats had come to light. The IRS disallowed the deduction, arguing that the cost must be capitalized. Federal claims court found in favor of the taxpayer, stating that asbestos removal was necessary to keep the taxpayer's property in ordinary operating condition and did not increase the value of the building. The court determined the costs were not capital in nature, and were deductible as business expenses.

Northern, TC Summary Opinion 2003-113. The taxpayer owned a commercial building, which was rented to a tenant. The roof leaked, damaging the tenant's materials. The taxpayer paid for removal and replacement of the roof-covering material, and deducted the cost as a business expense. The IRS disallowed the deduction, arguing that the cost should be capitalized. Although the repairs were extensive, the court found in favor of the taxpayer and allowed the deduction. The court observed that:

> "…it is necessary to take into consideration the purpose for which an expenditure is made in order to determine whether such expenditure is capital in nature or constitutes a current expense…the taxpayer's only purpose in having the work done was to prevent leakage and keep the leased property in an operating condition over its probable useful life…"

Ingram, TC Memo 2000-323. The taxpayer was allowed to deduct costs of substantial periodic repairs to tugboat engines.

Cell phones. Cellular telephones are listed property. If business use is 50% or less, MACRS and the Section 179 deduction are not allowed, and the purchase price must be depreciated SL over seven years. Taxpayers must be able to substantiate business use with adequate records or sufficient evidence corroborating the taxpayer's claimed usage. [Reg. §1.274-5T(b)]

Charitable contributions. See *Charitable Contributions*, Tab 5, of the *1040 Quickfinder® Handbook* and in Tab 11 of the *Tax Planning for Individuals Quickfinder® Handbook*.

Circulation expenses. The cost of increasing circulation of a newspaper, magazine or other periodical is deductible as a current operating expense, or may be capitalized and amortized as a deferred expense. (IRC §173)

Club dues are nondeductible. This applies to organizations with a principal purpose of providing access to or conducting entertainment activities for members or their guests. Out-of-pocket business meals and entertainment expenses incurred at a club are deductible, subject to limits.

Computer software. See *Computer Software*.

Cost of goods sold. See *Cost of Goods Sold*.

Demolition expenses. Costs incurred to demolish a structure are added to basis of the land where the demolished structure was located.

Depletion. See Tab J.

Depreciation. See Tab J.

Development costs. Costs of developing a mine or other natural deposit (other than an oil or gas well) may be deducted. The costs must be paid after the discovery of ores or minerals in commercially marketable quantities.

Donations of patents, etc. A deduction for a contribution of a patent or certain other items of intellectual property to charity is limited to the lesser of (1) the taxpayer's basis in the property or (2) the FMV. Taxpayers may deduct certain additional amounts in later years, based on a specified percentage of qualified income received by the charitable organization from the contributed property. No deduction is permitted for income received by the charity after the expiration of the legal life of the patent or other intellectual property. [IRC §170(e) and (m)]

Donations to business organizations are deductible if: (1) the donation relates directly to the taxpayer's trade or business, (2) a reasonable expectation of financial return exists and (3) the donation is not a nondeductible lobbying expense.

Education expenses. An employer can deduct ordinary and necessary education expenses for training employees.

- *Educational Assistance Program.* Up to $5,250 of qualified educational assistance can be excluded from an employee's income (IRC §127). See Tab K for more information about educational assistance programs.

- *Working Condition Fringe Benefit.* Employer-provided education is excludable from an employee's income if the expense would have been deductible as a business expense if paid out of the employee's pocket.

Limit for individuals. An individual is generally not allowed to deduct education expenses if (1) the education is required to meet minimum requirements of the individual's employment or trade, or (2) the education will qualify the individual for a new trade or business. See *Education Costs* of the *1040 Quickfinder® Handbook* for more information about deducting education expenses for individuals.

- *Hope and Lifetime Learning Credits.* Qualified tuition and related expenses paid on behalf of a taxpayer, spouse or dependent may qualify for a credit on the individual's Form 1040.

- *Tuition and Fees Deduction.* Up to $4,000 of education expenses may be eligible for an above-the-line deduction as an adjustment to income on an individual's Form 1040 [IRC §222(b)(2)]. Qualifying expenses include those allowed in computing the Hope and lifetime learning credits [IRC §222(d)(1)]. See Tab 13 of the *1040 Quickfinder® Handbook* for more information about the tuition and fees deduction.

Employee awards. See *Awards and bonuses*.

Employee benefit programs. See Tab K.

Entertainment. See *Meals and entertainment*.

Entertainment expenses included in W-2 wages. When an employer adds the personal value of a benefit to an employee's taxable W-2 wages, the employer's deduction is limited to the lesser of the actual cost of the benefit, or the amount included in the employee's taxable wages. This rule applies to expenses for activities generally considered to be entertainment, amusement or recreation and facilities used in connection with such activities, such as a company airplane. Covered employees generally include officers, directors and 10% or greater owners of private and publicly held companies. [IRC §274 (a) and (e)]

Environmental clean-up costs. Revenue Ruling 94-38 held that costs incurred to construct groundwater treatment facilities were capital expenses. Other costs incurred to clean up land and to treat groundwater contaminated with hazardous waste resulting from business operations were deductible as business expenses. However, Revenue Ruling 2004-18 issued a clarification of the prior ruling, stating that otherwise deductible costs incurred by a manufacturing operation must be included in inventory under the uniform capitalization rules of Section 263A. If a taxpayer purchases land contaminated prior to acquisition, the cost must generally be capitalized. Section 198, however, allows for the deduction of environmental remediation costs for an area designated by a state to be a "qualified contaminated site."

Environmental remediation costs incurred to clean up land contaminated with a taxpayer's hazardous waste during operation of the taxpayer's manufacturing activities are allocable to the inventory produced under Section 263A during the year costs are incurred. (Rev. Rul. 2005-42)

Franchise. See *Intangible Assets*.

Fringe benefits. See Tab K.

Gifts. See *Awards and bonuses*.

Impact fees on real estate development (Rev. Rul. 2002-9). Impact fees are one-time charges imposed by a state or local government for offsite capital improvements necessitated by a new or expanded development. The Revenue Ruling treats impact fees as capital expenses that are added to the basis of the buildings. This allows developers to depreciate impact fees over the life of constructed buildings, rather than adding the fees to the basis of nondepreciable land. Impact fees may also be considered for purposes of computing the low-income housing credit. The Revenue Ruling provides procedures for obtaining an automatic change in accounting method.

Impairment losses. See *Impairment Losses*.

Improvements and repairs. Cost of incidental repairs that keep property in efficient operating condition and do not materially add to its value or appreciably prolong its life are deductible as current operating expenses (Reg. §1.162-4). Also see *Capital expenses*.

Insurance. See *Insurance*.

Intangible assets. See *Intangible Assets*.

Intangible drilling costs. See *Intangible Drilling Costs.*

Interest. See *Interest Expenses*.

Inventories. See *Inventories*.

Lawyers costs incurred on behalf of clients. Costs such as filing fees, travel expenses, expert witness fees, etc., paid by a law firm on behalf of a client may be deductible depending on the fee structure. Such expenses paid under a contingent "net fee arrangement" (an agreement stating expenses will be paid out of a settlement before the lawyers fees are determined) have generally been considered by the courts as nondeductible advances when incurred, and are not included in income when recouped. In contrast, client expenses paid under a "gross fee arrangement" (where lawyers fees are based solely on a percentage of a settlement) are considered ordinary and necessary business expenses and are deductible when incurred. [*Boccardo*, 75 AFTR 2d 95-2244 (9th Cir. 1995)]

Lease payments. See *Lease and Rental Expenses*.

Legal and professional fees. Legal, accounting and other professional fees that are ordinary and necessary expenses of operating a business are deductible as a current operating expense. Fees paid to acquire a business asset must be added to the basis of the asset. Fees paid to organize a partnership or corporation are electively deducted as a current business expense up to $5,000. The $5,000 deduction is reduced for organizational costs exceeding $50,000. Any remaining costs are amortized over 180 months.

Tax preparation fees attributable to preparation of Schedules C, E and F of Form 1040 are deductible as a business expense and are not subject to the 2% AGI limitation on Schedule A. (Rev. Rul. 92-29)

Licenses and fees. Annual license and regulatory fees paid to state or local governments generally are deductible. However, costs for licenses that are essential to the establishment of a taxpayer's trade or business must be capitalized. For example, costs of acquiring (including issuing or renewing) a liquor license, taxicab medallion or license, or a television or radio broadcasting license must be amortized as Section 197 intangibles.

Lodging expenses incurred in connection with business travel are deductible if reasonable and necessary. The travel must be directly related to the conduct of the taxpayer's business. Personal activities during business travel will not automatically disqualify the deduction, but the trip must be primarily for business in order to qualify for deduction. [IRC §162(a)(2)]

Machinery parts. Unless UNICAP applies, the cost of replacing short-lived parts of a machine to keep it in good working condition are deductible.

Meals and entertainment. In general, 50% of business-related meal and entertainment expenses are deductible. The limit applies to employers (including partnerships and corporations) even if they reimburse their employees for 100% of the expenses. See Tab K for more information, including exceptions to the 50% limit.

Moving machinery. The cost of moving and installing machinery from one location to another is deductible. The cost of installing newly purchased machinery must be added to the basis of the machinery.

Nonaccountable plan. Employee expense reimbursements made under a plan that does not meet the requirements for an accountable plan (see *Accountable plan*) are considered made under a nonaccountable plan. Reimbursements made under a nonaccountable plan are treated as taxable wages to the employee.

Not-for-profit activities. If an activity is not engaged in for profit, the deduction for expenses associated with the activity is limited to income. The deduction limit applies to individuals, partnerships, estates, trusts and S corporations. The limit does not apply to C corporations. See information about hobby loss limits in Tab 6 of the *1040 Quickfinder® Handbook*.

Organizational costs. See *Organizational and Start-Up Costs*.

Outplacement services. The cost of providing outplacement services to employees to help them find new employment is deductible if the services are provided on the basis of need and a substantial business benefit exists for the employer (positive business image, maintaining employee morale, avoiding wrongful termination suits, etc.). If the employee can choose to receive cash or taxable benefits in place of the services, the value of the services is included in the employee's income.

Penalties and fines. See *Penalties and Fines*.

Personal expenses. In general, personal expenses are not deductible [IRC §262(a)]. If an expense relates to an item that is used for both personal and business purposes, only the business portion may be deducted.

Political and lobbying expenses. Amounts paid to influence legislative matters or to participate in political campaigns generally are not deductible [IRC §162(e)]. Dues paid to a tax-exempt organization are not deductible to the extent the amounts are used by the organization for nondeductible lobbying activities. Payment for advertising in convention programs or admission to dinners or inaugural events is considered indirect political contributions and is not deductible if any of the proceeds are for the benefit of a party or candidate.

An exception exists for expenses of lobbying a local governing body with regard to local legislation that is of legitimate business interest to the taxpayer. A *de minimis* exception states that in-house expenses connected with lobbying are deductible, but only if the total of such expenses do not exceed $2,000 for the tax year. A professional lobbyist is allowed to deduct business expenses in connection with lobbying.

Reimbursed employee expenses. See *Accountable plan*.

Rent. See *Lease and Rental Expenses*.

Repairs. See *Improvements and repairs*.

Research and development costs. See *Research and Development Costs*.

Restaurant or tavern smallwares (Rev. Proc. 2002-12). Costs of replacing smallwares such as glassware, dinnerware, pots and pans, tabletop items, kitchen utensils and food storage supplies are deducted in the year they are available for use at a taxpayer's restaurant. An automatic change in accounting method is available subject to limitations set forth in the Revenue Procedure. **Note:** The deduction is for replacement items only. Costs of opening a restaurant with an inclusive package of smallwares purchased as part of a business acquisition must be deducted and/or amortized or capitalized as start-up costs.

Rotable spare parts. Companies that provide maintenance contracts with equipment sold or leased often use spare parts from pools to complete repairs, then recondition the old parts and return them to the pool for later use. These "rotable spare parts" are treated as depreciable assets, not inventory. (Rev. Rul. 2003-37)

Start-up costs. See *Organizational and Start-Up Costs*.

Supplies and materials. Costs of incidental supplies and materials are deductible as current operating expenses. This includes office supplies, books and equipment with a useful life of less than one year. If an unusually large purchase is made, the cost is considered a prepaid expense, and a deduction is not allowed until the year in which the items are used. Supplies and materials used to manufacture a product are added to inventory and deducted as cost of goods sold.

Taxes. See *Taxes*.

Telephone. In the case of an individual, any charge (including taxes thereon) for basic local telephone service with respect to the first telephone line provided to any residence of the taxpayer is a personal expense. [IRC 262(b)]

Trademark and trade names. See *Intangible Assets*.

Travel. Costs for transportation, lodging and meals are generally deductible if the expenses are reasonable and necessary, and if the trip is primarily for business. See *Lodging* and *Meals and entertainment*.

Tools. The cost of tools with a useful life of less than one year is generally deductible when purchased, unless UNICAP applies. Tools with a useful life of more than one year are depreciated. See Tab J for information about depreciation.

Truck tires (Rev. Proc. 2002-27). Original and replacement truck and tractor tires often have a useful life of less than one year. Revenue Procedure 2002-27 establishes the original tire capitalization method (OTCM). Under the method, the cost of original tires is depreciated as part of the vehicle and the cost of replacement tires is deducted as a current expense. If a taxpayer uses OTCM, it must use the method consistently for all its vehicles.

Wages. See *Wages*.