What kind of deductions can I take as a small business?

Sure, you pay tax on your business profits. But there’s good news, too. You can reduce your taxable income significantly by taking all the deductions you’re entitled to as business expenses.

To determine whether you can deduct an expense, ask yourself: Is this expense both ordinary and necessary to the business? The IRS requires both elements.

1. An expense is ordinary if it is common and accepted in your industry.
2. An expense is necessary if it is helpful and appropriate for your business.

Read below for information about some of the most common small business deductions.

Automobiles

As a small business owner, you can deduct automobile expenses for visits to clients, vendors, or travel to business meetings away from your regular workplace. If you operate your business out of your home, a drive from your home to a supplier and back home again is a 100% deductible business expense.

When figuring auto expenses, each year you typically can choose between taking the standard mileage rate (which generally changes every six months to a year), or deducting your actual expenses for items such as gas, oil changes, tires, repairs, preventive maintenance, insurance and registration.

- If you choose to deduct your actual expenses in the year you start using your car for business, you can't switch to the standard mileage rate later.
- If you choose the standard mileage method first, you can switch to actual expenses in a later year.

In choosing the method that yields the higher deduction, the number of miles you drive each year is probably the most important factor.

- If you do a lot of driving, then the standard mileage rate method may work better for you.
- Automobiles that consume more gas or require a lot of maintenance may let you claim a higher deduction using the actual expense method.

When deducting your automobile expenses, you are typically required to keep a record of the use of the vehicle. Often, the best way to do this is with a written log of your trips noting the date, the miles driven, and the purpose of each trip. Try to keep a record of your trips as they occur, when it's easier to keep track of the details or perhaps use a phone app to track your activity.

- Keep a record of your gas purchases, insurance and registration payments, and repairs and maintenance costs.
- If the IRS ever audits you, you will likely need to provide written documentation to substantiate your deduction.

If you're self-employed, even if you claim the standard mileage rate, you can also deduct:

- The business part of interest on your car loan
- State and local property taxes
- Parking fees and tolls

Bad debts

How can something bad be good for you? Easy: If you loaned money to customers, suppliers or employees who never paid you back, you may be able to claim a bad-debt deduction to offset part of your loss. This type of debt must have the following characteristics:

- **Debtor-creditor relationship—**There must be a legal obligation for a debtor to pay a creditor a specified sum of money. The best way to establish this relationship is with a written document stating the amount of the loan, interest rate, repayment schedule, etc. This is particularly important if you lend your corporation money. Without written documentation of the loan, the IRS may treat the advance as a contribution of capital to the business and it will not be deductible.
- **Worthlessness—**You must prove that the debt is uncollectible and that you attempted to collect it.
- **Loss—**You must have sustained a loss because of the debt.

It's also possible to claim a bad-debt deduction if someone doesn't pay you for work you performed or products you sold.

- To qualify for this tax-saving deduction, though, you must use the accrual method of accounting, which entails booking income when a product or service is sold, for example.
- If your business uses the cash-basis method, you can't deduct a worthless receivable as a bad-debt expense because you don't count income until it is received and would not need a deduction to offset the amount not included in your income.

Depreciation

With an ordinary business expense, you typically deduct the entire cost of the purchase in the tax year of the expense. But if you purchase an asset for your business that you will use beyond the current tax year, you usually are required to spread out the deduction over the asset's expected life. This concept of spreading out a deduction over the life of an asset is called depreciation.

The asset needs to meet three requirements in order to be depreciated. It must be:

1. Used in the business or held to produce income
2. Expected to last more than one year
3. Something that wears out, gets used up, or loses its value over time

The following assets can't be depreciated:

- Property that you place in service and dispose of in the same year
- Inventory
- Land
- Repair and maintenance expenditures that do not increase the value of your asset, make it more useful, or increase its life. (These expenses are typically deductible in full in the year you incur them.)

Of course, there are always exceptions. Small businesses may be able to deduct the entire cost of a depreciable asset in the year it is placed in service instead of spreading the cost out over the life of the asset.

- This is can be accomplished with bonus depreciation or Section 179 deductions after the section of the tax code that authorizes it.
- It also goes by the phrase "expensing," because you get to deduct the full cost at once—just like you do for business expenses—rather than depreciating the capital asset over time.
- For assets placed in service in the 2022 tax year, you can take a maximum Section 179 deduction of $1,080,000.
- The amount you can expense is reduced if you purchase more than $2,700,000 in eligible property during the year.

While the idea of taking a huge deduction right away may sound good to you, be careful, because there is a downside. If you sell an asset, you may have to recapture all or part of the depreciation deductions. (Recapture means reversing all or part of your earlier deductions by adding them back as income.)

Bonus Depreciation: Bonus depreciation has been changed for qualified assets acquired and placed in service after September 27, 2017. The old rules of 50% bonus depreciation still apply for qualified assets acquired before September 28, 2017. These assets had to be purchased new, not used. The new rules allow for 100% bonus "expensing" of assets that are either new or used.

- The percentage of bonus depreciation phases down in 2023 to 80%, 2024 to 60%, 2025 to 40%, and 2026 to 20%.
- After 2026 there is no further bonus depreciation unless it gets extended.

- This bonus "expensing" should not be confused with expensing under Code Section 179 which has entirely separate rules, see above.
- The 100% bonus expensing is also available for certain productions (qualified film, television, and live staged performances) and certain fruit or nut trees planted or grafted after September 27, 2017.
- 50% bonus first year depreciation can be elected over the 100% bonus expensing for the first tax year ending after September 27, 2017.

Employee compensation

Compensation you pay employees is deductible, including:

- Salaries
- Awards
- Bonuses
- Payroll taxes
- Fringe benefits such as health insurance, sick pay and vacation pay

You get a deduction whether you pay wages to employees, to whom you provide a W-2, or use independent contractors, to whom you issue Form 1099-NEC. You can also write off the cost of qualified benefits such as,

- Group-term life insurance
- Adoption assistance
- Dependent-care assistance
- Educational assistance

Other deductible fringe benefits include qualifying expenses such as:

- Discounts on goods or services
- Flights on airplanes
- Meals and lodging
- Memberships in country clubs
- Tickets to entertainment or sporting events
- Use of a car

Home office

You can work out of your home and save on taxes at the same time. Sound impossible? It’s not, but the home office deduction is a bit tricky, so you need to know all the ins-and-outs. To take the home office deduction, you have to use your home office regularly and exclusively for your business. Generally, your home office must be your principal place of business, or you must use it to meet clients or customers on a regular basis.

- **Exclusive use** means that you've got a specific area of your home that you use only for your trade or business. For example, if the den in your home is used only as your office, you can take the deduction. But if the kids also play there or you use it as an entertainment area, you can’t. So do yourself a favor and move the toys and that big-screen TV to another room in your house.
- **Regular use** means that you use the space as an office on an ongoing basis. Occasional or incidental use does not qualify for business use, even if the office is used exclusively for business purposes.

To claim that your home office is your principal place of business, you are required to perform the most important part of your work there or use the office for administrative or management activities, and not perform these activities at any other fixed location, such as another office off-site.

Examples of administrative and management activities include:

- Billing customers
- Keeping books and records
- Setting appointments
- Ordering supplies
- Writing reports

For example, if your business involves repairing clients' computers in their homes, you can deduct your home office if you use it to set up appointments and bill customers, even though you don't repair the computers in your office.

You can also claim the home office deduction if you store inventory or product samples there, or if you operate a day care facility.

The size of your deduction depends on the percentage of your home that is used for business. If your total business expenses exceed gross income from business use of your home, your deduction can be limited.

The two most common methods of calculating business percentage are:

- Dividing your home office's square footage by that of the entire house
- Dividing the number of rooms used for business by the home's total number of rooms, if all rooms are about the same size

Beginning with 2013 tax returns, the IRS began offering a simplified option for claiming the deduction. This new method uses a prescribed rate multiplied by the allowable square footage used in the home.

- For 2022, the prescribed rate is $5 per square foot with a maximum of 300 square feet.

- If the office measures 150 square feet, for example, then the deduction would be $750 (150 x $5).
- The space must still be dedicated to business activities.

With either method, the qualification for the home office deduction is determined each year. Your eligibility may change from one year to the next.

Because the home office deduction is a complex area that has been the subject of much controversy and many court cases, you may want to look at more detailed discussions of this deduction in [IRS Publication 587: Business Use of Your Home].

Insurance

You can deduct insurance expenses for your business as long as they're ordinary and necessary. Common examples include:

- Casualty and theft insurance
- Professional liability or malpractice insurance
- Accident and health insurance
- Coverage for vehicles used in your business

There are a few types of insurance costs that you may not deduct. These include:

- Life insurance where you are directly or indirectly the beneficiary. This includes policies you take out on yourself to secure a loan for your business
- Loss-of-earnings insurance that pays for lost earning due to sickness or disability

Interest

Generally, you can deduct all of the interest you pay during the tax year on debts related to your business.

- For example, if you take out a bank loan to buy business equipment, that interest is deductible.
- If you're just starting your business and you use a credit card to help with start-up costs, or if a relative loans you money, such interest costs are also tax-deductible.

A corporation can deduct the interest it pays on loans from its shareholders. There should be a valid business purpose for such a borrowing arrangement and written documentation in place detailing the:

- amount of the loan
- interest rate
- maturity date

Since these types of arrangements may receive increased scrutiny from the IRS, you should have evidence that the transaction is a loan and not an investment.

Loans that are for both personal and business uses are only partially deductible because the personal use will limit your deduction. For example, if you take out a car loan on a vehicle that you use for both business and personal reasons, part of the loan interest won't be deductible.

Legal and professional fees

Fees that you pay to professionals, such as attorneys and accountants, are deductible when they relate to your business. If you purchase depreciable business assets, the fees paid for professional services are not deducted, but are added to the tax basis (or cost) of business asset.

Example: You negotiate the purchase of a pool-cleaning route for $22,500. You pay $2,500 in professional fees for an attorney to draft a non-compete agreement with the seller and hire an accountant to perform a due-diligence review of the books. For tax purposes, your cost basis in the pool route is $25,000 ($22,500 + $2,500).

If you began the business this year, legal fees to incorporate or to organize your business as a partnership may also be deductible.

- In 2022, you can deduct up to $5,000 in business start-up expenses and another $5,000 in organizational expenses in the year you begin business.
- Additional expenses need to be amortized over 15 years.

If you are a sole proprietor, you can deduct accounting and tax preparation fees on Schedule C, to the extent that they are related to your business.

Pension plans

If you set up and maintain a retirement plan such as a Simplified Employee Pension (SEP) plan or a Savings Incentive Match Plan for Employees (SIMPLE) plan, you can deduct contributions you make for yourself and your employees.

If you don't have aby full-time employees, except your spouse, you may find that an individual 401(k) plan may offer an even better deal than a SEP or SIMPLE plan.

Typically, qualified contributions for a sole-proprietor are not deductible as a business expense but are a deduction for calculating your adjusted gross income and therefore reducing your income tax.

You can also deduct trustee fees incurred to maintain and administer the plan if contributions to the plan don't cover those fees. To learn more about different plans and how to set them up, see:

- IRS Publication 560: Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)
- IRS Publication 590-A: Contributions to Individual Retirement Arrangements (IRAs)

Rent

The IRS defines rent as any amount that you pay to use property you do not own. Most of us are familiar with the concept of paying rent for office space, land or equipment. The home office deduction discussed above allows for the deduction of a portion of your rent on your home, condo or apartment if you use part of it as a place of business.

If you rent property from your relatives or a related company and the IRS deems the rent to be excessive, the IRS will disallow the deduction.

- To avoid this, make sure the rent is comparable to what you would pay a stranger.
- Contact a real estate agent and ask them to prepare comparisons of similar properties in the area to substantiate the rent you are paying to a related party.

Rents are usually deductible in the year they are paid.

- For rent paid in advance, you can only take a deduction for the portion that applies to your use of the property during the tax year.
- For example, on January 1, 2022 you sign a three-year lease for office space, agreeing to pay a total of $30,000 in rent. You pay the entire cost up front. You can deduct $10,000 in 2022 and another $10,000 in each of the next two years.

Taxes

There are many taxes that you can deduct when operating a business. For example, if your state taxes the gross income of your business, you can deduct that tax on your federal return. As an employer, you can also deduct your share of your workers' employment taxes.

Here are some other taxes you can deduct:

- Personal property taxes imposed by your state or local government for business property.

- Real estate taxes, which are deductible to the extent that you use the land for your business. If you qualify for the home office deduction, you can deduct a portion of your real estate tax against your gross revenue.
- Sales and excise taxes, which are deductible when paid for business-related purchases or services. But if the tax is on a depreciable asset, add the tax to the basis of the asset.

Fuel taxes that you pay for gasoline, diesel or other types of motor fuels are already reflected in the cost of the fuel, so you can't deduct these taxes as a separate item. Note that you may be entitled to a credit or refund for federal excise tax you paid on fuels used, for example, in a farming operation where your vehicles are used off-road.

Travel, meals, and entertainment

Go out on the town with your clients, pick up the bill and get a tax deduction. What could be easier? Just make sure that the outing is business-related. In other words, any payments you deduct for travel and meals must be ordinary and necessary in your trade or business.

- In general, for tax years prior to 2018, entertainment expenses must be directly related to, or associated with, the conduct of your trade or business.
- Beginning in 2018, generally, entertainment expenses are no longer deductible.

Travel expenses include those for ordinary and necessary travel away from home over night for your business. You must meet two conditions to take the travel expense deduction:

1. Your duties require you to be away from home (your regular place of business, regardless of where you maintain your family home) substantially longer than an ordinary day's work.
2. You need sleep or rest to meet the demands of your work while you're away.

If your trip meets these requirements, you can deduct a wide variety of travel-related expenses, including costs for:

- Transportation (using a plane, train, bus or car) between your home and your business destination, including taxi, commuter bus and limousine fares
- Shipping items such as samples or display materials
- Using your own vehicle for business travel. You can choose between deducting actual expenses or taking the standard mileage rate.
- Tolls and parking
- Rental cars
- Meals and overnight lodging. You may deduct only 50% of the cost of business meals. Except that in 2021 and 2022 you can deduct 100% of the cost of qualified business meals provided by a restaurant.

Other deductible travel-related expenses include:

- Costs for dry cleaning and laundry care
- Telephone calls
- Use of fax machines
- Tips

Meal expenses include those incurred while traveling away from home or for business-related meals with business associates at your place of business, a restaurant or other location. This deduction may also apply to meals you furnish on your premises to your employees.

Entertainment expenses fall into a broad category and include any activity generally considered to provide amusement or recreation. Some examples include hosting clients at social, athletic or sporting clubs, theaters, yacht trips, hunting or fishing, vacations and the like. Beginning with tax years after 2017, generally no entertainment expenses are any longer deductible.

For more information on travel, see IRS Publication 463: Travel, Entertainment, Gift, and Car Expenses.

Other

So far, we've discussed the most common small business deductions. Other deductible expenses include:

- Advertising
- Educational expenses
- Licenses and regulatory fees
- Dues and subscriptions for professional organizations or business publications
- Recruiting services for hiring employees
- Penalties and fines you pay for late performance or nonperformance of a contract

Expenses you can't deduct

Sorry, the news on write-offs isn't all good: Some business expenses are not deductible under any circumstances including:

- the dues you pay at a club to be a member even if your membership is for business
- federal income tax payments
- lobbying expenses
- penalties and fines you pay when you break the law
- political contributions