Learning Objectives

- Classify self-employed and employee expense deductions for AGI vs. from AGI
- Identify requirements for travel and transportation expense; complete Form 2106
- Identify how to calculate home office deduction
- Determine how to claim common business expenses
- Complete a Schedule C (Profit or Loss from Business)
- Understand special rules applicable to moving expenses
- Ascertain when activity is a hobby and identify tax treatment
Business Deductions

- Deduction *from* AGI are itemized deductions
  - Subtracted after AGI is calculated such as employee expenses – reflected as itemized deductions on Schedule A
  
or

- Deduction *for* AGI such as
  - Self-employed taxpayer’s business expenses for those engaged in trade or business (on Schedule C)
  - Expenses associated with rental/royalty income (on Schedule E)
Classification of Business Deductions

Are expenses from self-employment?

Yes

Deduct For AGI

Schedules C, E or F

No

Deduct From AGI

Next Slide
Classification of Business Deductions

Are expenses reimbursed by employer?

No

If necessary for performance of job, itemize deductions on Schedule A (subject to 2% AGI)

No tax effect

Yes

Does firm have accountable plan?

Yes

Did employee substantiate & return excess funds?

- Reimbursement included in gross wages
- Deduction on Schedule A - miscellaneous itemized (2% AGI)

No

From prior

Yes

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Travel Expenses

- Expenses include lodging, taxis, laundry, tips, and meals
  - Meals are only 50% deductible
- To deduct, travel expenses must result from a documented business reason
  - Ordinary and necessary
  - Substantiated and not lavish
Travel status requires being away from home overnight
  ◦ “Overnight” defined as long enough to need relief from work and
  ◦ Need to be away from “tax home” to be on travel status
  ◦ Tax home is defined as primary place of business - not necessarily the same as family residence

Expenses of temporary assignments are deductible, if not practical to return home each night

Long-term temporary assignments, generally over one year, may require reclassification of new tax home for taxpayer

No travel deduction allowed unless taxpayer keeps proper records
Travel Expenses

Deductibility dependent on (a) where travel occurred and (b) classifying trip as business, pleasure or combination

➢ If primarily business trip in U.S.
  ◦ All travel costs (to/from) are deductible
  ◦ Travel expenses split between business and personal

➢ If primarily pleasure trip (in or outside U.S.)
  ◦ Travel costs (to/from) are not deductible
  ◦ Meals, lodging, local transportation and incidental expenses are split between personal and business

➢ If primarily business trip outside U.S.
  ◦ Travel costs (to/from) split between business and personal based on number of days
  ◦ Other travel costs deductible, if associated with business
Per Diem Substantiation

3 methods of calculating per diem

- **Regular Federal Rate Method** (lodging, meals & incidentals)
  - A standard base rate of $116 per day, but the federal rate is higher in specified “high cost areas”
  - Per diem amounts for each part of country updated regularly at [www.irs.gov](http://www.irs.gov) – Publication 1542
  - This method requires tracking number of nights in each locality

- **High-Low Method** (lodging, meals & incidentals)
  - Easier to use if employees travel extensively
  - A few high areas are specified by IRS ($258/day) and the rest are low areas ($163/day)
  - If chose this method, must continue throughout the year

Per diem eliminates necessity of keeping copious records
Rates are split into meals (only 50% deductible) and lodging
Per Diem Substantiation

- Meals and Incidental Expenses (M&IE) Method
  - Allows a per diem for meals and incidentals, plus actual lodging receipts
  - Use either high-low M&IE rates ($65 and $52)
  - If taxpayer is self-employed and elects a per diem method, he/she must choose this one

Note: sometimes rates revised more often than annually
Example

Gretchen, a Sustainability Director, travels from Idaho to New Mexico for business, paying $380 for airfare. She then spends $330 on lodging and $150 on meals, for the business portion of the trip. While there, she goes on a personal sightseeing tour of the Turquoise Trail and spends $400 on car rental and lodging and $85 on meals. What may she deduct for business travel?
Example
Gretchen, a Sustainability Director, travels from Idaho to New Mexico for business, paying $380 for airfare. She then spends $330 on lodging and $150 on meals, for the business portion of the trip. While there, she goes on a personal sightseeing tour of the Turquoise Trail and spends $400 on car rental and lodging and $85 on meals. What may she deduct for business travel?

Solution
Since the trip was primarily business and in the U.S., all the airfare is deductible; the lodging of $330 and 50% of the $150 business meals are also deductible. None of the personal expenses are deductible. Total deduction = $785.
Transportation

- Certain transportation expenses for business purposes are deductible by taxpayers
- Taxpayer doesn’t have to be away from tax home to get transportation deduction
  - Commuting is never deductible, except if:
    - Traveling between home and work locations outside the metro area where taxpayer has regular place of business
    - Traveling between home and temporary work when taxpayer has regular place of business
    - Travel when taxpayer’s principal place of business is home

*Plus can deduct additional cost of hauling tools/instruments*
Transportation

- Cost of plane, rail, bus and auto (actual or standard) potentially deductible
- May choose standard mileage deduction
  - $.50 per mile
  - Plus business portion of
    - Parking, tolls and personal property taxes
    - Auto loan interest (if self-employed)
- To use standard mileage deduction, taxpayer must
  - Own or lease car
  - Not rent out
  - Not own fleet using 4+ autos simultaneously
  - Not have taken depreciation other than straight-line
  - Not have taken Section 179 depreciation on auto
Transportation

- May choose to take actual expenses
  - If choose actual expenses - cannot change to standard
  - If choose standard - may change to actual, but then must use straight-line depreciation

- Must keep adequate cost records
  - To calculate deduction, multiply actual expenses by business-use percentage

- Business use % = Business miles/Total miles
Transportation

- Actual expenses include
  - Gas, oil, repairs and maintenance
  - Depreciation
  - Personal property taxes
  - Interest on car if self-employed

- Business-related parking/tolls *fully deductible*
  - Not multiplied by business use percentage

- Reporting
  - Taxpayers other than self-employed, report on Form 2106, which carries to Schedule A
**Office in Home (OIH)**

- Deduction for business use of a home is allowed *only by exception*, including:
  - Home used regularly and exclusively as principal place of business or required for the “convenience of employer” when regular office not provided
    - or
  - The regular place to manage business or meet with clients/patients
    - or
  - Office is separate structure and used exclusively for business
    - or
  - Dwelling unit is used for inventory storage and home is taxpayer’s sole place of business
OIH – Gross Income Limitation

- OIH deduction cannot be used to create a net loss for the business
  - *Other than allocable portion of mortgage interest and property taxes*
  - These are generally tax deductible anyway
  - Any excess can be carried forward to future years

- The other costs of operating a home which are included in the home office allocation include
  - Rent, home insurance, repairs, cleaning, gardening, homeowners' association dues, and depreciation on the cost of the home
  - Any excess can be carried forward to future years
Example

Kitty, a part time cartographer, maintains an office in her home where she reads electronic maps and keeps client records. She allocates $12,000 in mortgage interest and taxes to her OIH and collects $11,000 in fees. Assuming no other business expenses, what is her current year OIH deduction? How would this change if she also allocated $2,500 in maintenance and utilities? Will she have an OIH carry forward in the first scenario?
Example
Kitty, a part time cartographer, maintains an office in her home where she reads electronic maps and keeps client records. She allocates $12,000 in mortgage interest and taxes to her OIH and collects $11,000 in fees. Assuming no other business expenses, what is her current year OIH deduction? How would this change if she also allocated $2,500 in maintenance and utilities? Will she have an OIH carry forward in the first scenario?

Solution
In the first example, she may deduct the entire $12,000 with no loss carry forward. In the second scenario, she would not be able to deduct the additional $2,500 as she is limited to the gross income derived from the trade or business, resulting in a $2,500 OIH carry forward.
Complete Form 8829 – “Expenses for Business Use of Your Home”

- If taxpayer is self-employed
  - Allowable deduction carries from 8829 to bottom of Schedule C

- If taken as an employee business expense
  - Allowable deduction carries to Schedule A
    - But can only take if necessary for employer convenience and
    - Employer does not provide a regular office
OIH Allocation

- Allocation % done on basis of square footage
  \[ \text{Home office square footage/Total home square footage} \]
- Two columns on 8829 for office in home expenses
  - Direct expenses
    - Work done directly on home office - for example, new cabinetry in home office
  - Indirect expenses
    - Applicable to entire home and allocable to OIH (for example, cleaning service)
    - These costs are multiplied by OIH allocation %
Entertainment

- Deduction for 50% of cost of entertainment connected with a trade or business
- Entertainment must be either directly related to, or associated with, active conduct of business
  - “Directly related” costs are those related to an actual business meeting, such as a business lunch
  - “Associated with” costs serve a specific business purpose
    - Must occur immediately before or after a business discussion
- Deduction for the cost (for example depreciation and maintenance) of entertainment facilities such as clubs, yachts, hunting camps, etc. is severely limited
Example

Manuel is a pharmaceutical representative who travels extensively. He entertains clients regularly and on a recent trip to St. Louis, he takes his boat to entertain clients. While there he spends $286 on business meals, pays green fees of $80 to discuss business over a golf game, pays $350 to license the boat before the trip and incurs a $250 repair charge on his boat after the trip. How much is Manuel’s meals & entertainment deduction (before the 2% AGI limitation)?
Example
Manuel is a pharmaceutical representative who travels extensively. He entertains clients regularly and on a recent trip to St. Louis, he takes his boat to entertain clients. While there he spends $286 on business meals, pays green fees of $80 to discuss business over golf, pays $350 to license the boat before the trip and incurs a $250 repair charge on his boat after the trip. How much is Manuel’s meals & entertainment deduction (before the 2% AGI limitation)?

Solution
Manuel may take ($286 + $80) x 50% = $183; the licensing and the boat maintenance are nondeductible expenses.
In this chapter, “deductible education” is identified as continuing education for employed and self-employed taxpayers*

- Allowed if needed to meet requirements of taxpayer’s current employer or regulations
- Allowed if maintains or improves existing skills in taxpayer’s current employment

Cannot deduct if

- Required to meet minimum requirements of job
- Qualifies taxpayer for new trade/business

*The myriad of educational tax incentives and student loan interest deduction provisions covered in chapters 5-6
Educational Expenses

What’s deductible?
- Cost of courses, lodging costs, 50% meals/entertainment and travel if primarily to obtain qualifying education
- However, travel as a form of education is nondeductible

Eligible educators can deduct up to $250 for classroom materials
- K-12 teacher, counselor or principal working at least 900 hours during school year (not available in 2010 unless it is extended)
Example

Roberta is a paralegal who goes to law school at night. Are her educational expenses deductible? What if Roberta flew from her home in El Paso to a continuing education conference for paralegals in Dallas (if 30 hours per year of continuing education is required for paralegals to maintain certification in Texas)?
Solution

Example

Roberta is a paralegal who goes to law school at night. Are her educational expenses deductible? What if Roberta flew from her home in El Paso to a continuing education conference for paralegals in Dallas (if 30 hours per year of continuing education is required for paralegals to maintain certification in Texas)?

Solution

In the first scenario, the costs of attending law school are nondeductible because the education would qualify her for a new trade/business as an attorney.

In the second scenario, her expenses at the conference would be deductible (meals & entertainment at 50% only) since she is complying with requirements to maintain her existing job.
Dues, Subscriptions & Publications

- Professionals engaged in practice or employed may deduct the cost of dues, subscriptions and publications related to their profession.
- Prepaid amounts must be allocated over useful life.
  - Expected useful life of a library, for example, exceeds one year, so would be allocated over useful life of library.
  - Short-lived publications (like annual tax service) immediately deductible.
Special Clothing & Uniforms

- Uniforms and special clothes are deductible if
  - Required as condition of employment
  - Can’t be worn outside of work

- Protective wear always deductible
  - Items such as safety shoes, hard hats, etc.
  - Laundering of uniforms is deductible
May deduct gifts up to $25 per donee per year
  ◦ Plus cost of wrapping/shipping
  ◦ Husband and wife = one donee (unless both clients)
  ◦ No limitation for small business gifts up to $4 each, if taxpayer’s or company’s name imprinted on item

Deduction for tangible non-cash personal property up to $400 is allowable
  ◦ If given to employees for safety or length of service awards
  ◦ Or up to $1,600 is allowable if in conjunction with a “qualified plan”

Gifts to taxpayer’s supervisor are not deductible
Substantiation Requirements

- Taxpayers must have written proof of expenses for entertainment (E) and gifts (G)
  - Amount (E & G)
  - Time and place (E)
  - Date and description (G)
  - Business purpose (E & G)
  - Business relationship (E & G)
Schedule C vs. C-EZ

- Taxpayer who operates business as a sole proprietorship must file Schedule C (long form) or Schedule C-EZ (short form) or Schedule F (farm) if:

  - Business expenses are $5,000 or less per year
  - Business does not carry inventory
  - Business does not have net loss for the year
  - Taxpayer only has one business as a sole proprietor
  - Business does not have employees
  - Taxpayer not required to file a Form 4562
  - Business must not include an OIH deduction
  - Business must not have had disallowed passive losses in prior years
  - Business uses cash method of accounting
Self-Employment Tax

- Taxpayers with net earnings of $400 or more required to pay self-employment tax
  - File Schedule SE with Form 1040
- Tax equals
  - Social security tax (12.4% of first $106,800)
    - plus
  - Medicare tax (2.9% of all net earnings)
- Taxpayer gets a deduction for AGI equal to half of the self-employment tax
Manufacturer’s Deduction

- In 2010, manufacturer’s deduction available, equal to 9% of lesser of:
  - Qualified production income
  - Taxable income or AGI
- But in no event can it exceed more than 50% of employer’s W-2 wage expense
- Available to individuals, S-Corporations, C-Corporations, estates, trusts, cooperatives and partnerships
Moving Expenses

- Deduction for AGI – can deduct costs of moving personal items and travel (except meals) to new locality
- Moving expenses must be reasonable
- Qualified moving expenses reimbursed by an employer are not reported as part of gross income
- Taxpayers in military or involuntarily transferred do not need to meet time/distance test (see next slide)
Time/Distance Tests

- Time/distance tests must be met to qualify for moving expense deduction
  - Taxpayer must change job sites
  - Distance of former residence to new job location must be at least 50 miles more than distance from former residence to former job location
  - EE must work 39 weeks of twelve months after move (or if self-employed 78 weeks of next 24 months)
Hobby Losses

- Losses are limited for activities not engaged in for profit motive
  - Can only deduct hobby expenses up to amount of hobby income

- Hobby income must always be included

- If taxpayer can show profit in 3 out of prior 5 years (or 2 out of 7 if involved with horses), then assumed it is verifiable trade/business
The End