What is A Business Expense?

I have found a commonality among new and old business owners. There is a lack of understanding and miss information about business expenses. Keeping track of business expenses can be a frustrating and sometimes confusing task for a small business. Start up and existing businesses, alike need to pay attention to this aspect of managing their operation because it is the basis for evaluating the ongoing status of the business and paying taxes properly. Today’s column will address some of the general issues around this topic that I have experienced recently in our SCORE client interactions and seminars. I encourage each business to work with their business Accountant for the specifics of this topic and also to use the IRS publications.

It may sound redundant, but let us start from the beginning. What is a business expense? These are the various costs incurred in the process of carrying on a trade or business operation. These costs are usually deductible if the business is operated to make a profit.

The most common question is what can I deduct from my business income. In order for an expense to be deductible, it must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary.

Having stated that broad, general definition one must consider carefully how the various costs are treated in your accounting system to establish accurate data upon which to make decisions and also to base your tax liabilities. For example, it is important to separate business expenses from the following expenses: The expenses used to figure the cost of goods sold, Capital Expenses, and Personal Expenses.

Cost of Goods Sold: If your business manufactures products or purchases them for resale, you generally must value inventory at the beginning and end of each tax year to determine your cost of goods sold. Some of your manufacturing expenses may be included in figuring the cost of goods sold. Cost of goods sold is deducted from your gross receipts to figure your gross profit for the year. If you include an expense in the cost of goods sold, you cannot deduct it again as a business expense.

Capital Expenses: You must capitalize, rather than deduct, some costs. These costs are a part of your investment in your business and are called capital expenses. Capital expenses are considered assets in your business. In general, three types of costs that you will need to capitalize are: Business start-up costs, Business assets, and Improvements. Again, see your accountant about electing to deduct or amortize certain business start-up costs.

Personal versus Business Expenses: Generally, you cannot deduct personal, living, or family expenses. However, if you have an expense for something that is used partly for business and partly for personal purposes, divide the total cost between the business and personal parts. You can deduct the business
part. But make sure you have written rational for this calculation.

**Business Use of Your Home:** If you use part of your home for business, you may be able to deduct expenses for the business use of your home. These expenses may include mortgage interest, insurance, utilities, repairs, and depreciation.

**Business Use of Your Car:** If you use your car in your business, you can deduct car expenses. If you use your car for both business and personal purposes, you must divide your expenses based on actual mileage. Refer to Publication 463, Travel, Entertainment, Gift, and Car Expenses.

Other Types of Business Expenses can include the following (but each have specific rules…see your Accountant and tax person for these): Employees' Pay, Retirement Plans, Rent Expense, Interest, Taxes, and Insurance. This list is not all inclusive of the types of business expenses that you can deduct. For additional information, refer to IRS Publication 535, Business Expenses.

If you need to review your business expenses, contact SCORE, mentors to America’s Small businesses. They provide free, confidential counseling as well as informational seminars. For example, next Tuesday evening’s SCORE seminar will be taught by CPA Diane Lund on the topic of Planning for Business Accounting and Taxes and on October 22nd Bobbi Olson will be teaching a workshop on QuickBooks Basics for the Small Business. I highly recommend these opportunities.

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