

Understanding Small Business Tax Deductions

Most salons and spas are overpaying their taxes. How do I know this? One of the services that we offer is what we refer to as a "Second Opinion." When we do a second opinion for a salon they send us their last two years tax returns. We then analyze the returns, determine if there are any areas that need improvement, and then meet with the salon owner to discuss various tax planning opportunities that they are missing. Invariably, we find numerous deductions that salons are missing. It is not unusual for us to amend past returns to get refunds.

Why are salons overpaying their taxes? I believe that most owners are too busy to do any tax planning. They don't understand that there is a difference between tax preparation and tax planning. Tax preparation is just putting numbers on the tax return after the fact. Tax planning is determining what tax strategies fit your circumstances to minimize taxes.

Tax planning has a great effect on how much money is in your pocket at the end of the year. You probably know that the tax code allows you to deduct costs of doing business from your gross income. What you are left with is your net business profit. This is the amount that gets taxed.

So knowing how to maximize your deductible business expenses lowers your taxable profit. By planning, you may enjoy a personal benefit from a business expenditure -- a nice car to drive, a combination business trip/vacation, a retirement savings plan -- if you follow the myriad of tax rules. Here is how the IRS decides when an expense is deductible.

Ordinary and Necessary Expenses

I won't burden you with a lot of tax code sections, but in my tax seminars I make sure that people understand what the tax codes allows as a deduction. There is no list in the code of what is and what isn't deductible. Section 162 (§162) is the cornerstone for determining the tax deductibility of every business expenditure. I believe that these are the most beautiful words in the English language. Read slowly... these 35 words could save you taxes...

Internal Revenue Code § 162. Trade or business expenses. (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...

Section 162 goes on -- and on -- but the important part is that expenses must be "ordinary and necessary" or they can't be deducted. However, the tax code doesn't define either "ordinary" or "necessary." Luckily, in many cases a legitimate business expense under Section 162 is obvious. For instance, office equipment and supplies are clearly deductible.

Pubs and regs. In some cases, such as outlays for travel, the IRS provides specific instructions for determining whether or not an expense is "ordinary and necessary." This is often done through various IRS publications ("pubs") and regulations ("regs").

Court decisions. When a specific expense hasn't been mentioned in Section 162 or in publications or regulations, federal courts have tried to figure out what Congress intended and then apply it to a particular set of facts. The legal consensus is that "ordinary and necessary" refers to the purpose for which an expense is made. For instance, renting space is ordinary and necessary for many business folks, but it is neither unless it is actually used in running a business. "Ordinary" has been held by courts to mean "normal, common, and accepted under the circumstances by the business community." "Necessary" has been taken to mean "appropriate and helpful."

Given these broad legal guidelines, it is not surprising that some folks have tried to push the envelope on "ordinary and necessary" business expenses, and the IRS has pushed back. Sometimes a compromise is reached, and sometimes the issue is thrown into a court's lap.

Example:

Mr. Henry, an accountant, deducted his yacht expenses, contending that because the boat flew a pennant with the numbers "1040," it brought him professional recognition and clients. The matter ended up before the tax court. The court ruled that the yacht wasn't a normal business expense for a tax professional, and so it wasn't "ordinary" or "necessary." In short, the yacht expense was personal and thus nondeductible. (Henry v. CIR, 36 TC 879 (1961).)

The laugh test. Tax professionals frequently rely on the "laugh test": Can you put down an expense for your business without laughing about putting one over on the IRS? In the example above, the tax court laughed the accountant and his yacht out of court.

Personal Expenses

The number one concern of the IRS when auditing business deductions is whether purely personal expenditures are being claimed as business expenses. For instance, you can't deduct the cost of commuting to work, because the tax code specifically says this is a personal, not a business, expense. Ditto with using the business credit card for a vacation or cruising the beach in the company car. Because such shenanigans are common, IRS auditors are ever watchful.

Fortunately, you can often arrange your affairs -- legally -- in a way that lets you derive considerable personal benefit and enjoyment from business expenditures.

Be careful if you deal with relatives. An IRS auditor will look askance at payments to a family member or to another business in which your relatives have an ownership interest. An auditor may suspect that taxable profits are being taken out of your business for direct

or indirect personal benefit in the guise of deductible expenses. For example, paying your spouse's father, who is in prison, \$5,000 as a consultant's fee for your salon would smell bad to an auditor.

Given that the tax code does not have a list of items that are deductible, and given that “ordinary and necessary” is all that the tax code gives us, tax planning can save you hundreds or even thousands of tax dollars.