

Module 2.3: Organizing Your Paperwork

The way you organize your paperwork is to produce two results. The first is to provide you the data to let you know if you are making a profit and how much so you can make the proper adjustments. The second is to document things in a way that will allow you to legally pay the least amount in taxes on your profits. Those two results are the focus of this module.

One of the first things a taxpayer should do when starting a business is open a business checking account, to be used for business purposes only. The worst thing you can do is co-mingle your business and personal expenses in one checking account, because it can lose you a lot of money if your business should ever be audited.

The business checkbook may serve as a backup record-keeping system for business expenses, but only as an extra validation. Some new business people believe that if they run all income and expenses through a business checking account, then that is good enough for a record-keeping system. Not really. If your checking account statement shows a purchase at Home Depot, and you don't have the actual receipt, then whose to say it wasn't a personal expense?

If you receive cash payments, then it should be deposited daily. Deposit slips should list details of the items deposited, with copies kept for documentation. It is a best practice to reconcile the bank statements each month to ensure that the checkbook, financial books, and bank accounts agree.

Except in a few cases, the law does not require any special kind of records. So any record-keeping system that clearly shows income and expenses is acceptable. A good record-keeping system simply includes a summary of all business transactions. Before the advent of computer accounting software, most small businesses just used a handwritten ledger or spreadsheet. In fact, many small business sole proprietors still use spreadsheets today. Unfortunately, there are still those that like to throw everything into a box and "worry about it later", but that's one of the best ways there is to lose money.

While a simplified method of record keeping may work for some small businesses, it will not provide the financial statements beneficial to all businesses and necessary for tax return preparation for certain entity types like partnerships and corporations. These financial statements, such as Income Statements, Balance Sheets, or Profit & Loss Statements allow business owners and possible investors to determine the health of the business. We will discuss these subjects in more detail in the next two modules.

Your income can be paid to you in many ways. The most common are cash, check, debit or credit cards if your company accepts them. While you can certainly lump them all together in your accounting system, it is not a very good idea to do so. If you are using a spreadsheet, you would have a column for the date, the customer name, cash, check, debit, and credit. If you are

using a software program, you would have a separate account for each type of payment. This way, it will make it easier to balance your checking and credit card statements - which should be done monthly.

A good businessperson knows who is doing business with them, what and when they are purchasing and how they are paying. If a problem crops up, you will then have the background information you need to resolve it. This will project an image of a business that is professional and one that people will want to do business with.

There are also some forms that you may receive. If someone hires you as an independent contractor and pays you over \$600 during the year, then are required to send you IRS Form 1099-NEC stating the amount. If you receive business income from other types of business income such as contest winnings or prizes, you may receive an IRS Form 1099-MISC. And if your business uses a third party processor, such as PayPal or Square, you may receive an IRS Form-1099K stating how much they ran through their systems.

When it comes to expenses, there are a lot of things to consider. Due to the vast number of industries that exist, it is impossible to list every single business expense here. In this module, we will look at a comprehensive list of common IRS business expense categories applicable to most businesses and which ones you need special handling for.

So, what is a Business Expense Category?

A business expense category is an organized way to group expenses for financial analysis and tax reporting purposes. It's important to know what type of expenses are included or not included in a category to apply the appropriate rules when it comes to deducting them when you create financial statements and on your tax return.

I also want to point out here that your book income profit is usually not the same as tax income profit. One of my objectives by the end of this course is to let you know why and how to organize your expenses to account for that.

So, instead of providing a master list that includes everything a business can deduct, the IRS has defined a business expense as meeting two requirements:

- **Incurred in a trade or business:** A trade or business must be profit-motivated. You must plan and have the ability to make a profit, even if that profit never actually occurs. If the IRS doesn't believe you ever intended to make a profit, the agency will call your business a hobby and disallow your expenses.
- **Ordinary and necessary:** According to the IRS, "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."

One of the best resources on what business expenses are and what is and is not deductible is [IRS Pub 535: Business Expenses](#).

35 IRS Business Expense Categories

As we mentioned, it's impossible to cover every type of deductible business expense. However, here are the most common business expense categories identified by the IRS. A lot of these business expenses may be deductible on your accounting system, but not deductible on your tax return. You need to know the difference, so you are not spending money that gives you no benefit.

1. Employee wages: You can deduct gross wages, salary, commission bonuses, or other compensation paid to your employees. This includes wages paid to a spouse or children, provided they performed services for your business, the amount is fair, and the payments were made through payroll. There are special rules for shareholder-employees which we will address in Module 3.7.

2. Employee education expenses: Payments made to employees for reimbursement of tuition, books, and other materials are deductible.

3. Employee benefits: Payments made on behalf of employees to cover the following programs are tax-deductible:

- Accident and health plans
- Adoption assistance
- Cafeteria plans
- Dependent care assistance
- Life insurance

Check out the bonus section for more information on these.

4. Rent or lease payments: Payments made to rent office space, equipment, a warehouse for inventory and supplies, or vehicle lease payments are all tax-deductible. A schedule C business (or sole proprietor) cannot rent property from the business owner. However, an S corporation or C corporation is allowed to rent property (other than a home office) from the shareholders as long as the amount is fair.

There is a lot of confusion about home offices. Only sole proprietors can claim the home office deduction, because the owner and the business are considered one. For instance, if an S corporation you owned rented space in your home for an office, you would then have to report that as rental income on your personal return. This would essentially cancel each other out and cause a lot of extra paperwork, so the IRS just said you can't do it. However, if you owned an office building or warehouse, the corporation could rent it from you at market rates and you would then include it as rental income on your personal return. If you are considering this, I would really advise you talk to a good tax professional to run the numbers both ways, and see

what saves you the most tax liability. This is an example of why you need to know these rules to prevent throwing away your profits.

5. Taxes for leased business property: Taxes paid to a lessor on leased office space, equipment, and vehicles used for business purposes are a deductible business expense.

6. Interest paid on business debt: Interest payments made on all loans, lines of credit, and other liabilities incurred for your trade or business are tax-deductible. You should be aware that interest on income tax debt, loans with respect to life insurance and interest on personal credit cards and loans are not deductible business expenses. This is why it is so important to get accounts that are strictly in the business name and only used for the business.

As a side note, starting in 2018, the maximum deductible interest expense is limited if your average annual gross receipts for the prior three years are greater than \$25 million, so most of us don't have to worry about that.

One other error that I have seen a lot is small business owners do is deducting the full amount of the credit card payments they make when they pay them on their tax return. You have to remember that you can only deduct the interest charges, because you already deducted the rest of the balance when you purchased the items on your credit card statement.

However, in your accounting system, the entries for credit payments have to go into two accounts - one reduces your debt liability account and the other adds to your tax expense account. This comes into play if you have to produce Balance Sheets.

Small businesses such as sole proprietorship, partnerships and S corporations that receive less than \$250,000 a year in receipts are not required to do a balance sheet on their tax returns. However, for partnerships and corporations, potential investors will ask for the Balance Sheet, so it is still a good thing to produce one. We'll study this in more depth later.

7. Payroll taxes: Employment taxes paid on behalf of your employees is a deductible business expense. This includes Social Security and Medicare as well as federal and state unemployment taxes. Remember that your business pays 1/2 of the Social Security and Medicare taxes for each employee.

8. Excise taxes: If you purchase alcohol, tobacco, or fuel for your business, you may be required to pay excise taxes. The good news is that you can deduct excise taxes on your tax return.

9. Personal property taxes: Personal property taxes paid on business property are deductible. "Personal" in this context refers to property that can be removed from the business without damaging it, as opposed to real property like buildings. Some examples of personal property are office furniture, machinery and equipment.

10. Insurance premiums: Premiums paid to protect your business against loss or theft are deductible business expenses. For example, insurance for:

- Natural disasters like hurricanes, earthquakes, and floods

- Business bad debt
- Liability insurance
- Malpractice
- Workers' compensation insurance
- Life insurance on the owners or principle employees
- Insurance on vehicles used for business

11. Self-employed health insurance: If you are self-employed, payments made for medical, dental, and qualified long-term care insurance for yourself, your spouse, and your dependents are deductible. The premiums are not deductible on Schedule C like other business expenses, but rather Form 1040, Schedule 1, line 16 as an adjustment to income. There are also special rules for pass-through entities like partnerships and S corporations. This deduction can only be taken if you have no other source you can be covered by insurance, such as your spouse's employer - even if you don't take advantage of it.

12. Business startup costs and organizational costs: There are some special rules for these expenses. Costs incurred to get your business up and running are deductible business expenses. Within the first year, you can deduct up to \$5,000 for startup costs and \$5,000 for organizational costs. Any amount of more than \$5,000 must be amortized (deducted) over a 15-year period. Organizational cost are such things as filing fees, lawyer fees or notary fees to create the format of your business. Startup costs could be advertising or training employees before the business opens - the operational staff.

13. Bad business debts: If you use the accrual basis of accounting, you record income as soon as a service is provided, and the customer owes you money. If you are later unable to collect from the customer, you can deduct the amount as a business bad debt. Businesses using the cash basis of accounting don't record income until the cash is received, so they never have bad debts.

14. Travel, meals, and lodging to employees: If you reimburse employees for travel, meals, and lodging for business travel, it is deductible. If you don't have an expense policy in place, you need to create one. A documented policy will provide employees with a set of guidelines that must be followed for all employee expense reimbursements. It should include information like what expenses are reimbursable, any dollar limits, the process to follow when submitting a reimbursement request and the necessary approvals required. I've put a sample Daily Expense Report in the download section to the right.

15. Advertising and marketing costs: Expenses incurred to promote your business are deductible business expenses. This includes items like business cards, flyers, websites, and fees paid to companies like Constant Contact to send promotional emails.

16. Car and truck expenses: If you use your vehicle for business, you can deduct the portion that you use the vehicle for business, but not personal use. There is a standard mileage rate that you can use, or you can deduct a portion of vehicle-related expenses like gas, repairs, car wash, and parking fees and tolls. Module 3.3 is dedicated to properly handling these expenses. This is another place where the book deduction is different from the tax deduction and why special reporting requirements are in place.

17. Charitable contributions: C corporations may deduct charitable contributions as a direct expense on the books. For all other business formats, the charitable contributions flow down to the Schedule A on the owners/partners/shareholders personal returns. They can only be used as a tax deduction if you itemize instead of using the standard deduction on your personal return. So just be aware that these contributions are deductible on your books, but may not be deductible on your tax return. I've had a lot of disappointed business owners when they found out about this rule.

18. Club dues and membership fees: Membership dues paid to the chamber of commerce and other professional/trade associations of which you are a member are deductible business expenses. However, fees paid for the following are deductible on your books, but not on your taxes:

- Country clubs
- Golf and athletic clubs
- Hotel clubs
- Sporting clubs
- Airline clubs

19. Franchise, trademark, and trade name: Fees paid to purchase a franchise, trademark, or trade name are tax-deductible business expenses. If paid before the business start date, they can be part of the organizational expenses.

20. Interview expense allowances: If the business pays for a prospective employee to travel for an interview, they are deductible business expenses. This includes travel costs like airfare and lodging for candidates who are from out of town as well as parking fees or other costs. Meals are also deductible up to 50% of the cost.

21. Legal and professional fees: Payments made to attorneys, certified public accountants (CPAs), financial planners, or other professionals for your business are deductible business expenses. If paid before the start of business, these are organizational expenses.

22. Tax preparation fees: Fees paid to a tax preparer to prepare your tax return are tax-deductible. If you prepare your own taxes using tax software like [HRBlock's](#), the amounts paid to purchase the software and e-file your federal and state tax returns are also deductible business expenses.

23. License and permits: Payments for a business license, liquor license, real estate agent license, and other permits required for your trade or business are all tax-deductible business expenses.

24. Penalties and fines: Penalties paid for late performance or nonperformance of a contract are deductible. However, penalties and fines for breaking a law, such as speeding or filing a tax return late, are not deductible even if business-related. Note the difference is penalties in the pursuit of business are deductible, not irresponsibility.

25. Repairs: Minor repairs to your office, such as painting and plumbing leaks, are deductible business expenses. However, major repairs that will increase the value of the property must be capitalized and depreciated. For example, replacing a roof or heating, ventilation, and air conditioning (HVAC) system. We'll discuss this more in Module 3.8.

26. Subscriptions: Subscriptions to magazines and journals that are related to your business are tax-deductible. Personal magazine subscriptions are not tax-deductible.

27. Supplies and materials: Supplies used in your business are tax-deductible. This includes, but are not limited to:

- Paper
- Ink for printer
- Pens, pencils, and notepads
- Cleaning supplies
- Books and manuals

28. Utilities: Payments made for electricity, telephone, and gas for your office space are deductible business expenses. They are prorated for the home office deduction.

29. Telephone: Monthly service fees paid for telephone service in a commercial office space are tax-deductible. A mistake new business owners make is: if you have a home office, you are not allowed to deduct the basic telephone service charges and taxes for the first line in your home. However, any subsequent telephone lines added for business use are deductible business expenses. If you use a mobile phone for your business phone, then you can prorate the amount you use for business and personal use. If the business owns the phone and it is used 100% for business, or you provide phones for your employees, then it is fully deductible (most people have a separately owned phone for personal use in this case).

30. Depreciable assets: Purchases made for furniture, equipment, and machinery typically must be depreciated over the number of years they are expected to last. However, most small businesses will be able to deduct 100% of furniture, equipment, and machinery purchased from 2018 through 2022 with the use of bonus depreciation or Section 179. More on this in Module 3.8.

31. Payments to 1099 contractors: Payments made to independent contractors that provide goods and services to your business are tax-deductible. (Make sure you send them a Form 1099-NEC.)

32. Home office: If you have a home office, you can deduct \$5 per square foot of office space, up to a maximum of 300 square feet. If you prefer, you may deduct a portion of your actual household expenses based on the percentage that you use your home for business. This includes, but is not limited to, the following:

- Utilities
- Real estate taxes
- Insurance
- Deductible mortgage interest

33. Client gifts: You can deduct on your taxes up to \$25 for each client gift that you purchase. This can include gift card purchases, gift baskets, or other items. I have a client that gave \$100 bottles of wine at Christmas to his best clients. He stopped doing that after I told him this.

34. Continuing education: You can deduct payments for registration fees and materials for seminars and courses that you and your employees attend as part of continuing education credits for your trade or business.

35. 401(k) plan contributions: Your employer contribution to employee 401(k) plans is tax-deductible.

So, what cannot be written off as a business expense?

A good rule of thumb when it comes to what you cannot write off as a business expense is anything that is considered or can be interpreted to be a personal expense. In addition, the following expenses are always nondeductible:

- Penalties and fines for violating a law
- Illegal payments such as bribes
- Entertainment, even if connected to business such as entertaining a client
- Country Club dues

Can you deduct job expenses?

Prior to 2018, employees could deduct the cost of job-related expenses that an employer did not reimburse. For years 2018 and later, employee business expenses are no longer deductible on your personal tax return. However, they are deductible by the employer if they reimburse the employee.

Bottom Line

While these are the most common expenses that are found in most business, you still need to customize it to your needs. A service business is going to have a different set of expenses than a retail business or a manufacturing business. You really need to sit down, examine and document exactly what you will be spending your money on for your business and then categorize it.

The rest of this course will be structured on what you choose for your income and expense categories, and the differences in how you handle them for book accounting vs how you handle them for tax accounting.