PacificCPE

COURSE

34505A

Small Business Tax: Deductions, QBI, and Recordkeeping

Deductions are where small business tax planning gets real. This course covers the full landscape of deductible business expenses—including travel, meals, home office, and timing rules—along with the limits and exclusions that can trip up even experienced preparers. It also explains how to calculate the qualified business income deduction and walks through net profit or loss reporting. The course closes with practical recordkeeping requirements to help clients stay audit-ready.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the rules for determining whether an expense can be deducted as a business expense.
- Identify common types of expenses that are not deductible.
- Identify which type of taxpayers are eligible for the qualified business income deduction. This chapter covers the rules for determining the qualified business income (QBI) deduction.
- Recall the types of business records that should be maintained and for how long.

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Chapter 1: BUSINESS EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Identify the rules for determining whether an expense can be deducted as a business expense.
- Identify common types of expenses that are not deductible.

I. INTRODUCTION AND OVERVIEW

Owners can deduct the costs of running their business. These costs are known as business expenses.

These are costs the owner does not have to capitalize or include in the cost of goods sold, but can deduct in the current year.

A. ORDINARY AND NECESSARY

To be deductible, a business expense must be both ordinary and necessary.

An ordinary expense is one that is common and accepted in a particular field of business.

A necessary expense is one that is helpful and appropriate for a particular business.

An expense does not have to be indispensable to be considered necessary. In this context, 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.

If a business owner has an expense that is partly for business and partly personal, he or she should separate the personal part from the business part. The personal part is not deductible.

B. COST OF GOODS SOLD

If a business manufactures products or purchases them for resale, some of the business’s expenses may be included in figuring cost of goods sold. The owner can

deduct the cost of goods sold from the business's gross receipts to figure his or her gross profit for the year. If the business uses an expense to figure the cost of goods sold, it cannot deduct it again as a business expense.

The following are types of expenses that go into figuring cost of goods sold:

- The cost of products or raw materials, including freight;
- Storage;
- Direct labor costs (including contributions to pension or annuity plans) for workers who produce the products; and
- Factory overhead.

Under the uniform capitalization rules, owners must capitalize the direct costs and part of the indirect costs for certain production or resale activities. Indirect costs include rent, interest, taxes, storage, purchasing, processing, repackaging, handling, and administrative costs.

This rule does not apply to small business taxpayers. Taxpayers qualify as a small business taxpayer if they (a) have average annual gross receipts of $32 million in 2026 or less for the 3 prior tax years, and (b) are not a tax shelter (as defined in section 448(d)(3)). If the business has not been in existence for all of the 3-tax-year period used in figuring average gross receipts, base the average on the period it has existed, and if the business has a predecessor entity, include the gross receipts of the predecessor entity from the 3-tax-year period when figuring average gross receipts. If the business (or predecessor entity) had short taxable years for any of the 3-tax-year period, annualize the business' gross receipts for the short tax years that are part of the 3-tax-year period.

C. CAPITAL EXPENSES

A business owner must capitalize, rather than deduct, some costs. These costs are a part of the investment in the business and are called "capital expenses." Capital expenses are considered assets in the business. In general, three types of costs are capitalized:

- Business startup costs (see **Note** below);
- Business assets; and
- Improvements.

Note

A business owner can elect to deduct or amortize certain business startup costs.

Although the owner generally cannot take a current deduction for a capital expense, he or she may be able to recover the amount spent through depreciation, amortization, or depletion. These recovery methods allow the owner to deduct part of his or her cost each year. In this way, the owner is able to recover his or her capital expense. A taxpayer can elect to deduct a portion of the costs of certain depreciable property as a section 179 deduction. A greater portion of these costs can be deducted if the property is qualified disaster assistance property.

Going Into Business

The costs of getting started in business, before actually beginning business operations, are capital expenses. These costs may include expenses for advertising, travel, or wages for training employees.

When an owner goes into business, all costs to get the business started should be treated as capital expenses. Usually costs are recovered for a particular asset through depreciation. Generally, these costs cannot be recovered until the business is sold or is otherwise dissolved. However, an owner can choose to amortize certain costs for setting up the business.

If an individual attempts to go into business but is not successful, the expenses incurred in trying to establish the business fall into one of two categories:

- The costs the individual had before making a decision to acquire or begin a specific business. These costs are personal and nondeductible. They include any costs incurred during a general search for, or preliminary investigation of, a business or investment possibility; and
- The costs the individual had in his or her attempt to acquire or begin a specific business. These costs are capital expenses and an individual can deduct them as a capital loss. If a corporation attempts to go into a new trade or business and is unsuccessful, it may be able to deduct all investigatory costs as a loss.

The costs of any assets acquired during an unsuccessful attempt to go into business are a part of the owner’s basis in the assets. The owner cannot take a deduction for these costs; the costs of these assets will be recovered when they are disposed of.

Business Assets

There are many different kinds of business assets, such as land, buildings, machinery, furniture, trucks, patents, and franchise rights. The business must capitalize the full cost of the asset, including freight and installation charges. Certain property produced for use in the trade or business must be capitalized under the uniform capitalization rules.

De Minimis Safe Harbor for Tangible Property

Although you must generally capitalize costs to acquire or produce real or tangible personal property used in your trade or business, such as buildings, equipment, or furniture, you can elect to use a de minimis safe harbor to deduct the costs of some tangible property. Under the de minimis safe harbor for tangible property, you can deduct de minimis amounts paid to acquire or produce certain tangible business property if these amounts are deducted by you for financial accounting purposes or in keeping your books and records. See the following for the requirements for the de minimis safe harbor.

You have an applicable financial statement

If you elect the de minimis safe harbor for the tax year, you can deduct amounts paid to acquire or produce certain tangible business property if:

- You have a trade or business or are a corporation, partnership, or S corporation that has an applicable financial statement;
- You have, at the beginning of the tax year, written accounting procedures treating as an expense for nontax purposes:
  - Amounts paid for property costing less than a certain dollar amount, or
  - Amounts paid for property with an economic useful life of 12 months or less;
- You treat the amount paid during the tax year for which you make the election as an expense on your applicable financial statements in accordance with your written accounting procedures;
- The amount paid for the property does not exceed $5,000 per invoice (or per item substantiated by invoice); and
- The uniform capitalization rules do not apply to the amount.

You do not have an applicable financial statement

If you elect the de minimis safe harbor for the tax year, you can deduct amounts paid to acquire or produce certain tangible business property if:

- You have a trade or business, partnership, or S corporation that does not have an applicable financial statement;
- You have, at the beginning of the tax year, accounting procedures treating as an expense for nontax purposes:
  - Amounts paid for property costing less than a certain dollar amount, or
  - Amounts paid for property with an economic useful life of 12 months or less;
- You treat the amounts paid for the property as an expense on your books and records in accordance with your accounting procedures;
- The amount paid for the property does not exceed $2,500 per invoice (or per item substantiated by invoice); and
- The uniform capitalization rules do not apply to the amounts.

How to make the de minimis safe harbor election

To elect the de minimis safe harbor for the tax year, attach a statement to the taxpayer's timely filed original tax return (including extensions) for the tax year when qualifying amounts were paid. The statement must be titled "Section 1.263(a)-1(f) de minimis safe harbor election" and must include your name, address, taxpayer identification number (TIN), and a statement that you are making the de minimis safe harbor election under section 1.263(a)-1(f). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group.

In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group. In the case of an S corporation or a partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. The election applies only for the tax year for which it is made.