Chapter 8

Deductions: Employee and Self-Employed-Related Expenses

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Employee vs. Self-Employed
(slide 1 of 2)

- Business expenses for self-employed persons are deductible FOR AGI
- Business expenses for employees are generally deductible FROM AGI subject to 2% of AGI floor
Employee vs. Self-Employed

• Person is classified as an employee if:
  – Another controls details of how work is performed
  – Can be discharged without creating legal liability to another
  – Another furnishes tools or the place of work
  – Income based on time spent rather than task performed
Employee Expenses

• Fall into one of the following categories:
  – Transportation
  – Travel
  – Moving
  – Education
  – Entertainment
  – Other
Transportation Expenses
(slide 1 of 2)

• Transportation expense defined
  – Very limited, only from job site to job site and commuting to temporary work place
  – Commuting from home to work and back is nondeductible

• Exceptions:
  – Additional costs incurred to transport heavy tools
  – Employees with more than one job
Transportation Expenses
(slide 2 of 2)

• Amount deductible
  – Actual expenses
    • Must keep adequate records of all expenses and depreciation is limited, or
  – Automatic mileage method
    • 36 cents per mile for business miles for 2003
      – Adjustment to basis of auto is required for depreciation considered allowed
    • Plus parking, tolls, etc.
    • Adequate documentation of mileage required
Travel Expenses (slide 1 of 2)

- Travel expense defined
  - Expenses while “away from tax home” on business
  - Includes transportation, lodging, 50% meals, and miscellaneous expenses
• “Away from home” requirement
  – Need not be a 24-hour period but must be longer than ordinary work day and taxpayer will need to rest during release time
  – Being “away” should be a temporary situation (not in excess of 1 year)
  – “Tax Home” generally means business location, post, or station of the taxpayer
Restrictions on Travel Expenses
(slide 1 of 2)

• Convention travel expenses
  – No deduction for travel unless directly related to taxpayer’s trade or business
  – Example: Doctor attending out-of-town seminar on estate planning would not have deductible travel expenses
Restrictions on Travel Expenses
(slide 2 of 2)

• Education travel expenses
  – Travel as a form of education is not deductible
    • Example: Spanish language professor traveling to Spain to work on the language would not have deductible travel expenses
    • Example: Spanish history professor traveling to Spain to study historical documents available only in Spanish museums would have deductible travel expenses
Combined Business/Pleasure Travel
(slide 1 of 4)

- Only actual expenses for business are deductible
  - Meals, lodging and other expenses must be allocated between business and personal days
- Deductibility of transportation costs depends on whether the trip is domestic or foreign
Combined Business/Pleasure Travel
(slide 2 of 4)

• For domestic travel
  – If primary purpose of trip is business, transportation is deductible in full
  – If primary purpose is pleasure, no deduction for transportation allowed, but other expenses (e.g., lodging) associated with business days are deductible
Combined Business/Pleasure Travel
(slide 3 of 4)

• For foreign travel
  – Transportation expenses must be allocated between business and personal unless:
    • Trip is 7 days or less,
    • Less than 25% of time was for personal purposes, or
    • Taxpayer had no substantial control over arrangements for the trip
Combined Business/Pleasure Travel
(slide 4 of 4)

- Travel days are considered business days
- Weekends, legal holidays and intervening days are business days if both the preceding and succeeding days are business days
- If trip is primarily for pleasure, no transportation expenses are deductible
Moving Expenses

- Deductible for moves in connection with the commencement of work at a new principal place of work
- Two tests must be met for moving expenses to be deductible
  - Distance test
  - Time test
Distance Test

• Distance from old home to new job must be at least 50 miles farther than from old home to old job

• New home location not relevant for decision
Example of Distance Test

- Gail lived 20 miles from her old job
- Gail’s new job is 75 miles from her old home
- Gail meets the distance test
Time Test (slide 1 of 2)

- Taxpayer must be full-time employee for 39 of the 52 weeks following the move, or
- Self-employed must work in new location for 78 of the 104 weeks following the move – 39 of the weeks must be in the first 12 months
- Test waived if die, disabled, discharged, or transferred
Time Test (slide 2 of 2)

• If time test not met during taxable year, two alternatives:
  – Take the deduction in year moved. If test is not met in following year, either:
    • Include the amount deducted in gross income in the following year, or
    • File amended return for year of move
  – Alternatively, wait until time test is met and then file amended return for year of move
Deductible Moving Expenses

- Expenses of moving household goods and personal effects to new location
- Expenses of travel for family to new location
  - Actual auto costs (not depreciation) or mileage rate of $.12 per mile
  - Meals are not deductible as moving expense
Tax Treatment of Moving Expenses

- Unreimbursed moving expenses are deductible *For AGI*
- Reimbursement or payment by employer:
  - For qualified moving expenses, amount is excluded from gross income, but no deduction for related expenses
  - For nonqualified moving expenses, amount is included in gross income and no deduction is allowed
• Education expenses are deductible if they are incurred:
  – To maintain or improve existing skills, or
  – To meet the requirements of the employer, profession, licensing, or state law
Education expenses are not deductible if they are incurred:

- To meet minimum educational standards for existing job, or
- To qualify taxpayer for new trade or business
Education Expenses (slide 3 of 3)

- Education expenses include:
  - Tuition
  - Books
  - Supplies
  - Transportation
  - Travel (including lodging and 50% meals)
Deduction For Qualified Tuition and Related Expenses (slide 1 of 2)

• Starting in 2002, a deduction is allowed for qualified tuition and related expenses
• For 2003, maximum deduction allowed is $3,000
• No deduction is allowed if AGI exceeds:
  Single $65,000
  Married $130,000
Deduction For Qualified Tuition and Related Expenses  (slide 2 of 2)

- Qualified tuition and related expenses include whatever is required for enrollment
  - Usually, student activity fees, books, room and board are not included
- Expenses need not be work related
- Deduction is not available for married persons filing separately
Entertainment Expenses
(slide 1 of 2)

• Deductions are very restricted due to abuse possibilities
  – Amount allowed
    • 50% meals and entertainment
    • 100% of transportation costs
    • Amounts cannot be lavish or extravagant
  – Beginning in 1998, the 50% cutback for meals is eased for certain, very limited, types of employees
Entertainment expenses are classified as either:

- *Directly related to* business
  
  - Actual business meeting or discussion occurs during meal or entertainment

- *Associated with* business
  
  - Meal or entertainment that directly precedes or follows business meeting or discussion
Restrictions on Entertainment Expenses (slide 1 of 3)

- Club dues
  - Generally not deductible
    - Exception: Clubs formed for public services and community volunteerism (e.g., Kiwanis, Rotary)
  - Business entertainment expenses incurred at club are still deductible (50%)
Restrictions on Entertainment Expenses (slide 2 of 3)

- Ticket purchases for entertainment
  - Amounts paid in excess of face value of ticket are not deductible
  - Limitation on deductibility of luxury skybox expenditures
Restrictions on Entertainment Expenses (slide 3 of 3)

- Business gifts
  - Business gifts of tangible personalty with a value of $25 or less per person per year are deductible
  - If the value is $4 or less (e.g., pen with company name) then not subject to $25 limit

- Gifts to employers or superiors are not deductible
Office in the Home
(slide 1 of 3)

• Deductibility is very restricted due to abuse possibilities
  – Office must be used exclusively and on a regular basis as:
    • The principal place of business, or
    • A place of business used by clients, patients, or customers
  – For employees, office must also be for the convenience of the employer
Office in the Home
(slide 2 of 3)

• What constitutes “principal place of business”?  
  – Home office qualifies as a principal place of business if:
    • Taxpayer conducts admin. and mgmt. activities in the home office, and
    • There is no other fixed location where taxpayer conducts these activities
    • Effective for tax years beginning after 12-31-98
Office in the Home
(slide 3 of 3)

- Office in the home expenses cannot cause net loss from the business activity
  - Office in home deduction limited to business gross income in excess of other business expenses (ordering rules apply)
  - Excess is carried forward (subject to limit)
  - Form 8829 is used to report office in home expenses
Other Employee Expenses

- A partial list of other employee expenses that are deductible includes:
  - Special clothing (uniforms)
  - Union dues
  - Professional expenses
  - Job hunting in same profession
Classification of Employee Expenses (slide 1 of 2)

- Depends on whether they are reimbursed and, if reimbursed, under what type of plan.
• Employers can have three types of reimbursement plans
  – Accountable
  – Nonaccountable
  – No reimbursement is given
Accountable Plan (slide 1 of 2)

• Plan must require adequate accounting to the employer for expense reimbursed, and
• Any excess reimbursements must be returned to the employer
Accountable Plan (slide 2 of 2)

- Adequate accounting is
  - Submitting a record, with receipts, to the employer, or
  - Using a per diem allowance that is not more than the Federal per diem rate
- Employee reports no income and takes no deduction to the extent of the reimbursed expenses
Substantiation for Expenditures
(slide 1 of 2)

• No deduction allowed for an expense if the taxpayer does not have adequate records for the expense
  – Therefore, taxpayers need to have good records for employee or self-employed expenses
  • In some cases, use of per diem allowance will be deemed substantiation
Substantiation for Expenditures
(slide 2 of 2)

• Records should include:
  – Business relationship with other persons involved (who)
  – Type of expense (what)
  – Time of expense (when)
  – Place of expense (where)
  – Purpose of expense (why)
  – Amount of expense (how much)
Nonaccountable Plan

• Plan that does not require adequate accounting or return of excess reimbursement or both
  – Reimbursed amounts received under this plan are included in gross income
  – Expenses are deductible FROM AGI as miscellaneous itemized deductions subject to the 2% AGI limitation
Unreimbursed Employee Expenses

- Expenses are deductible FROM AGI as miscellaneous itemized deductions subject to the 2% AGI limitation
Miscellaneous Deductions

- Miscellaneous itemized deductions subject to the 2% AGI limitation
  - Certain miscellaneous expenses must be added together and the amount in excess of 2% of taxpayer’s AGI is deductible FROM AGI (i.e., itemized deduction reported on Sch. A)
Examples of Miscellaneous Deductions Subject to 2% Floor

- Most reimbursed expenses under a nonaccountable plan
- Unreimbursed employee expenses
- Section 212 expenses not related to rents and royalties
- Tax return preparation fee
- Hobby expenses
- Investment expenses (except interest and taxes)
Computing 2% of AGI Limitation (slide 1 of 4)

• Example 1

Taxpayer, a single individual, provides the following information for 2003:

$30,000 AGI
$ 3,500 deductible interest expense and taxes paid
$ 1,500 employee business expenses, and
$ 500 tax return preparation fee
Computing 2% of AGI Limitation (slide 2 of 4)

• Example 1 (cont’d)

Interest and taxes $3,500

Misc. expenses:

Employee bus. exp. $1,500
Tax return prep. 500
Total $2,000
Less 2% AGI 600 1,400

Itemized deductions $4,900
Example 2
Assume the same facts as in Example 1, except that the taxpayer has only $200 of employee business expenses.
Computing 2% of AGI Limitation (slide 4 of 4)

• Example 2 (cont’d)

  Interest and taxes $3,500
  Misc. expenses:
    Employee bus. exp. $200
    Tax return prep. 500
    Total $700
  Less 2% AGI 600 100
  Itemized deductions $3,600
  Take standard deduction $4,750
If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:

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