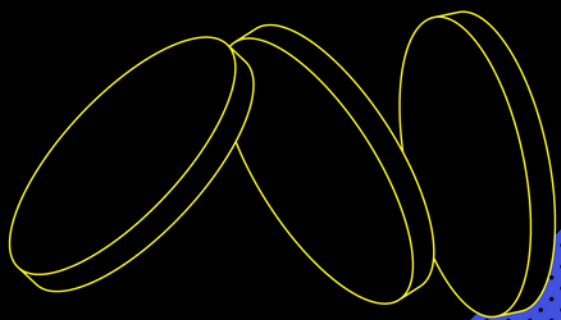


# THE ULTIMATE GUIDE FOR SELF-EMPLOYED INDIVIDUALS



ON HOW TO  
TRACK YOUR  
BUSINESS  
EXPENSES  
EFFECTIVELY

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# INTRODUCTION

Are you a self-employed professional looking for a comprehensive resource for managing and tracking your business expenses? Look no further than The Formations Expense Guide! This guide is essential for anyone who wants to categorize and track their expenses effectively, ensure they are maximizing deductions, and make smart financial decisions for their business.

## SEPARATING BUSINESS AND PERSONAL FINANCES

As a business owner, it's essential to take steps that support the growth and success of your company. One important decision you should make is to open a separate business bank account to manage your business income and expenses.

Maintaining separation between your personal finances and business finances has several advantages:



- Adds credibility to your business
- Protects your limited liability protection
- Avoids piercing the corporate veil
- Maintains accurate records
- Avoids a secondary audit on your personal tax return
- Allows for easy tracking of business receivables and payables
- Could be a requirement depending on the nature of your business
- Builds business credit

If you haven't opened a separate business bank account yet, you're missing out on the benefits and putting your business at risk. Our team of experts can set you up with a business account quickly, so you can enjoy all the benefits.

## THE GRAY AREA

In today's day and age, the line between personal and business expenses is more blurred than ever. Navigating the complexities involves two key elements: judgment and documentation. Using sound judgment around separating personal and business expenses is critical, as well as keeping documentation to ensure the expense is compliant in the event of an audit.



### WHAT'S AN EXPENSE?

An expense must be both ordinary and necessary. An ordinary expense is common and accepted in your business or industry. A necessary expense is helpful and appropriate for your industry or business. An expense does not have to be essential to be considered necessary.

Generally, you cannot deduct personal expenses. But, if you have an expense for something used partly for business and partly for personal purposes, you can divide the cost between the two and deduct the business portion.

## AVOIDING COMMINGLING

Commingling is when it's hard to determine which funds or assets belong to the company and which are personal. Commingling can make you liable for civil liabilities and criminal charges in cases of fraud or embezzlement.



Due to the legal nuances, it can be daunting to consistently and accurately identify the distinction between personal and business finances. It's always recommended to avoid commingling as much as possible.

That's where a business card connected to your business bank account becomes incredibly useful. We recommend having all of your business expenses go through a business card when possible.



## REIMBURSING OWNERS AND EMPLOYEES

While we recommend that most business expenses go through a business account, sometimes you might pay with the wrong card. When business expenses are purchased with personal assets, there's an IRS-approved method for reimbursements called a Business Accountable Plan or BAP.

BAP is a plan that allows you to reimburse owners and employees for business expenses that were paid for out-of-pocket. These reimbursements are tax-free and are not subject to withholding taxes or W2 reporting. There are four requirements for a business to make reimbursements with a BAP:



- The expenses must be business related
- You must have documentation of the expenses
- The request for reimbursement must be made promptly
- The employee must return any excess monies to the employer promptly

Using a BAP passes the employee or owner's business-related expenses to the business. These expenses are then deducted from the corporate tax return. If the IRS determines your BAP does not meet the requirements of an accountable plan, they can deem your plan as non-accountable, which would tax the expenses as employee income.

# HOW TO APPROACH BUSINESS EXPENSES

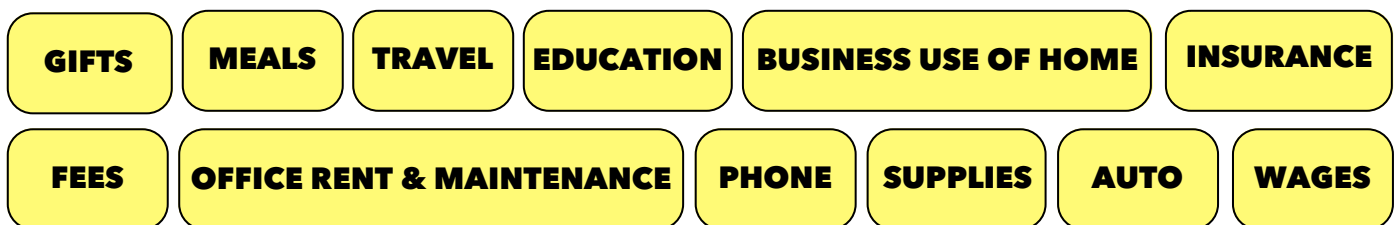
There are many different types of business expenses, each with their own definitions and nuances. And of course, there's the age-old question: can I deduct that?

## WHAT ISN'T DEDUCTIBLE

Formations golden rule for identifying deductions is: no pets, no personal care, and no kids (unless your kids work for you). First, identify whether the expense benefits the business primarily. The key question to ask is: Would I have paid for this expense for my personal use? If the answer is no, then you have a clear route to deducting it on your books. It gets more complex if you answer yes to this question.

It can be a challenge to think of appropriate expenses to heap on the business instead of personally. Still, you can always chat with a Formations expert if you have questions about any expenses and how to guarantee they are defensible.

## EXPENSE CATEGORIES





## MEALS

Meals expenses have to involve someone who is relevant to your business dealings, such as a colleague or potential client. You also have to record who that meal was with and what it was about in order to fully audit-proof the deduction, and even then they are easily challenged. We recommend only using your company funds for easily identifiable meal expenses.

Typically, you only get to deduct 50% of the cost. But for the 2021 and 2022 tax years, the IRS is allowing 100% deduction of business-related meals provided by a restaurant.



## TRAVEL

The IRS defines travel expenses as “ordinary and necessary expenses for traveling away from home for your business, profession, or job.” Any travel must serve a business purpose.

If you mix business and personal you must be able to allocate the time and costs between the two and separate any personal expenses. To deduct meals and lodging, it must involve being away from your business home overnight.

Deductible travel expenses include the actual cost to travel, transportation, lodging, business meals, dry cleaning or laundry services, business communications, and incidentals. Examples include:



- Travel including airfare, bus fair, and train fare
- Transportation like rental cars, taxis, Uber/Lyft, parking fees, and tolls
- Lodging such as hotels, inns, Airbnb, VRBO, HomeAway, etc.
- Meals that are non-entertainment
- Dry Cleaning or Laundry
- Business Communications
- Incidentals

Travel is one of the most widely abused deductions according to the IRS. The types of travel expenses that are easiest to deduct and defend are lodging, airfare, and transportation (taxis, Uber/Lyft, buses, etc). These are costs that are easily defended because you likely would not have to pay for them if you were not traveling for business. Where it starts to get complicated though is if you are combining personal and business travel.

## USE OF HOME

To qualify for the home office deduction, you must be self-employed and use part of your home "regularly and exclusively" for business. Your office doesn't need to be in a separate room, but it has to be in an area of your home where you don't do anything else. It can be a dedicated nook in the corner of your basement, for example, but it can't be the kitchen table where your family also eats. Deductible expenses include mortgage interest, insurance, utilities, repairs, and depreciation.

## USE OF AUTO

The IRS allows you to deduct either the actual expenses, such as fuel, maintenance, and repairs, or use what is called the standard mileage method which is a flat rate set by the IRS each year.



Both methods require the tracking of personal and business miles. There are apps available to help track the mileage. Don't want to track mileage or put wear and tear on your own car but need to get around town to meet clients? You can also deduct the cost of a taxi, public transportation, Uber, and Lyft.

## **OFFICE RENT & MAINTENANCE**

You can deduct rent as an expense only if the rent is for property you use in your trade or business. If you have or will receive equity in or title to the property, the rent is not deductible.

When it comes to repairs and maintenance, business owners can generally deduct the expenses if they don't have to be capitalized. A capitalized cost is when the purchase leads to some sort of economic benefit. So if the maintenance keeps the space in good working condition without increasing its value or prolonging its useful life, you can deduct it.

If the cost is a betterment, restoration, or adaptation, it must be capitalized and depreciated. But there are a few exceptions, if the invoice is \$2,500 or less, if the total cost of the project is \$10,000 or less, or if the repair expenses are routine.

## **CELL PHONE & INTERNET**

Your phone is most likely frequently at your side or in your hand, communicating with clients and vendors. You can either deduct the percentage of your phone used for business purposes or set up a separate line specifically for your business and deduct the cost of the added line. And, in today's digital world, the cost of your internet is also a business deduction. Both the cell phone and internet expenses also fall under the Business Accountable Plan as reimbursable employee business expenses.

## **EQUIPMENT & SOFTWARE**

Your computer, printer, office furniture, and fixtures are also allowed expenses. Any software you must purchase to run and maintain your business, such as CRM and marketing platform subscriptions, are also deductible. Most equipment purchases are not accounted for as an expense in one year. Instead, the expense is spread out over the life of the equipment.

## **SUPPLIES & GIFTS**

Business supplies are items purchased and typically used up during the year. The most common business supplies are typically office supplies, including staplers, sticky notes, highlighter pens, and supplies used to run copiers, printers, and other office machines. But those are handled differently if you buy supplies for use in products you manufacture or sell.

If you give business gifts, you can deduct no more than \$25 of the cost of business gifts you give directly or indirectly to each person. If you and your spouse both give gifts to the same person, both of you are treated as one taxpayer. Also, entertainment doesn't qualify as a gift. You need to have records that prove the business purpose of the gift and amount spent.

## **EDUCATION & EDUCATION MATERIALS**

Self-employed individuals can deduct the cost of work-related education expenses during the year. The expense must either be for education that maintains or improve skills needed in your current role or be required to keep your present salary, status, or job. Deductible expenses include but are not limited to: tuition, books, supplies, lab fees, transportation and travel costs, and the cost of research. Still unsure about what qualifies? The IRS made a quick quiz to help you figure out which educational expenses are deductible.

## **MARKETING & ADVERTISING**

Marketing is one of the broadest business expenses out there. Overall, you can deduct expenses related to advertising placements, direct marketing, sponsorships, PR, newsletters, digital advertising and SEO, advertising materials (such as business cards, brochures, web pages, and more), events, and more.

You can not deduct costs that are primarily personal, related to political parties or candidates, or personal hobbies involving customers or partners.

## **PROFESSIONAL SERVICES, CONSULTANTS & CONTRACTORS**

Just like your customers and clients need your professional help, there are times when you need to seek the advice of other experts. Whether you have to reach out to a graphic designer or lawyer for legal advice, the cost of these professional consultations are deductible. And, if you need to hire independent contractors to perform services for your business, these fees also qualify for tax deductions.

## **INSURANCE & LICENSING**

Professional licenses and renewals, memberships, industry association fees, and liability insurance are all deductible. And, if you pay for health insurances for yourself, your family, and your employees, there are additional tax benefits available.

## COMMISSIONS & FEES

Certain types of commissions and fees paid to employees or independent contractors can be deducted. A few different types of commissions have to be amortized or spread out over 15 years.

The expenses are considered capital expenses and include:

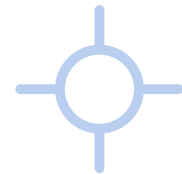
- commissions, bonuses, or fees to secure a business lease
- commissions for getting a business-related mortgage
- commissions for issuing or selling stock or securities

## SALARIES & WAGES

Salaries and wages paid to employees and owners are tax-deductible expenses if they are:

- Ordinary and necessary
- Reasonable in amount
- paid for services provided within the current year

So, that means your reasonable compensation set during the S-Corp formation process is deductible. Curious about how to set reasonable compensation? We use several different variables to help us determine the right reasonable compensation for you: net income, equity distribution, and personal tax liability.



## ACCURACY AND CHASING THE 1%

Any financial expert will preach that the goal of categorizing and accounting for expenses is to be accurate. But, what they fail to mention, is that your time is valuable too. If you're working tirelessly to take your accuracy from 99% to 100% – don't. Chasing the 1% may not be worth late nights and early mornings. And, it could be overkill.

If you make an error on your tax return that results in owing more tax, the IRS charges a late payment penalty. The penalty is 0.5% per month or partial month up to a maximum of 25% on the outstanding amount. So, depending on the circumstance, you may want to reconsider reconciling that 1%.

And remember, your time is valuable too. Check-in with a Formations expert to identify areas where you can offload your back-office tasks, so you can focus on the parts of the business you're passionate about.

# TRACKING EXPENSES

In order to take advantage of tax deductions, you need to be able to consistently track your business expenses. Monthly expenses tracking help keep your business healthy. It frees up cash flow and ensures you're getting paid back for business expenses quickly. It also helps with compliance, ensures you don't miss out on personal reimbursements, and mitigates leaning on your patchy memory for financial statements.

**DOWNLOAD  
THE EXPENSE  
TRACKER**



Our team of industry experts put together a monthly expenses tracker for you to make this a seamless process. Download the tracker, spend less time in complex spreadsheets, and get organized today.

## CONCLUSION

Expenses might seem daunting, but they don't have to be. And they shouldn't have to fall solely on your shoulders. Our experts help you manage all aspects of your business finances and maximize your financial well-being.

Here's how we do it:

- We untangle your finances by getting you into the right business structure
- We take over your back-office tasks, including bookkeeping, accounting & taxes
- We help you save money through strategic tax planning & financial management

Schedule a call with a Formations expert to get started!

**SCHEDULE A CALL**

