Above the Line vs. Below the Line Deductions

- An "above the line" deduction is a deduction from income that occurs *before* the calculation of the taxpayer's adjusted gross income ("AGI").
- A "below the line" deduction is a deduction from the already determined adjusted gross income.
- This distinction can be very important because the taxpayer's AGI often determines whether and to what extent certain deductions and credits apply (e.g., student loan interest, earned income tax credit, IRA contributions, etc.)

Deductibility of Business Expenses

- Any business owner can deduct all expenses "ordinary and necessary" to the business. These are "above the line" deductions in determining AGI.
- Business expenses incurred by employees of other businesses that are not reimbursed can also be deductible. However:
  - This is a "below the line" deduction (subtracted after AGI is tallied)
  - It is subject to the 2% of AGI limit to all itemized deductions (other than those listed in §67(b) of the IRC.
  - Since it's a below the line deduction, it can't be taken if the employee chooses the standard deduction.
- Other expenses in making money (e.g., brokerage fees in stock trades) are "below the line" deductions.

Capitalization of Expenses

- Normally, purchasing an asset that holds its value is not deductible as a business expense because you still own the asset so you didn't spend it.
- However, when an asset is purchased for business purposes and it has a limited useful life (e.g., a business car or manufacturing machine), it can be deducted because it's a business expense that will gradually become useless.
- However, one may not write off the entire cost of the assets in the year that it's purchased. Instead, one must take the expected longevity of the asset and divide the cost by that number and deduct, in effect, the percentage of the object that is being "lost" to depreciation each year.
- This is a similar concept but not the same as depreciating an asset.

Capitalization (continued)

- All prepaid expenses that will secure benefits for years to come must be capitalized, including:
  - Prepaid business insurance
  - Acquiring rental buildings
  - Acquiring machinery
  - Securing intellectual property protection for the company's work
  - Legal fees (etc.) for a transaction that will have benefits for years
  - Wages, in producing a long term asset, such as a building
- This can be disadvantageous to a taxpayer who must deduct expenses slowly rather than all at once. It can also be helpful because you might not have the income in that first year to make such a large deduction useful.

Capitalization (continued)

- Both "direct" costs in purchasing the asset and "indirect" costs must be capitalized. Indirect costs include:
  - Repair and maintenance of business property
  - Utilities and rent
  - Other materials and labor that are not direct costs
- The following are not considered "indirect" costs and thus can be written off entirely and don't have to be capitalized:
  - Advertising and marketing
  - Business and financial planning
  - Professional education or seminars

Repairs and Maintenance

- Whether work done on business property is a repair or improvement is an important distinction.
  - A repair is an ordinary business expense and is deductible
  - An improvement must be capitalized (though it can be added to the basis if it is sold before it's fully capitalized)
- The regulations distinguish as follows:
  - If repair does not "materially add to the value of the property nor appreciable prolong its life," it does not need to be capitalized.
    - Example: new retaining wall to mitigate health hazard
  - Otherwise (such as if it's a replacement that prolongs the life of the property), it does.
    - Example: new drainage system built on land

Inventory Accounting

- If a business purchases inventory for sale, it must capitalize the cost of the inventory if it will be sold in future years.

- This is called "using inventories" when the taxpayer/business owner when merchandise is acquired or built long prior to when it will be sold and paid for. This is confusing.

- Businesses that must use inventories must also use the "accrual" method of accounting, at least regarding those assets, because the accrual method is the only way the cost of producing the merchandise can be worked in with the rest of the income calculation in a manner that's consistent.

Method of Inventory Accounting 1

- Once merchandise is produced or acquired, the cost that went into creating the merchandise is written off as the merchandise is sold.

- Therefore, sale yields profits (or losses) of:
  - Gross receipt from the sale

    minus
  - Cost of the goods sold during the year based on the capitalization of the initial expense

Method of Inventory Accounting 2

- calculating which pieces of the inventory is sold during any given transaction (to determine the expense of the sold item) can be complicated, especially in cases where the sold items are all basically the same.
  - E.g., if a hardware store sells a hammer, it's not easy to tell whether that's a hammer that was produced or bought last year or two years ago.
- So, the taxpayer may choose either of these methods:
  - First in, first out (FIFO) - each item sold is assumed to be the oldest one that is in inventory
  - Last in, first out (LIFO) - each item sold is assumed to be the newest one that is in inventory