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Small Business Tax Deductions: Current vs. Capital Expenses

The timing of tax deductions for your small business depends partially on whether you can count an expense as capital or current.

Most people know that the tax code governs which expenses a business can deduct from their taxes, but not everyone knows that the tax rules also dictate what year a business can take those deductions in.

Business can take deductions for certain expenses the same year they make them. For other expenses, the business must break up the deduction and take it over several years. The first kind of deduction is known as a current expense; the second is called a capital expense. The differences between the two can be subtle and complex. This article will give lay out the basics, but small businesses may need to consult with a tax professional to make sure that they are classifying their deductions correctly.

Current Expenses

Current expenses are the day-to-day expenses that keep a small business running, like rent, paper and printer ink. Dealing with current expenses is pretty easy: a small business can simply subtract the total amount of all current expenses from the business' gross income during the tax year that the business incurred the expense in.

Capital Expenses

When a business purchases an asset, however, the rules for deductions get a little bit more complicated. An asset is anything that a small business expects will generate revenue for the business for several years past the original purchase date. Common examples of capital expenses are buildings, equipment and vehicles.

The IRS views capital expenses as investments in the business, thus the business can't simply deduct the money spent on the asset from its gross income. The money hasn't really left the business, it was just transformed into an asset that the business hopes will generate more money. Deductions for capital expenses typically must occur over several years, except where Section 179 applies (discussed below). Spreading the deduction over multiple tax years - also known as "capitalization", "amortization" or "depreciation" - helps businesses to accurately assess their profitability from year to year.

A good rule-of-thumb is that, if a business expects to use something for more than a year, the business should capitalize it.

Section 139

Section 139 muddies the water somewhat, but most small businesses can really benefit from using Section 139. Section 139 allows a business to deduct expenses that the IRS would normally consider capital expenses as if they were current expenses. Section 179 only applies to certain kinds of property, and has an upper limit of $500,000 for 2010 and 2011.

In addition, any business that starts to use more than $2,000,000 worth of Section 179-eligible property in a single year has to reduce its Section 179 deduction by the amount exceeding $2,000,000. So if a business is taking a full Section 179 deduction of $500,000, but has placed $2,100,000 of Section 179 property into service, it would need to reduce its deduction by $100,000 to $400,000.

Finally, a business' Section 179 deduction can't exceed its total income for a year. For example, if a business has an income of $200,000 in a year, but placed $250,000 worth of Section 179 property into service during that year, the business could only take a $200,000 Section 179 deduction. The business could carry over the remaining $50,000 in Section 179-eligible deductions to the next year, though.

Repairs vs. Improvements

As if capital expenses weren't complicated enough, there's also the issue of repairs and improvements to consider.

When a business makes a simple repair on a capitalized item, it can deduct the cost of the repair as a current expense.

If the business makes an *improvement* on the capitalized item, however, it must capitalize the cost of the improvement. This most commonly applies to real estate -- adding a room, improving the plumbing, etc. - but it can also apply to other things as well, such as business equipment.

The tax code states that a modification is an improvement when:

- It increases the value of the asset
- It enables a new use of the asset
- It lengthens the useful life of the asset

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