



DEDUCTIONS AND CREDITS

Powerful Ideas: Business Deductions and Credits



Prepared for
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Business Income Tax Deductions and Credits

Income tax deductions and tax credits – in general

An income tax deduction is a reduction in the amount of income a taxpayer is required to pay tax on. Deductions are subtracted from taxable income, reducing the amount of income subject to tax, thereby reducing the amount of a taxpayer's liability. For example, if a taxpayer has a marginal tax rate of 24%, for every dollar of deductions, the taxpayer will save 24 cents of taxes.

A tax credit is an amount of money that a taxpayer is able to subtract from a tax liability owed to the government, i.e., a tax liability is calculated based on the taxpayer's income and deductions, and credits are used to reduce the amount of tax liability owed. For example, if, after adding up all income and deductions, a taxpayer owes a tax liability of \$10,000, and has tax credits of \$5,000, the taxpayer will pay taxes of only \$5,000.

What tax deductions are available for businesses?

In general, expenses for operating a business are deductible if the expense is both ordinary and necessary. An ordinary expense is one that is common and accepted in a trade or business. A necessary expense is one that is helpful and appropriate for a trade or business, however, an expense does not have to be indispensable to be considered necessary.

Business expenses are comprised of two primary categories that determine how and when the expense may be deducted: operating expenditures and capital expenditures.

Operating expenditures

An operating expense results from the ongoing costs a company incurs to run its basic business. In contrast to capital expenditures, operating expenses are fully deductible in the year they are paid. Operating expenditures that are deductible in the year they are paid include wages, the purchase of inventory, research and development expenses, pension plan contributions, property taxes, business travel, rent, and insurance costs.

Capital expenditures

Capital expenditures are the funds that a business uses to purchase major physical goods or services to expand the company's abilities to generate profits. These purchases can include equipment, vehicles, or the purchase or construction of a new building. It is often necessary to deduct capital expenditures over a period of time, unless other provisions (such as accelerated depreciation) allow the taxpayer to deduct the expense in the current tax year.

In addition to ordinary and necessary expenses, the Internal Revenue Code (IRC) provides additional statutorily created deductions available to businesses. A non-exhaustive list of available statutory deductions includes:

Qualified business income deduction

IRC §199A provides a 20% deduction against Qualified Business Income (QBI) for the owners of pass-through entities. Pass-through entities include sole proprietorships, partnerships, S corporations, or LLCs taxed as a pass-through entity. For 2025, the deduction is subject to limitations which are phased in for owners whose taxable income exceeds \$394,600 if married filing jointly or surviving spouse (or \$197,300 if married filing separately or single/head of household) but is less than \$494,600 if married filing jointly or surviving spouse (or \$247,300 if married filing separately or single/head of household). For taxpayers whose income exceeds the maximum taxable income threshold amount, the deduction is the lesser of:

1. 20% of QBI, or
2. The greater of (a) 50% of W-2 wages or (b) 25% of wages plus 2.5% of the unadjusted basis of assets.

In addition, taxpayers engaged in a specified trade or business (SSTB), which includes health professionals, legal professionals, accounting professionals, actuarial professionals, financial professionals, performers, athletes, and others, cannot claim the deduction if their income exceeds the maximum taxable income threshold amount.

Election to expense certain depreciable assets

IRC §179 allows a taxpayer to immediately expense the cost of qualifying property—rather than recovering such costs through depreciation deductions over a period of years. The deduction applies to new and used equipment, as well as off-the-shelf software. For 2025, the maximum amount that may be deducted under IRC Section 179 is \$1,250,000 and the deduction is reduced by the amount by which the cost of §179 property placed in service during the year exceeds \$3,130,000.

Bonus depreciation

IRC §168(k) allows businesses to immediately deduct 100% of the cost of eligible property (including new and used property) in the year it is placed in service through 2022, with the amount of allowable bonus depreciation is phased down ratably over the following years: 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026.

What tax credits are available for businesses?

A non-exhaustive list of available credits includes:

Research and development credit

The Research and Development Credit (R&D Credit) was created to incentivize increases in research and development by businesses. The R&D Credit is found in IRC §41 and is a nonrefundable credit for activities performed which are “Qualified Research Expenditures.”

Employer credit for paid family or medical leave

Eligible employers may claim a credit equal to a percentage of wages paid to qualifying employees on leave under the Family and Medical Leave Act (FMLA). In order to receive the credit, employers must provide at least two weeks of leave under the FMLA and compensate workers at a minimum of 50 percent of their regular earnings. The credit ranges from 12.5% to 25% of the cost of each hour of paid leave, depending on how much of a worker’s regular earnings the benefit replaces. The credit is effective for wages paid in taxable years beginning after December 31, 2017, and before January 1, 2026.

Work opportunity tax credit

The work opportunity tax credit (WOTC) is a federal tax credit available to employers who hire and retain veterans and individuals from other target groups with significant barriers to employment. The amount of the credit employers can claim depends upon the target group of the individual hired, the wages paid to that individual in the first year of employment, and the number of hours that individual worked. There also is a maximum tax credit that can be claimed.

Small business health care tax credit

The small business health care tax credit is a credit provided to small business owners to help offset the cost of offering health insurance to employees. In order to qualify for the credit, the employer must:

1. Pay average wages of less than \$66,600 a year per employee;
2. Purchase health insurance coverage via the Small Business Health Options Program (SHOP) Marketplace or through a licensed agent who can enroll the business in a SHOP plan;
3. Pay at least 50% of a qualified employee’s health care premiums; and
4. Have fewer than 25 full-time equivalent employees (the maximum credit requires no more than 10 full-time equivalent employees and maximum average annual wages less than or equal to \$33,300).

Credit for small employer pension plan startup costs

Employers may be able to claim a tax credit for some of the costs of starting a SEP plan, SIMPLE IRA or qualified plan. In order to claim the credit, an employer:

1. Must have 100 or fewer employees who received at least \$5,000 in compensation in the preceding year; (
2. Must have at least one plan participant who is a non-highly compensated employee; and
3. In the three tax years before the first year of eligibility, must not have provided the same employees contributions or accrued benefits in another plan sponsored by the employer, a member of a controlled group that includes the employer, or a predecessor of either.

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