

The Tax Professional's Guide to Understanding the Importance of Substantiating Business Expense Deductions



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NSTP's Suggested Research Materials

- IRS Publication **334** “*Tax Guide for Small Business*” (Schedule C)
- IRS Publication **463** “*Travel, Entertainment, Gift and Car Expenses*”
- IRS Publication **535** “*Business Expenses*”
- IRS Publication **583** “*Starting a Business and Record Keeping*”



Sec. 162 Trade or Business Deductions

- *Ordinary & necessary* in order to carry on a *trade or business*
- *Facts and circumstances* surrounding the *expense paid or incurred*
- ***Necessary:*** appropriate and helpful to the taxpayer's business (***S.B. Heining, SCt, 44-1 USTC-9109***)
- ***Ordinary:*** *common and accepted in the particular business activity*

Deductibility

- Proper tax year: Incurred **vs.** Paid
- Operating expense **vs.** Cost of Goods Sold **vs.** Capitalized expenditure
- Going into business **vs.** “in business”
- How much in current tax year **vs.** subsequent tax year(s)



Deductibility

- Limitations on current year losses, At-risk issues, Passive Activity Issues
- Allocation Issues: Determine Business Portion
- Reasonableness of position taken by taxpayer
- Consistency **vs.** annual fluctuations



Substantiating Allowable Deductions

- Generally, **law** does not require any *specific* kind of records
- Taxpayer can choose *any* recordkeeping system suitable that *clearly* reports *allowable deductible* expenses
- *Electronic* records require same type of information as *hard copy* books & records
- Supporting Documents are **required** in order to substantiate deductions: invoices, cancelled checks, etc.



Substantiating Allowable Deductions

- Answer interrogatories for business purpose: “what, why, when, who and how much”
- **Required** “logs” for vehicles, computers, etc. *“listed property”*
- **Audit proof** the deductions
- Protect against IRS attack of **Sec. 183** “hobby **vs.** business” issues



Substantiating Allowable Deductions

- Protect against Capitalization **vs.** current year deductibility
- Protect against Personal **vs.** Business expense
- Show that “*economic performance*” occurred in current tax year
- Show reasonable amounts paid if transactions occurred with “*related parties*”



Substantiating Allowable Deductions

- Records should be able prove “*placed in service*” dates of fixed assets
- Records should be able to prove “*placed in service*” dates of intangible assets e.g.
 - Sec. **195** Start-up Expenditures
 - Sec. **197** Amortization of Goodwill and Certain Other Intangible Costs of Acquisition of Business Assets
 - Sec. **248** Organizational Expenditures of a Corporation
 - Sec. **709** Organization Expenditures of a Partnership

Substantiating Allowable Deductions

- Proper records needed to prove that fixed assets and intangible assets **disposed** in proper tax year
- Proper records needed to prove that a business bad debt **existed** and **when** it became “*wholly worthless*”



Substantiating Allowable Deductions

- Easy audit targets when proper record keeping ignored:
 - *Food & entertainment*
 - *Vehicle use*
 - *Gifts to clients*
 - *Home office deductions*
 - *Non-compliance for not issuing IRS Form 1099 MISC*



Substantiating Allowable Deductions

- Easy audit targets when proper record keeping ignored:
 - *Fixed assets reported as “supplies”*
 - *Cancelled checks unavailable*
 - *Invoices lost*
 - *Auto logs don’t exist*

