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. Heininger, 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*