

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



**Paul La Monaca, CPA, MST**

**Director of Education**

**&**

**Nina Tross , EA, MBA**

**Executive Director**

**National Society of Tax Professionals**

# Tax Gap Issues

- Voluntary self-assessing system
- Taxpayer reports the liability to government
- Taxpayer responsibility to prove
- Compliance rate after enforcement **83.1%**
- Annual Gross Tax Gap **\$458 Billion**
- IRS Enforcement Efforts (\$52 Billion)
- Net Tax Gap **\$406 Billion**

# Tax Gap Issues

- Underreporting of taxable income: combination of *underreporting* gross income and *over reporting* allowable deductions
- **Schedule C's** account for **\$122 B**
- **Corporations** with *less than* **\$10M** in assets account for **\$19 B**

# 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*
- “*Reasonable allowance*” for salaries or other compensation for personal services actually rendered
- Traveling expenses while away from home in pursuit of a trade or business
- Including meals & lodging *other than* amounts which are *lavish & extravagant*

# Sec. 162 Trade or Business Deductions

- Rentals and other payments made as a condition to a continued use or possession for the purpose of a trade or business
- *Facts and circumstances* surrounding the expense *paid or incurred*

# Sec. 162 Trade or Business Deductions

- ***Necessary***: appropriate and helpful to the taxpayer's business (***S.B. Heininger, S Ct, 44-1 USTC-9109***)
- *“As long as it can be determined by the taxpayer that the cost was appropriate and helpful to the taxpayer's business”*
- ***Ordinary***: common and accepted in the particular business activity
- *“Ability of the taxpayer to be able to substantiate and verify that position”*



# Deductibility

- Proper tax year: Incurred **vs.** Paid
- If cash basis: current year **vs.** prepayment *before* liability incurred
- Operating expense **vs.** Cost of Goods Sold **vs.** Capitalized expenditure
- Going into business **vs.** “in business”
- Sec. **195** “Start-up” expenditures amortized over 15 years



# Deductibility

- How much in current tax year **vs.** subsequent tax year(s)
- Limitations on current year losses and deductions:
  - **Sec. 465 At-risk Issues,**
  - **Sec. 469 Passive Activity Loss Issues**
  - **Sec. 274 food & entertainment 50% cut back**
- Allocation Issues: Determine Business Portion
- Reasonableness of position taken by taxpayer
- Consistency **vs.** annual fluctuations

# Deductibility

- Allocation Issues: Determine Business Portion
- Assets of business used by taxpayer
  - High on auditor's list: autos, computers, real estate, cell phones, etc.
- 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

- Tax Court *disallows* deductions not substantiated
- Sloppy record keeping
- Sec. 6662 assessment of a 20% penalty for substantial understatement of tax
- Considered *negligence and disregard for the rules and regulations*

# 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: assume that *every* return prepared will be audited
- Protect against IRS attack of **Sec. 183** “hobby **vs.** business” issues



# Sec. 183 Hobby Loss Issues

- Not engaged in for profit
- Industry Codes that appear to provide pleasure activities: boats, horses, home based businesses, dogs, airplanes, etc.
- Make noises of intent to make a profit
- “Intent” to make a profit **vs.** “expectation” of a profit in the current tax year

# Sec. 183 Hobby Loss “Noises”

- Books & records
- Local registration to do business
- Pay local taxes
- Separate bank account & credit card
- Website & Business stationery
- Join professional associations
- Continuing education



# 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

- Properly account for inventory if applicable
- “Repair regulation” issues \$2,500 per item or per invoice allowing a current year deduction instead of capitalized asset as long as election properly made on a timely filed return



# 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*” under **Sec. 166**



# 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*



# NSTP THANKS YOU!

- We invite you to come see us at our booth in the Exhibit Hall so that you can learn more about the **benefits of membership in NSTP**
- We also ask that you attend our presentation on **“Schedule C Issues Facing the Tax Professional”** on Wednesday & Thursday morning at **8:00 AM in Room 1**