

Tips for Taxpayers

To Deduct or Not Deduct, That is the Question!

Internal Revenue Code section 162(a) states that all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business are deductible.

An ordinary expense is one that is common and accepted in a particular field of business, trade or profession, a necessary expense is one that is helpful and appropriate for a particular business trade or profession.

Action item:
Use a log to track auto, meals, and entertainment deductions.

For individual taxpayers, business expenses are usually deducted either on schedule C for sole proprietors', or single member LLC owners, or on form 2106 attached to schedule A (miscellaneous itemized deductions, subject to 2% of adjusted gross income), for W-2 employees.

In our experience, the most contested business expenses, by the IRS, are travel, meals and entertainment, and automobile deductions.

Meals and Entertainment: The cost of entertainment a client, customer or employee can qualify as an ordinary and necessary business expense. To qualify as a deduction the expenses must be directly related to or associated with the active conduct of a trade or business or for the production or collection of income. The deduction for meals and entertainment expenses are usually limited to 50% of the amounts that would otherwise be deductible.

Travel: Expenses for transportation and lodging are deductible for business travel away from the taxpayer's tax home. The tax home is the main place of business where most of the time, income or degree of business activity occurs. To deduct lodging costs, taxpayers must be away from their tax home longer than an ordinary work day, and must be away long enough that they cannot reasonable be expected to complete the trip without sufficient sleep or rest. There are also additional rules if the primary purpose of a trip is not business.

Substantiation Requirements: IRC section 274(d) sets forth specific requirements for substantiating deductions for travel, meals and entertainment. Taxpayers are required to maintain an account book, diary, log, trip sheet or similar records as well as documentary evidence such as receipts, cancelled checks. The importance of substantiation cannot be overemphasized, as the IRS puts more weight on contemporaneous documentation than only documenting the item after a taxpayer has been notified of audit.

You might consider a full-featured accounting software to track income and expenses. We highly recommend these programs for small businesses. Using accounting software will help you monitor the health of your company, and provide an audit roadmap for the IRS.

Consider regularly preparing a balance sheet and profit and loss reports. These reports help you analyze how your business is doing, whether you are profitable, and how you are spending your money.

This article was written by Kelsey Hernandez, EA, CPA, a manager at Bosma Group who specializes in small businesses taxation. Bosma Group is a CPA firm dedicated to serving closely held growing businesses. Call Kelsey at 775-786-4900 or by email at khernandez@thebosmagroup.com.