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Tax & Business Alert

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WHAT EXPENSES CAN'T BE WRITTEN OFF BY YOUR BUSINESS?

If you check the Internal Revenue Code, you may be surprised to find that most business deductions aren't specifically listed there. For example, the tax law doesn't explicitly state that you can deduct office supplies and certain other expenses. Some expenses are detailed in the tax code, but the general rule is contained in the first sentence of Section 162, which states you can write off "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

BASIC DEFINITIONS

In general, an expense is *ordinary* if it's considered common or customary in the particular trade or business. For example, insurance premiums to protect a store would be an ordinary business expense in the retail industry.

It's possible for an ordinary expense to be unnecessary — but, to be deductible, an expense must be ordinary and necessary.

A *necessary* expense is one that's helpful or appropriate. For example, a car dealership may purchase an automatic defibrillator. It may not be necessary for the business operation, but it might be helpful if an employee or customer suffers a heart attack. It's possible for an ordinary expense to be *un*necessary — but, to be deductible, an expense must be ordinary *and* necessary.

A deductible amount must be reasonable in relation to the benefit expected. For example, if you're attempting to land a $3,000 deal, a $65 lunch with a potential client should be OK with the IRS. (The Tax Cuts and Jobs Act eliminated most deductions for entertainment expenses but retained a 50% deduction for business meals.)

RELEVANT U.S. TAX COURT CASES

Here are three recent U.S. Tax Court cases in which specific taxpayer deductions were disallowed:

1. A married couple owned an engineering firm. For two tax years, they claimed depreciation of $76,264 on three vehicles, but didn't provide required details, including each vehicle's ownership, cost and useful life. They claimed $34,197 in mileage deductions and provided receipts and mileage logs, but the court found they didn't show related business purposes. The court also found the mileage claimed included commuting costs, which can't be written off. The court disallowed these deductions and assessed taxes and penalties. (TC Memo 2023-39)

2. The court ruled that a married couple wasn't entitled to business tax deductions because the husband's consulting company failed to show that it was engaged in a trade or business. In fact, invoices produced by the consulting company predated its incorporation. And the court ruled that even if the expenses were legitimate, they weren't properly substantiated. (TC Memo 2023-80)

3. A physician specializing in gene therapy deducted legal expenses of $360,295 for two years on Schedule C of his joint tax returns. The court found that most of the legal fees were to defend the husband against personal conduct issues. The court denied the deduction for personal legal expenses but allowed a deduction for $13,000 for business-related legal expenses. (TC Memo 2023-42)

PROCEED WITH CAUTION

The deductibility of some expenses is clear, while others are more complicated. Keep careful records to substantiate expenses you plan to deduct. Generally, if an expense seems like it's not normal in your industry — or could be considered personal or extravagant — proceed with caution. Not surprisingly, the IRS and courts don't always agree with taxpayers about what is ordinary and necessary. (See examples in "Relevant U.S. Tax Court cases" above.) Contact us with questions about deductibility. ■

GETTING A NEW BUSINESS OFF THE GROUND

New businesses are launched every day, as evidenced by the number of Employer Identification Numbers requested, according to the U.S. Census Bureau. In the aftermath of the COVID-19 pandemic, there was a large increase in the number of businesses formed. For 2023, roughly 5.5 million new business applications were filed.

HOW TO TREAT EXPENSES FOR TAX PURPOSES

Entrepreneurs often don't know that many of the expenses incurred by start-ups can't be currently deducted on their tax returns. Be aware that the way you handle some of your initial expenses can make a large difference in your federal tax bill. Here are three rules to keep in mind if you're starting or planning to launch a new business:

1. Start-up costs include those incurred or paid while creating an active trade or business — or investigating the creation or acquisition of one.

2. Under the tax code, taxpayers can elect to deduct up to $5,000 of business start-up and $5,000 of organizational costs in the year the business begins. As you know, $5,000 doesn't go very far these days! And the $5,000 deduction is reduced dollar-for-dollar by the amount by which your total start-up or organizational costs exceed $50,000. Any remaining costs must be amortized over 180 months on a straight-line basis.

3. No deductions, including amortization deductions, are allowed until the year when "active conduct" of your new business begins. Generally, that means the year when the business has all the pieces in place to start earning revenue. To determine if a taxpayer meets this test, the IRS and courts generally ask questions such as: Did the taxpayer undertake the activity intending to earn a profit? Was the taxpayer regularly and actively involved? Did the activity actually begin?

ELIGIBLE EXPENSES

In general, start-up expenses are those you make to:

- Investigate the creation or acquisition of a business,
- Create a business, or
- Engage in a for-profit activity in anticipation of it becoming an active business.

To qualify for the election, an expense also must be one that would be deductible if it were incurred after a business began. One example is money you spend analyzing potential markets for a new product or service.

To be eligible as an "organization expense," an expense must be related to establishing a corporation or partnership. Some examples include legal and accounting fees for services related to organizing a new business and filing fees paid to the state of incorporation.

PLAN NOW

If you have start-up expenses that you'd like to deduct this year, you need to decide whether to take the election described above. Recordkeeping is critical. Contact us about your start-up plans. We can help with the tax and other aspects of your new business. ■

SENDING THE KIDS TO DAY CAMP MAY BRING A TAX BREAK

Among the many challenges of parenthood is what to do with your kids when school lets out. Babysitters are one option, or you might consider sending them to a day camp. There's no one-size-fits-all answer, but if you do choose a day camp, you could be eligible for a tax break. (Unfortunately, overnight camps don't qualify.)

DOLLAR-FOR-DOLLAR SAVINGS

Day camp can be a qualified expense under the child and dependent care tax credit. The credit is worth 20% to 35% of the qualifying costs, subject to an income cap. As of this writing, the maximum amount of expenses that can be claimed is $3,000 for one qualifying child or $6,000 for two or more children, multiplied by the percentage that applies to your income level. For those qualifying for the 35% rate with maximum expenses of $3,000, the credit equals $1,050, or $2,100 for two children with expenses of at least $6,000. The applicable credit percentage to use drops as your adjusted gross income (AGI) rises. When AGI exceeds $43,000, the percentage is 20% of qualified expenses, subject to the $3,000 or $6,000 limit.

Tax credits are particularly valuable because they reduce your tax liability dollar-for-dollar — $1 of tax credit saves $1 of taxes. This is compared to deductions, which simply reduce the amount of income subject to tax. So, if you're in the 24% tax bracket, a $1 deduction saves you only $0.24 of taxes.

QUALIFYING FOR THE CREDIT

Only dependents under age 13 generally qualify. However, the credit may also be claimed for expenses paid to care for a dependent relative, such as an in-law or parent, who is incapable of self-care. Eligible care costs are those incurred while you work or look for work.

Expenses paid from, or reimbursed by, an employer-sponsored Flexible Spending Account can't be used to claim the credit. The same is true for a dependent care assistance program.

DETERMINING ELIGIBILITY

Additional rules apply to this credit. Contact us if you have questions about your eligibility for the credit and the exceptions. ■

HELP PREVENT FINANCIAL SCAMS AIMED AT OLDER PEOPLE

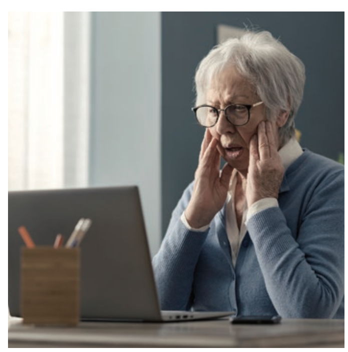
In any season, scam artists are seeking new ways to steal financial data and money from vulnerable people. Such fraudulent activities often target older adults. Whether you're in this age bracket or you worry about senior loved ones, here are seven ways to help prevent elder financial abuse and fraud:

1. Keep both paper and online financial documents in a secure place. Monitor accounts and retain statements.

2. Exercise caution when making financial decisions. If someone exerts pressure or promises unreasonably high or guaranteed returns, walk away.

3. Write checks only to legitimate financial institutions, rather than to a person.

4. Be alert for phony phone calls. The IRS doesn't collect money this way. Another scam involves someone pretending to be a grandchild who's in trouble and needs money. Don't provide confidential information or send money until you can verify the caller's identity.



5. Beware of emails requesting personal data — even if they appear to be from a real financial institution. Remember, your banker or financial professional already has your personal information. Ignore contact information provided in emails. Instead, contact financial institutions through phone numbers you look up yourself.

6. As much as possible, maintain a social network. Criminals target isolated people because often they're less aware of scams and lack trusted confidants.

7. Work only with qualified professionals, including accountants, bankers and attorneys.

Most important, never let your guard down. Thieves are on the lookout for vulnerable people, so proactively be on the lookout for thieves. ■