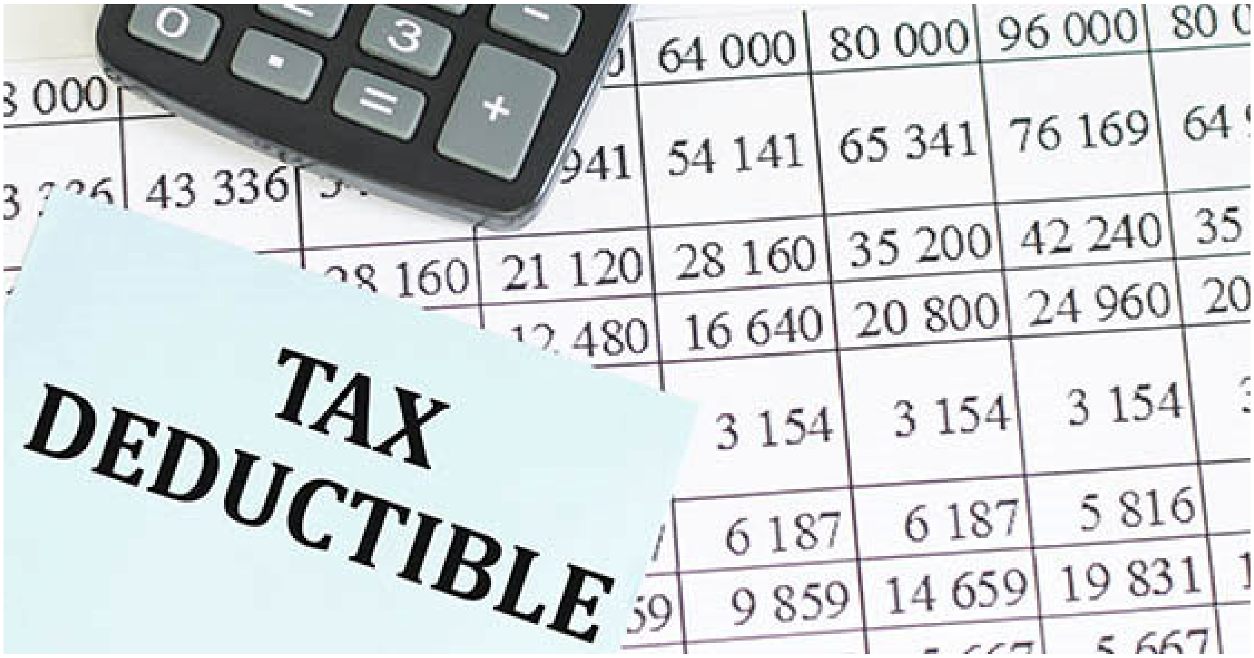

What types of expenses can't be written off by your business?

If you read the Internal Revenue Code (and you probably don't want to!), you may be surprised to find that most business deductions aren't specifically listed. 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.

A *necessary* expense is defined as one that's helpful or appropriate. For example, let's say a car dealership purchases an automated external defibrillator. It may not be necessary for the operation of the business, but it might be helpful and appropriate if an employee or customer suffers cardiac arrest.

It's possible for an ordinary expense to be *un*necessary — but, in order to be deductible, an expense must be ordinary *and* necessary.

In addition, 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. (Keep in mind that the Tax Cuts and Jobs Act eliminated most deductions for entertainment expenses but retained the 50% deduction for business meals.)

Examples of taxpayers who lost deductions in court

Not surprisingly, the IRS and courts don't always agree with taxpayers about what qualifies as ordinary and necessary expenditures. Here are three 2023 cases to illustrate some of the issues:

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 U.S. Tax Court found they didn't show any 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 Tax 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 had multiple legal issues and deducted legal expenses of $360,295 for two years on joint Schedule C business tax returns. The Tax 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. But for other expenses, it can get more complicated. Generally, if an expense seems like it's not normal in your industry — or if it could be considered fun, personal or extravagant in nature — you should proceed with caution. And keep careful records to substantiate the expenses you're deducting. Consult with us for guidance.