

Abstract: Running a business requires that strong, supportable records be kept. Every expense that appears on a tax return might have to be defended if the IRS decides to audit the return. And failing to operate in a businesslike manner and keep good records might lead the IRS to deem the activity a hobby rather than a business. This means expenses may be limited or disallowed. This article and a sidebar illustrate how the IRS (and sometimes the courts) view business records, what they're looking for and what's considered acceptable substantiation.

Protect your business with meticulous records

If you run a business, you know that you need to support expenses with detailed records. To be deductible, every expense on your tax return might have to be defended if your company is subject to an audit. Plus, failing to operate in a businesslike manner, complete with good records, might lead the IRS to deem the activity a hobby rather than a business — and your expenses may be limited or disallowed.

While there's no one right way to keep business records, some types of expenses do require more details. For example, records relating to automobile expenses, travel, meals and office-at-home costs are subject to special requirements or limitations.

To claim deductions, an activity must be engaged in for profit

For a business expense to be deductible, the taxpayer must establish that the primary objective of the activity is making a profit. The expense must also be substantiated and be an “ordinary and necessary” business expense. In one court case (*Gaston v. IRS, 2021*), a taxpayer claimed deductions that created a loss, which she used to shelter other income from tax.

She engaged in various activities that included acting in the entertainment industry and selling jewelry. The IRS found her activities were more like hobbies than businesses engaged in for profit and it disallowed her deductions.

The taxpayer did, however, have some success when she took her case to the U.S. Tax Court. The court found that she **was** engaged in the business of acting for profit during the years at issue, though not all of the claimed expenses were ordinary and necessary business expenses. The court allowed deductions for expenses including headshots, casting agency fees and lessons to enhance the taxpayer's acting skills. But the court disallowed other deductions because it found insufficient evidence “to firmly establish a connection” between the expenses and the business.

In addition, the court found that that taxpayer didn't prove that she engaged in her jewelry sales activity for profit. She didn't operate it in a businesslike manner, spend sufficient time on it or seek out expertise in the jewelry industry. Therefore, all deductions related to that activity were disallowed.

We can help

Contact us if you need assistance retaining adequate business records. Taking a meticulous, proactive approach can protect your deductions and prevent the IRS from viewing your business as a hobby.

Sidebar:

Proper records are required

In another case, a taxpayer worked as a contract emergency room doctor at a medical center. He also started a business to provide emergency room physicians overseas. On Schedule C of his tax return, he deducted expenses related to his home office, travel, driving, continuing education, cost of goods sold and interest. The IRS disallowed most of the deductions.

In U.S. Tax Court, the doctor used charts to illustrate his expenses but didn't provide receipts or other substantiation showing the expenses were actually paid. He also failed to account for the portion of expenses attributable to personal activity.

The court disallowed the deductions, stating that his charts weren't enough and didn't substantiate that the expenses were ordinary and necessary in his business. It noted that "even an otherwise deductible expense may be denied without sufficient substantiation." The doctor also didn't qualify to take home office deductions because he didn't prove it was his principal place of business. (*Elbasha v. IRS, 2022*)

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