Small Business Tax Deductions Themes

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There are some over-arching themes and concepts for all small business deductions. The business expense must be-

- Ordinary and necessary (IRS Publication 334), and
- Paid or recognized in the current tax year, and
- Directly related to your business, and
- Reasonable, and not lavish or extravagant (**IRC Section 162** and IRS Publication 463).

Let's break these down. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate, although not necessarily required, for your business. In Samp v. Commissioner (Tax Court Memo 1981-706), an insurance agent had a handgun since he traveled to an area with a recent unsolved murder. The Tax Court responded with "A handgun simply does not qualify as an ordinary and necessary business expense for an insurance agent, even a bold and brave Wyatt Earp type with a fast draw who is willing to risk injury or death in the service of his clients."

You must appreciate a Wyatt Earp reference from a Tax Court judge. Ouch. Clean up on aisle Allstate.

The expense must be paid or recognized in the current year. Expenses that were paid but not deducted in previous years cannot be "caught up" by deducting them today without amending your prior tax returns (which are easy to do, and should be done if there is money to be had). There is some wiggle room by paying expenses in advance. Under the Code of Federal Regulations (CFR), Title 26 (Internal Revenue), Chapter 1, Subchapter A (Income Tax) or **Treasury Regulations Section 1.263(a)-4** for short, there is a rule called the 12-month rule. This allows you to deduct in full an amount where the benefit received from paying the expense spans two tax years.

Here is the exact wording allowing the immediate deduction of prepaid expenses for "any right or benefit for the taxpayer that does not extend beyond the earlier of-

- 12 months after the first date on which the taxpayer realizes the right or benefit; or
- The end of the taxable year following the taxable year in which the payment is made."

Here is the link to the Treasury Regulations on the 12-month rule-

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You'll need to search for Prepaid Rent, or scroll through a bunch of hoopla.

An example you see often is a one-year rental lease that starts July 1 and ends June 30 the following year. If you pre-paid the entire lease amount, you can deduct the entire amount since the benefit (the use of the rental space) is 12 months. However, let's say the lease term started February 1 of the following year, but you prepaid the entire amount December 31 of the current year. Since the benefit extends past the end of the following tax year, none of it is deductible in the current year and only a portion is deducted the following year.

Just because you can deduct an expense in one lump sum, doesn't mean that you should. Remember the conversation about depreciation, tax planning and increased marginal tax rates in the future? Also, this small business tax deduction scheme is usually reserved for those using cash-based accounting.

The expense must be related to your business- that seems obvious. Finally, the expense must not be lavish or extravagant. IRS Publications 463 states "You cannot deduct expenses for entertainment that are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances. Expenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts." The IRS hasn't updated to remove the word "entertainment" but you get the idea.

The link for **IRS Publication 463** (Travel, Entertainment, Gift, and Car Expenses) is below-

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So, your Board of Directors meeting might spend $500 on catering but a $5,000 expenditure to hold your board meeting in Fiji might be considered lavish and extravagant. Be reasonable out of the gate, and it will be hard for the IRS to knock you off your perch.

> **Sidebar:** S Corps are subject to hobby loss rules in a sense. In other words, if your S Corp loses money each year, the IRS might consider the activity a hobby or an activity not in pursuit of a profit. What are we talking about here? You have an S corporation that earns very little. You contribute additional paid in capital each year to create shareholder basis so you can deduct your automobile or other owner-friendly deductions. You create a tax loss, and since you have basis, you can deduct that loss on your individual (Form 1040) tax returns. Scam. Harsh? Not at all.

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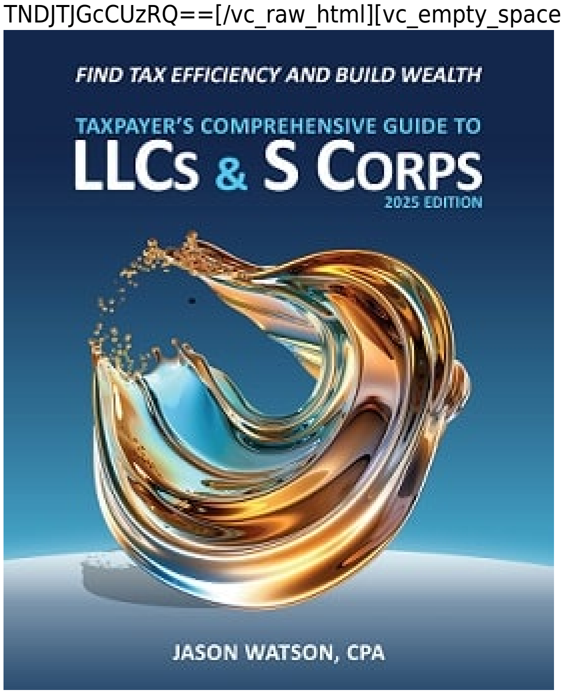

Taxpayer’s Comprehensive Guide to LLCs and S Corps 2025 Edition

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