

## **Business versus Personal Expenses; and Documentation Required**

It is that time of year again. You, and your accountant, are in the process of reviewing and finalizing your personal and business returns for your Dental Practice. As part of that review, your accountant is usually confronted with questions regarding what represents a business expense and what supporting documentation is required for that expense. With that in mind, we wanted to provide you with this summary for your review and consideration. As always, please call us with any questions; we appreciate the continued opportunity to serve you.

### **Business Expenses**

Business expenses are the costs of carrying on your trade or business, in this instance, the Dental Practice. These expenses are usually deductible as long as the business is operated to make a profit.

### **What Can You Deduct**

To be a deductible business expense, the expense must be both “ordinary” and “necessary.” Both of these terms, “ordinary” and “necessary,” have specific definitions. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable, however, to be considered necessary.

### **Ordinary Expense Further Defined**

Ordinary has the connotation of normal, usual, or customary. An expense may be ordinary even if it only happens once. The transaction, however, which gives rise to the expense, must be of common or frequent occurrence in the type of business involved (*e.g.*, the Dental Practice). Also, the fact that a particular expense would be an ordinary or common expense in the course of one’s business does not necessarily make it an ordinary or common business expense for another business.

### **Necessary Expense Further Defined**

As for the term necessary, the courts have suggested that the term necessary requires no more than the expense must be appropriate and helpful in developing the taxpayer’s business. This minimal requirement implies that the expenses need not be indispensable or unavoidable. Moreover, the courts have tended to accept the taxpayer’s judgment of the business value of expenditures. Courts recognize that you cannot authorize the government to assume the role of business efficiency experts in reviewing the commercial decisions of the taxpayer.

### **Personal versus Business Expenses**

One of the common difficulties that arise for our clients is the determination of whether an expense represents a business expense or a personal expense. The reason this determination is

important, among others, is that a personal expense is not deductible even though it may be necessary to the taxpayer's business or profession or may relate to a personal transaction with a business client. Expenses that are personal in nature do not become deductible merely because they increase the taxpayer's social contacts and have the potential of increasing business. A more direct business relationship is required. For example, meal and entertainment expenses are not deductible under the rationale that everyone encountered by a taxpayer is a potential patient. Rather, to be deductible, an expense must be incurred primarily to benefit the taxpayer's trade or business and there must be a proximate, rather than merely remote or incidental, relationship between the expense and the trade or business. Some examples of expenses that are not business expenses and therefore are not deductible include:

1. Credit card annual fees where the card is not used exclusively for business expenses.
2. Day care expenses for your children so that the dentist can work.
3. Automobile expenses of a dentist where the dentist does not use his or her personal vehicle to travel between offices, to see patients, or travel to the hospital. That is, where a dentist travels to the office, works all day, and then travels home, that dentist cannot deduct his or her automobile expenses. We see this as a commonly abused deduction on behalf of our dental clients.
4. As stated above, entertainment expenses, such as dining out, are not deductible business expenses merely because there is an incidental relationship, benefit, or contact with the Dental Practice. The expense incurred must be primarily for the benefit of the Dental Practice and not be primarily for your own personal benefit.
5. A Dental Practice generally cannot deduct dues paid to a club organized for business, pleasure, recreation, or other social purposes. This disallowance rule includes country clubs, golf clubs, business luncheon clubs, athletic clubs, and even airline and hotel clubs. You can, however, deduct 50% of the cost of otherwise allowable business entertainment at a club, even if the dues you pay to the club are nondeductible.
6. The costs of educating a child.
7. Legal expenses for personal matters. As an example, a dentist that has his or her estate plan completed by the Dental Practice's attorney cannot pay the legal fees with the Dental Practice funds and cannot deduct such expenses as a business expense for the Dental Practice.
8. Premiums paid by the insured for insurance on a dentist's life where the beneficiary is the dentist's spouse.

Now that we have provided you with some examples of expenses that are not deductible, consider some common expenses that are deductible business expenses:

1. Employees' pay is generally deductible for the services they perform for the Dental Practice. This would not include, however, a spouse or child if that spouse or child is not performing any services.
2. If a dentist actually uses his or her automobile to travel between offices, to see patients, or travel to the hospital, the dentist can deduct the automobile expenses. Importantly, if you use your car for both business and personal purposes, you must generally divide your expenses based upon actual mileage. Depending upon the extent of the taxpayer's mixed business and personal use of their vehicle; this can be a complex calculation. Please contact us to discuss the documentation required for legitimate business use of your vehicle.
3. Retirement plan expenses for the Dental Practice.
4. Rent for property that the dentist uses in the dentists' trade or business. For example, the rent for the building/office where the Dental Practice is located.
5. Business interest expenses. For example, amounts charged for borrowing money used for operating your Dental Practice.
6. Entertainment expenses, subject to the limitations discussed above.
7. Federal, state, and local taxes directly attributable to your Dental Practice.
8. Ordinary and necessary costs of insurance for your trade, business, or profession.

### **Substantiation Requirement of Expenses**

To deduct business expenses, the Dentist must meet the stiff substantiation requirements of the Internal Revenue Code and the Treasury Regulations promulgated thereunder (the "Code"). The Code provides that generally, no deduction shall be allowed for a taxpayer based upon an approximation or unsupported testimony of the taxpayer. Rather, for most expenses, the taxpayer is required to substantiate its expenses by maintaining adequate records or sufficient evidence that corroborates the taxpayer's own statements regarding the following: (i) its amount; (ii) the time and place of the travel, entertainment, or use of the facility or the date and description of the gift; (iii) the business purpose of the item; and (iv) the business relationship between the taxpayer and the persons entertained, using the facility, or receiving the gift. For automobiles, other vehicles, computers and peripherals, and cellular telephones, the substantiation must show: (i) the amount of each expenditure with respect to the property, including the purchase price, lease payments, and maintenance expenses; (ii) the amount of the business or other profit-oriented use of the property for the taxable year and the amount of total use for the same period (for automobiles, measured in miles traveled); (iii) the date of each expenditure and use; and (iv) the business purpose of each expenditure or use.

So, what documentation do you need to meet the Code requirements for adequate records or sufficient evidence? Well, in most instances, you will need the actual receipts from those expenditures. Each and every expense does not necessarily need to be reviewed, but you must maintain such receipts and be in a position to confirm that you have such receipts. A common misunderstanding, for example, is that a credit card statement for the Dental Practice is sufficient to support the expense deduction. That is incorrect.

**CREDIT CARDS STATEMENTS ARE NOT SUFFICIENT DOCUMENTATION. YOU MUST HAVE THE RECEIPT OR OTHER DOCUMENTATION OF THE ACTUAL EXPENSE**

The credit card statement certainly helps, but it is not sufficient. Each Dental Practice must have the actual receipt to back up the credit card statement. A return cannot be prepared based solely upon a credit card statement. To include the expense on the Dental Practice return, you must maintain the actual expense receipt and orally communicate to your tax return preparer that you have maintained such receipts. In some instances, you may be required to produce back-up receipts for review. Other expense documentation that you may need, depending upon the expense, includes purchase documents, account statements, petty-cash slips, sales slips, payroll records, invoices, deposit slips, and canceled checks; all of which must be maintained and available for your tax return preparer's review, or more importantly, the review of the Internal Revenue Service.

As to storing these expense documents, we strongly suggest that you hire a bookkeeper to maintain your expense records electronically. That is, each month the bookkeeper should be categorizing and saving the documents electronically so that you can permanently maintain the records for future use. With the technology that we have at our disposal today, there is simply no good excuse for not maintaining the necessary documentation. The reason we suggest using a bookkeeper is that when we typically encounter professionals who try to do this themselves, we find that the quality of the recordkeeping is poor, or sometimes even nonexistent. You may have great intentions, but you are simply too busy, and should be focused on more important things, such as: (i) taking care of your family; (ii) servicing your patients; and (iii) marketing and operating your Dental Practice. We have heard from some clients that they cannot afford to hire someone to do this for them, and thus they do it themselves. My response is simply: "you cannot afford not to hire them."

We hope this helps you understand what type of expenses are deductible and what documentation you will need to obtain and maintain in order to have a complete and accurate return prepared. And as always, call us with any questions.

Sincerely,

Vincent J. Nardone of  
Nardone Law Group, LLC  
Your Legal and Tax Advisors