



SCHEDULE C

Training Manual

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1040 Schedule C

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Introduction

Schedule C is applicable to many different types of businesses. Clients vary in the range of income and types of deductions; however, the basic concepts are the same. All income must be reported on the tax return, and all expenses need to be ordinary and necessary in order to claim a deduction. These are basic rules. This course is focused on Schedule C, including a business between a husband and wife (qualified joint venture) and a single-member limited liability company (SMLLC).

In this course, we will discuss:

- ✓ requirements to start a business
- ✓ husband and wife business ventures
- ✓ recordkeeping for income and expenses
- ✓ required input for questions on Schedule C
- ✓ gross income
- ✓ business expenses
- ✓ home office deduction
- ✓ self-employment tax
- ✓ hobby losses

After successfully completing this course, you will be able to:

- ✓ recognize the requirements and recommendations for the keeping of different types of business records
- ✓ identify payments made by a Schedule C business that should be reported on Form 1099-MISC
- ✓ identify the types of items that are reported as gross receipts or sales, and the locations for reporting returns and cost of goods sold
- ✓ identify expenses incurred by a business that can be categorized as start-up costs, and the two methods that may be used to deduct those costs
- ✓ identify business expenses that can be deducted under categories including legal and professional fees, meals and entertainment, repairs and maintenance, taxes and licenses, utilities, wages and costs of goods sold
- ✓ identify the two methods available for calculating the home office deduction and determine which method is more advantageous to individual clients in given cases

Chapter 1

Sole Proprietor Businesses

Although Schedule C is used by sole proprietors to report their business activities to the Internal Revenue Service, the structure and nature of a sole proprietorship can take many different forms. In this chapter we will discuss the different types of businesses that use Schedule C, both pointing out the differences between them and discussing the key areas that all Schedule C businesses have in common.

Chapter Objectives

After successfully completing this chapter you will be able to:

- ✓ identify the conditions that must be met for a business to be eligible to file Schedule C-EZ
- ✓ identify the conditions that must be met for a business to be classified as a Qualified Joint Venture
- ✓ recognize the requirements and recommendations for the keeping of different types of business records
- ✓ identify payments made by a Schedule C business that should be reported on Form 1099-MISC

Schedule C-EZ

Although the focus of this course is on Schedule C, you may use the simplified version of Schedule C called Schedule C-EZ. Use Schedule C-EZ if your client has a profit from the business and **all** of the following conditions are met:

- ✓ The expenses are not greater than \$5,000.
- ✓ The client has no employees.
- ✓ The client uses the cash method of accounting.
- ✓ The client has no net loss from the business.
- ✓ The client has no inventory.
- ✓ The client is not depreciating or deducting the cost of his or her home.

Example: Janet is a self-employed artist. She made \$8,500 in income for the year and has business expenses of \$700, which consist only of art supplies. She has no employees and no inventory. Janet would be able to use Schedule C-EZ (Figure 1, below).

Figure 1: Schedule C-EZ

SCHEDULE C-EZ (Form 1040) Department of the Treasury Internal Revenue Service (IRS)	Net Profit From Business (Sole Proprietorship) ▶ Partnerships, joint ventures, etc., generally must file Form 1065. ▶ Attach to Form 1040, 1040NR, or 1041. ▶ See instructions on page 2.	OMB No. 1545-0074 2018 Attachment Sequence No. 09A
Name of proprietor _____		Social security number (SSN) _____
Part I General Information		
You may use Schedule C-EZ instead of Schedule C only if you: - Had business expenses of \$5,000 or less, - Use the cash method of accounting, - Did not have an inventory at any time during the year, - Did not have a net loss from your business, - Had only one business as either a sole proprietor, qualified joint venture, or statutory employee. And you: - Had no employees during the year, - Do not deduct expenses for business use of your home, - Do not have prior year unallowed passive activity losses from this business, and - Are not required to file Form 4562, Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, to find out if you must file.		
A Principal business or profession, including product or service _____		B Enter business code (see page 2)
C Business name. If no separate business name, leave blank. _____		D Enter your EIN (see page 2)
E Business address (including suite or room no.). Address not required if same as on page 1 of your tax return. _____ City, town or post office, state, and ZIP code _____		
F Did you make any payments in 2018 that would require you to file Form(s) 1099? (see the instructions for Schedule C) ☐ Yes ☐ No		
G If "Yes," did you or will you file required Forms 1099? ☐ Yes ☐ No		
Part II Figure Your Net Profit		
1 Gross receipts. Caution: If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see Statutory employees in the instructions for Schedule C, line 1, and check here ☐	1	
2 Total expenses (see page 2). If more than \$5,000, you must use Schedule C	2	
3 Net profit. Subtract line 2 from line 1. If less than zero, you must use Schedule C. Enter on both Schedule 1 (Form 1040), line 12, and Schedule SE, line 2, or on Form 1040NR, line 13, and Schedule SE, line 2 (see page 2). (Statutory employees do not report this amount on Schedule SE, line 2.) Estates and trusts, enter on Form 1041, line 3.	3	
Part III Information on Your Vehicle. Complete this part only if you are claiming car or truck expenses on line 2.		
4 When did you place your vehicle in service for business purposes? (month, day, year) ▶ _____		
5 Of the total number of miles you drove your vehicle during 2018, enter the number of miles you used your vehicle for: a Business _____ b Commuting (see page 2) _____ c Other _____		
6 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No		
7 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No		
8a Do you have evidence to support your deduction? ☐ Yes ☐ No		
b If "Yes," is the evidence written? ☐ Yes ☐ No		
For Paperwork Reduction Act Notice, see the separate instructions for Schedule C (Form 1040). Cat. No. 14374D Schedule C-EZ (Form 1040) 2018		

Requirements to Start a Business

In these economic times, we see more people who have lost their jobs. Without any job offers, they choose to start businesses. Some clients have business plans and are organized, while others are just flying by the seat of their pants. You should give clients information upfront about the requirements for filing and record keeping so they have every chance to be successful. This course outlines the requirements.

Husband and Wife Business Ventures

Many married couples not only live together but also choose to work together. When you have two people who join together to work in a business, the business is generally considered a partnership, and they would be required to file a Form 1065 Partnership return. However, there is an exception to this rule. If the husband and wife alone own and operate the business, they can elect to be a qualified joint venture.

On May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 was signed into law, changing the treatment of qualified joint ventures of married couples not treated as partnerships. The provision is effective for taxable years beginning after December 31, 2006.

The provision states that a qualified joint venture conducted by a husband and wife who file a joint return will not be treated as a partnership and therefore will not be required to file a partnership return (Form 1065). That is great news for a married couple, since the cost and complexities of filing a partnership can be daunting for a new business. A qualified joint venture (QJV) is a joint venture involving the conduct of a trade or business in which:

- ✓ The only members of the joint venture are a husband and wife.
- ✓ Both spouses materially participate in the trade or business.
- ✓ Both spouses elect to have the provision apply. To make this election, each spouse must file a separate Schedule C and report all income and expenses attributable to his or her interest in the venture (IRS Pub. 541).

Since each spouse will report a separate Schedule C, each will also report a separate Schedule SE (self-employment tax form). Separating the two Schedule C forms will normally not change the total tax that the couple owes on their tax return unless either spouse exceeds the social security limitation, which is \$128,400 for 2018.

Example: Joan and Harry Smith are married and both artists. They decide to rent a space that will serve as an art studio, a gallery for selling their paintings, and a classroom for giving art lessons. Together, they gross \$130,000 for the year, with expenses totaling \$44,840 (broken down as follows):

- ✓ Joan's income: \$100,000
- ✓ Joan's expenses: \$31,840
- ✓ Harry's income: \$30,000
- ✓ Harry's expenses: \$13,000

By breaking down income and expenses, Joan and Harry can report their self-employment taxes separately (See Figures 2, 3, 4, and 5 below).

Figure 2: Joan's Schedule C

SCHEDULE C (Form 1040)		Profit or Loss From Business (Sole Proprietorship)		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (IRS)		Go to www.irs.gov/ScheduleC for instructions and the latest information.		2018 Attachment Sequence No. 09	
Name of proprietor JOAN SMITH		Social security number (SSN) 123-45-6789			
A Principal business or profession, including product or service (see instructions) ARTIST		B Enter code from instructions 211510			
C Business name. If no separate business name, leave blank. JOAN'S PAINTINGS		D Employer ID number (EIN) (see instr.)			
E Business address (including suite or room no.) 100 WALL STREET City, town or post office, state, and ZIP code ARLINGTON VT 12345					
F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) _____					
G Did you "materially participate" in the operation of this business during 2018? If "No," see instructions for limit on losses				☒ Yes ☐ No	
H If you started or acquired this business during 2018, check here				☐ Yes ☒ No	
I Did you make any payments in 2018 that would require you to file Form(s) 1099? (see instructions)				☐ Yes ☒ No	
J If "Yes," did you or will you file required Form(s) 1099?				☐ Yes ☒ No	
Part I Income					
1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked	1	100000		
2	Returns and allowances	2			
3	Subtract line 2 from line 1	3	100000		
4	Cost of goods sold (from line 42)	4			
5	Gross profit. Subtract line 4 from line 3	5	100000		
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6			
7	Gross income. Add lines 5 and 6	7	100000		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8	Advertising	8	2000	18	Office expense (see instructions)
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans
10	Commissions and fees	10		20	Rent or lease (see instructions):
11	Contract labor (see instructions)	11		20a	Vehicles, machinery, and equipment
12	Depreciation	12		20b	Other business property
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)
15	Insurance (other than health)	15	500	23	Taxes and licenses
16	Interest (see instructions):			24	Travel and meals:
a	Mortgage (paid to banks, etc.)	16a		24a	Travel
b	Other	16b		24b	Deductible meals (see instructions)
17	Legal and professional services	17	250	25	Utilities
18	Total expenses before expenses for business use of home. Add lines 8 through 27a	18	1000	26	Wages (less employment credits)
19	Pension and profit-sharing plans	19		27a	Other expenses (from line 48)
20	Rent or lease (see instructions):	20		27b	Reserved for future use
20a	Vehicles, machinery, and equipment	20a		28	31840
20b	Other business property	20b		29	68160
21	Repairs and maintenance	21		30	
22	Supplies (not included in Part III)	22	24730	31	68160
23	Taxes and licenses	23			
24	Travel and meals:	24			
24a	Travel	24a	2200		
24b	Deductible meals (see instructions)	24b	160		
25	Utilities	25			
26	Wages (less employment credits)	26			
27a	Other expenses (from line 48)	27a			
27b	Reserved for future use	27b			
28	Total expenses before expenses for business use of home. Add lines 8 through 27a	28	31840		
29	Tentative profit or (loss). Subtract line 28 from line 7	29	68160		
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30	30			
31	Net profit or (loss). Subtract line 30 from line 29. • If a profit, enter on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32.	31	68160		
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198. Your loss may be limited.	32		32a	☐ All investment is at risk.
				32b	☐ Some investment is not at risk.

Figure 3: Harry's Schedule C

SCHEDULE C (Form 1040) Department of the Treasury Internal Revenue Service (IRS)		Profit or Loss From Business (Sole Proprietorship) Go to www.irs.gov/ScheduleC for instructions and the latest information. Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.		OMB No. 1545-0074 2018 Attachment Sequence No. 09	
Name of proprietor HARRY SMITH			Social security number (SSN) 987-65-4321		
A Principal business or profession, including product or service (see instructions) ARTIST			B Enter code from instructions 211110		
C Business name. If no separate business name, leave blank. JOAN'S PAINTINGS			D Employer ID number (EIN) (see instructions)		
E Business address (including suite or room no.) 100 WALL STREET City, town or post office, state, and ZIP code ARLINGTON VT 12345					
F Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify)					
G Did you "materially participate" in the operation of this business during 2018? If "No," see instructions for limit on losses. ☐ Yes ☒ No					
H If you started or acquired this business during 2018, check here ☐					
I Did you make any payments in 2018 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No					
J If "Yes," did you or will you file required Form(s) 1099? ☐ Yes ☒ No					
Part I Income					
1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ☐			1 30000		
2 Returns and allowances			2		
3 Subtract line 2 from line 1			3 30000		
4 Cost of goods sold (from line 42)			4		
5 Gross profit. Subtract line 4 from line 3			5 30000		
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)			6		
7 Gross income. Add lines 5 and 6			7 30000		
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising			8 2000		
9 Car and truck expenses (see instructions)			9		
10 Commissions and fees			10		
11 Contract labor (see instructions)			11		
12 Depreciation			12		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)			13		
14 Employee benefit programs (other than on line 19)			14		
15 Insurance (other than health)			15 500		
16 Interest (see instructions):			16		
a Mortgage (paid to banks, etc.)			16a		
b Other			16b		
17 Legal and professional services			17 250		
18 Office expense (see instructions)			18 1000		
19 Pension and profit-sharing plans			19		
20 Rent or lease (see instructions):			20		
a Vehicles, machinery, and equipment			20a		
b Other business property			20b		
21 Repairs and maintenance			21		
22 Supplies (not included in Part III)			22 8250		
23 Taxes and licenses			23		
24 Travel and meals:			24		
a Travel			24a		
b Deductible meals (see instructions)			24b		
25 Utilities			25 1000		
26 Wages (less employment credits)			26		
27a Other expenses (from line 48)			27a		
b Reserved for future use			27b		
28 Total expenses before expenses for business use of home. Add lines 8 through 27a			28 13000		
29 Tentative profit or (loss). Subtract line 28 from line 7			29 17000		
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30.					
31 Net profit or (loss). Subtract line 30 from line 29.			31 17000		
32 If you have a loss, check the box that describes your investment in this activity (see instructions). • If a profit, enter on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3 . • If a loss, you must go to line 32. • If you checked 32a, enter the loss on both Schedule 1 (Form 1040), line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2 . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on Form 1041, line 3 . • If you checked 32b, you must attach Form 6198 . Your loss may be limited.					
32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.					

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2018

Figure 4: Joan's Schedule SE

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service (99)	Self-Employment Tax ▶ Go to www.irs.gov/ScheduleSE for instructions and the latest information. ▶ Attach to Form 1040 or Form 1040NR.	OMB No. 1545-0074 2017 Attachment Sequence No. 17
Name of person with self-employment income (as shown on Form 1040 or Form 1040NR) JOAN SMITH		Social security number of person with self-employment income ▶ 123-45-6789

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.

Did you receive wages or tips in 2017?

No

Are you a minister, member of a religious order, or Christian Science practitioner who received IRS approval **not** to be taxed on earnings from these sources, **but** you owe self-employment tax on other earnings?

Yes → **You must use Long Schedule SE on page 2**

No

Are you using one of the optional methods to figure your net earnings (see instructions)?

Yes → **You must use Long Schedule SE on page 2**

No

Did you receive church employee income (see instructions) reported on Form W-2 of \$108.28 or more?

Yes → **You must use Long Schedule SE on page 2**

No → **You may use Short Schedule SE below**

Yes

Was the total of your wages and tips subject to social security or railroad retirement (Tier 1) tax **plus** your net earnings from self-employment more than \$127,200?

Yes → **You must use Long Schedule SE on page 2**

No

Did you receive tips subject to social security or Medicare tax that you **didn't** report to your employer?

Yes → **You must use Long Schedule SE on page 2**

No

Did you report any wages on Form 9919, Uncollected Social Security and Medicare Tax on Wages?

Yes → **You must use Long Schedule SE on page 2**

No → **You may use Short Schedule SE below**

Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code Z	1b	()
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	68160
3 Combine lines 1a, 1b, and 2	3	68160
4 Multiply line 3 by 92.35% (0.9235). If less than \$400, you don't owe self-employment tax; don't file this schedule unless you have an amount on line 1b. ▶	4	62946
Note: If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.		
5 Self-employment tax. If the amount on line 4 is: • \$127,200 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Form 1040, line 57, or Form 1040NR, line 55 • More than \$127,200, multiply line 4 by 2.9% (0.029). Then, add \$15,772.80 to the result. Enter the total here and on Form 1040, line 57, or Form 1040NR, line 55		
5		9631
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (0.50). Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27		
6		4816

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SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service (99)	Self-Employment Tax ▶ Go to www.irs.gov/ScheduleSE for instructions and the latest information. ▶ Attach to Form 1040 or Form 1040NR.	OMB No. 1545-0074 2018 Attachment Sequence No. 17
Name of person with self-employment income (as shown on Form 1040 or Form 1040NR) HARRY SMITH		Social security number of person with self-employment income ▶ 123-45-6789

Before you begin: To determine if you must file Schedule SE, see the instructions.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note: Use this flowchart **only** if you must file Schedule SE. If unsure, see *Who Must File Schedule SE* in the instructions.

Did you receive wages or tips in 2018?

No

Are you a minister, member of a religious order, or Christian Science practitioner who received IRS approval **not** to be taxed on earnings from these sources, **but** you owe self-employment tax on other earnings?

No

Are you using one of the optional methods to figure your net earnings (see instructions)?

No

Did you receive church employee income (see instructions) reported on Form W-2 of \$108.28 or more?

No

You may use Short Schedule SE below

Yes

Was the total of your wages and tips subject to social security (or railroad retirement (tier 1) tax **plus** your net earnings from self-employment more than \$128,400?

No

Did you receive tips subject to social security or Medicare tax that you **didn't** report to your employer?

No

Did you report any wages on Form 8919, Uncollected Social Security and Medicare Tax on Wages?

No

You must use Long Schedule SE on page 2

Section A—Short Schedule SE. Caution: Read above to see if you can use Short Schedule SE.

1a Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report	2	17000
3 Combine lines 1a, 1b, and 2	3	17000
4 Multiply line 3 by 92.35% (0.9235). If less than \$400, you don't owe self-employment tax; don't file this schedule unless you have an amount on line 1b. ▶ Note: If line 4 is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.	4	15700
5 Self-employment tax. If the amount on line 4 is: • \$128,400 or less, multiply line 4 by 15.3% (0.153). Enter the result here and on Schedule 4 (Form 1040), line 57, or Form 1040NR, line 55 • More than \$128,400, multiply line 4 by 2.9% (0.029). Then, add \$15,921.60 to the result. Enter the total here and on Schedule 4 (Form 1040), line 57, or Form 1040NR, line 55 . . .	5	2402
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (0.50). Enter the result here and on Schedule 1 (Form 1040), line 27, or Form 1040NR, line 27 . . .	6	

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2018

In general, spouses do not need an employer identification number (EIN) for the qualified joint venture. They follow the same rules as a sole proprietor; an EIN is necessary only if the business is required to file excise, employment, alcohol, tobacco, firearms, or certain retirement plan returns.

Tax Preparer Tip

We recommend that every business file for an EIN even if it is not required to do so. Filing for an EIN can prevent your clients from giving out their social security numbers to vendors or putting their social security numbers on any 1099s they need to issue. To obtain an EIN, the filing spouse should complete a Form SS-4 and request an EIN as a sole proprietor.

Single-Member Limited Liability Company (SMLLC)

Today, more sole proprietors are choosing to file as a single-member limited liability company (SMLLC). As a result, many clients are confused about how to report and pay the taxes. An LLC is an entity that is created at the state level. A SMLLC that does not elect to be taxed as a corporation will be classified by the existing federal guidance as a “disregarded entity,” which means the taxpayer is taxed as a sole proprietor. Simply put, an SMLLC will file a Schedule C.

Recordkeeping for Income and Expenses

Good recordkeeping is an extremely important part of running a business. Good recordkeeping helps business owners track how they are doing and improves their chances for success.

With good recordkeeping, your client should be able to see how well items are selling, which products produce the most income, which categories of income and expenses are doing well, and which services or items need a closer look.

The IRS recommends that the taxpayer keep all records that support an item of income or expense on a tax return until the statute of limitations for that return runs out. Generally, that time frame is the later of three years from the date the tax return is due or filed or as you can see from the chart below, permanent or 7 years

The IRS recommends that small business owners keep payroll and employment tax records for at least four years after the tax becomes due or is paid, whichever is later.

Use the following chart to help your business owners determine how many years their records should be kept:

Schedule C Business Records	Retention Period
Accounts payable	7 years
Accounts receivable	7 years
Audit reports	Permanent
Chart of accounts	Permanent
Depreciation schedules	Permanent
Expense records	7 years
Financial statements (annual)	Permanent
Fixed assets purchases	Permanent
General ledger	Permanent
Inventory records	7 years

Schedule C Business Records	Retention Period
Loan payment schedules	7 years
Purchase orders and sales records	7 years
Canceled checks	7 years
Tax returns	Permanent
Bank statements and bank reconciliations	7 years

Tax Preparer Tip

Your clients must keep records that relate to depreciation, amortization, or depletion deduction for at least three years after they sell or otherwise dispose of the property.

Financial statements, including the income statement (also referred to as a profit and loss statement) and the balance sheet, help clients not only in managing their daily business activities but also in dealing with banks and creditors. An income statement shows the income and expenses of the business for a given period of time, while a balance sheet shows the assets, liabilities, and equity (i.e., net worth) in the business on a given date.

A client who has decided on a business and has a business plan next needs to open a separate checking account for that business. A sole proprietor can use his or her social security number to open the account. However, we recommend that clients apply for an Employer Identification number (EIN) online, which is a free service offered by the IRS. The EIN is used instead of the social security number to identify a business entity.

So that your clients can easily monitor both their business and personal accounts, we strongly suggest that you advise clients to keep the accounts separate. If your clients do co-mingle their personal and business income, any deposits that are unaccounted for may be considered self-employment income if they are selected for an IRS or state audit.

Tax Preparer Tip

Clients who have self-employment income and receive monies from outside sources that are not related to the business should document the deposits in case of an audit. Making a note directly on the deposit slip is one way to track the deposits that may be unrelated to the business. Clients who deposit or transfer money from their personal savings accounts or from loans need to document these transactions. No one wants to be taxed on money twice.

Example: Judy is a sole proprietor and at times receives gifts of money from her parents. Sometimes she deposits the money into her business account. If Judy does not keep good records of the gifts, she could be taxed on that money in an audit. Judy makes a copy of each check and makes a separate deposit of the money. On the deposit slip, she makes a note of where the money came from; she also has her parents write a letter stating the amount was a gift. In case of an audit, Judy can prove she should not be taxed on these gifts.

Business expenses are generally tax deductible. Section 162(a) of the Internal Revenue Code defines business expenses as the ordinary and necessary expenses in carrying on a trade or business. However, the IRS does not expand on that definition, leaving it to the taxpayer to define what “ordinary and necessary” means for their respective businesses. Supporting documents should show the amount paid and that the amount was a business expense.

In case of an audit, a canceled check is not enough proof to substantiate a business expense. Although the law does not require any specific kind of records, supporting documents are needed to support the entries in the books and on the tax return. Your clients can actually choose any record-keeping system suited to the business as long as it clearly shows income and expenses.

Example: Suzanne is a new client, and her business is maintaining window boxes and planters for about 40 customers in the area. She purchases all the plants herself and any other decorative items that her customers may request. Suzanne tells you that she charges everything on one charge card and mainly shops at Wal-Mart, Lowes, and Home Depot. She does not save her receipts since she feels the credit card statement is sufficient documentation. A credit card statement is similar to a canceled check; it is not enough documentation. She should save each receipt, writing on it the name of the customer for whom she purchases the items. A receipt is necessary since it shows what she purchased and proves the purchase was truly a business expense.

Documents for expenses include the following:

- ✓ canceled checks
- ✓ cash register tapes
- ✓ account statements
- ✓ credit card sales slips
- ✓ invoices
- ✓ petty cash slips for small cash payments

Tax Preparer Tip

QuickBooks or another type of software program is highly recommended. Be aware that the IRS can now request electronic QuickBooks records.

Required Input for Questions on Schedule C

You should keep in mind several items that appear on the top portion of Schedule C (see Figure 6, below):

- ✓ business code (this question also appears on Schedule C-EZ)
- ✓ two questions about sending out 1099s (this question also appears on Schedule C-EZ)
- ✓ accounting method

Figure 6: Top Portion of Schedule C

A	Principal business or profession, including product or service (see instructions) Engineering Services	B Enter code from instructions 5 4 1 3 3 0
C	Business name. If no separate business name, leave blank.	D Employer ID number (EIN), (see instr.)
E	Business address (including suite or room no.) 1 Main Street City, town or post office, state, and ZIP code Albany, NY 12205	
F	Accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶	
G	Did you "materially participate" in the operation of this business during 2014? If "No," see instructions for limit on losses	☒ Yes ☐ No
H	If you started or acquired this business during 2014, check here	☐
I	Did you make any payments in 2014 that would require you to file Form(s) 1099? (see instructions)	☐ Yes ☒ No
J	If "Yes," did you or will you file required Forms 1099?	☐ Yes ☐ No

Business Code

You must classify each client's business or profession with a code that relates to the activity. These six-digit codes are based on the North American Industry Classification System (NAICS). Select the category that best describes a client's business. Business codes are used for statistical purposes and will not affect the outcome of the tax return, so if you really can't figure out a code for your client, use the code 999999.

Questions on Sending Out 1099s

Two questions appear on Schedule C:

1. Did you make any payments that would require you to file Form(s) 1099?
2. If "yes," did you or will you file all required Forms 1099?

Your client is required to file a Form 1099-Misc and Form 1096 if the amount paid to a service provider was \$600 or more. The forms need to be filed with the IRS by February 28th (March 31st if filing electronically) of the following year. The client needs to distribute the 1099-Misc forms to the workers by January 31st. Below are the types of business payments that need to be reported:

- ✓ payments made to a physician, physicians' corporation, or other supplier of health and medical services, issued mainly by companies providing medical assistance programs or health and accident insurance plans
- ✓ payments for services performed for a trade or business by people not treated as its employee (e.g., fees to subcontractors or directors, golden parachute payments)
- ✓ fish purchases paid in cash for resale
- ✓ crop insurance proceeds
- ✓ gross amounts paid to attorneys (due to the IRS by February 15th)

Tax Preparer Tip

We recommend that you send out a letter to all new clients before the season begins, informing them of these two questions on the tax return and the requirements to answer these questions. Include a copy of the Form W-9 that their contractors need to fill out.

Example: Allan Rogers is an electrician. He hires Kevin LaPenny to patch and paint walls where he has installed new outlets. As soon as Allan hires Kevin, Allan sends him a W-9 in order to get his social security number or federal ID number. Allan wisely does not wait until January to send out the W-9. He knows that he may not be able to find Kevin and may not be able to obtain his social security number (Figure 7, below).

Figure 7: Request for Taxpayer Identification Number

Form W-9 (Rev. October 2018) Department of the Treasury Internal Revenue Service	Request for Taxpayer Identification Number and Certification ▶ Go to www.irs.gov/FormW9 for instructions and the latest information.	Give Form to the requester. Do not send to the IRS.
1 Name (as shown on your income tax return). Name is required on this line; do not leave this line blank. Kevin LaPenny		
2 Business name/disregarded entity name, if different from above		
Print or type. See Specific Instructions on page 3.	3 Check appropriate box for federal tax classification of the person whose name is entered on line 1. Check only one of the following seven boxes.	
	☒ Individual/sole proprietor or single-member LLC ☐ C Corporation ☐ S Corporation ☐ Partnership ☐ Trust/estate	
	☐ Limited liability company. Enter the tax classification (C=C corporation, S=S corporation, P=Partnership) ▶ _____ Note: Check the appropriate box in the line above for the tax classification of the single-member owner. Do not check LLC if the LLC is classified as a single-member LLC that is disregarded from the owner unless the owner of the LLC is another LLC that is not disregarded from the owner for U.S. federal tax purposes. Otherwise, a single-member LLC that is disregarded from the owner should check the appropriate box for the tax classification of its owner.	
	☐ Other (see instructions) ▶ _____	
4 Exemptions (codes apply only to certain entities, not individuals; see instructions on page 3): Exempt payee code (if any) _____ Exemption from FATCA reporting code (if any) _____ (Applies to accounts maintained outside the U.S.)		
5 Address (number, street, and apt. or suite no.) See instructions. 78 Alfred Drive		Requestor's name and address (optional)
6 City, state, and ZIP code Sacramento, CA 95660		
7 List account number(s) here (optional)		
Part I Taxpayer Identification Number (TIN) Enter your TIN in the appropriate box. The TIN provided must match the name given on line 1 to avoid backup withholding. For individuals, this is generally your social security number (SSN). However, for a resident alien, sole proprietor, or disregarded entity, see the instructions for Part I, later. For other entities, it is your employer identification number (EIN). If you do not have a number, see <i>How to get a TIN</i> , later. Note: If the account is in more than one name, see the instructions for line 1. Also see <i>What Name and Number To Give the Requester</i> for guidelines on whose number to enter.		
		Social security number 0 2 5 - 4 4 - 8 9 7 0 or Employer identification number -
Part II Certification Under penalties of perjury, I certify that: 1. The number shown on this form is my correct taxpayer identification number (or I am waiting for a number to be issued to me); and 2. I am not subject to backup withholding because: (a) I am exempt from backup withholding, or (b) I have not been notified by the Internal Revenue Service (IRS) that I am subject to backup withholding as a result of a failure to report all interest or dividends, or (c) the IRS has notified me that I am no longer subject to backup withholding; and 3. I am a U.S. citizen or other U.S. person (defined below); and 4. The FATCA code(s) entered on this form (if any) indicating that I am exempt from FATCA reporting is correct. Certification instructions. You must cross out item 2 above if you have been notified by the IRS that you are currently subject to backup withholding because you have failed to report all interest and dividends on your tax return. For real estate transactions, item 2 does not apply. For mortgage interest paid, acquisition or abandonment of secured property, cancellation of debt, contributions to an individual retirement arrangement (IRA), and generally, payments other than interest and dividends, you are not required to sign the certification, but you must provide your correct TIN. See the instructions for Part II, later.		
Sign Here	Signature of U.S. person ▶ _____	Date ▶ _____

Tax Preparer Tip

If your client is required to issue a 1099-MISC to a writer for royalties, the filing requirement is \$10, not \$600. Royalties paid to a writer generally are included in Schedule C subject to self-employment tax.

Whereas Form W-9 is for contractors to fill out, Form I-9 is for new employees. Your clients should always ask a new employee to fill out Form I-9.

Form I-9 is used for verifying the identity and employment authorization of individuals your clients hire as employees in the United States. All U.S. employers must ensure proper completion of Form I-9 for each individual they hire as an employee in the United States, including both citizens and noncitizens. Both employees and employers (or authorized representatives of the employer) must complete the form. On the form, an employee must attest to his or her ability to work legally in the U.S. The employee must also present the employer with acceptable documents confirming this ability, as well as his or her identity. After confirming that the document(s) are genuine, the employer records the document information on Form I-9. The last page of Form I-9 lists acceptable documents. Employers are responsible for retaining completed forms (Figure 8, below).



Figure 8: Acceptable Documents for Establishing Identity and Employment Authorization

LISTS OF ACCEPTABLE DOCUMENTS		
All documents must be unexpired		
LIST A Documents that Establish Both Identity and Employment Authorization	LIST B Documents that Establish Identity	LIST C Documents that Establish Employment Authorization
OR		AND
1. U.S. Passport or U.S. Passport Card	1. Driver's license or ID card issued by a State or outlying possession of the United States provided it contains a photograph or information such as name, date of birth, gender, height, eye color, and address	1. Social Security Account Number card other than one that specifies on the face that the issuance of the card does not authorize employment in the United States
2. Permanent Resident Card or Alien Registration Receipt Card (Form I-551)		2. Certification of Birth Abroad issued by the Department of State (Form FS-545)
3. Foreign passport that contains a temporary I-551 stamp or temporary I-551 printed notation on a machine-readable immigrant visa	2. ID card issued by federal, state or local government agencies or entities, provided it contains a photograph or information such as name, date of birth, gender, height, eye color, and address	
4. Employment Authorization Document that contains a photograph (Form I-766)	3. School ID card with a photograph	3. Certification of Report of Birth issued by the Department of State (Form DS-1350)
5. In the case of a nonimmigrant alien authorized to work for a specific employer incident to status, a foreign passport with Form I-94 or Form I-94A bearing the same name as the passport and containing an endorsement of the alien's nonimmigrant status, as long as the period of endorsement has not yet expired and the proposed employment is not in conflict with any restrictions or limitations identified on the form	4. Voter's registration card	
	5. U.S. Military card or draft record	4. Original or certified copy of birth certificate issued by a State, county, municipal authority, or territory of the United States bearing an official seal
	6. Military dependent's ID card	
	7. U.S. Coast Guard Merchant Mariner Card	5. Native American tribal document
	8. Native American tribal document	6. U.S. Citizen ID Card (Form I-197)
	9. Driver's license issued by a Canadian government authority	
6. Passport from the Federated States of Micronesia (FSM) or the Republic of the Marshall Islands (RMI) with Form I-94 or Form I-94A indicating nonimmigrant admission under the Compact of Free Association Between the United States and the FSM or RMI	For persons under age 18 who are unable to present a document listed above:	7. Identification Card for Use of Resident Citizen in the United States (Form I-179)
	10. School record or report card	8. Employment authorization document issued by the Department of Homeland Security
	11. Clinic, doctor, or hospital record	
	12. Day-care or nursery school record	

Accounting Method

You must check off which accounting method the client is using (cash or accrual) and answer all of the questions asked. The accounting method is a set of rules for determining when to report income and expenses. Your client needs to choose the accounting method when she or he files the first tax return for the business.

Cash Method

Under the Cash Method, taxpayers generally report income in the tax year received and deduct expenses in the tax year paid. This method is the most commonly used. Taxpayers who receive property and services must also include the fair market value (FMV) of the property or services in their income.

Constructive receipt is a tax term that the IRS uses when discussing the cash basis method of accounting. It mandates that a taxpayer is liable for income that has not been physically received but has been credited to the taxpayer's account. Constructive receipt of income prevents taxpayers from deferring income into another tax year and thus deferring the tax. Constructive receipt does not require physical possession of the item of income in question.

Example: Joe sends Eric a check for services rendered on December 29, 2018. The check arrives in Eric's post office box on December 31, 2018. Eric does not deposit the check until January 2, 2019. Eric is required to include the income on his 2018 tax return because he had constructively received the income before the end of 2018.

Example: Alice realizes that she made more money than she expected this year. She does owe a few vendors money, but the amount is not due until January of the next year. If Alice writes the checks and makes sure that the checks are received before December 31, she can take the deduction and the vendors must claim the income in the current year.

Tax Preparer Tip

A client cannot hold checks or postpone taking possession of the checks from one tax year to the next in order to postpone paying the tax liability. If the money is available, it has been constructively received and the income must be reported.

Accrual Method

Under the Accrual Method, taxpayers will generally report income in the tax year **earned** and deduct expenses in the tax year **incurred**. The purpose of using the accrual method is to match income and expenses in the correct year. Under this rule, you report income on the earliest of the following dates (IRS Pub. 538):

- ✓ when the payment is received
- ✓ when the income amount is due
- ✓ when the income is earned
- ✓ when title has passed

Example: Henry runs a large construction company and uses the accrual method of accounting. He finishes a job on November 1, 2018, and sends out the invoice for \$10,000 to his customer Paul. Paul is having a tough time with cash flow and doesn't pay Henry until January 15, 2019. Henry must claim the \$10,000 on his 2018 tax return even though he did not receive the money until 2019.

Example: Robert owns a furniture retail store. Robert allows some of his good customers to take delivery of furniture but not pay him until later. Joe Applegate, a great customer, buys a new bedroom set for \$5,400 on December 20. He asks Robert to have it delivered on December 24 but will not be able to pay him until February of the next year. Under the accrual method of accounting, Robert must claim the \$5,400 in this year, even though he did not receive the income until February of the next year.

When inventory is a significant factor in producing revenue (i.e., material income producing factor of revenue), the accrual method of accounting is required for the sales and cost of goods sold. Other expenses may be reported under the cash method of accounting.

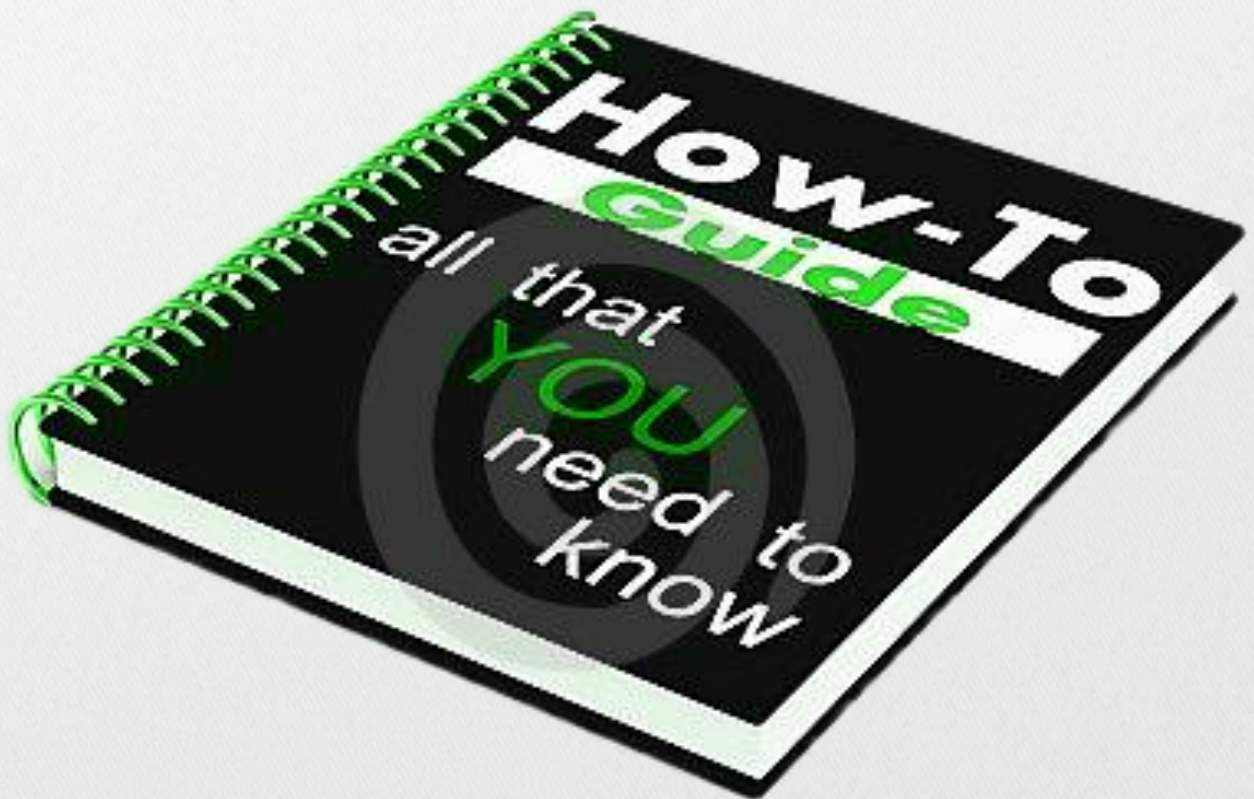
Summary

In this chapter we discussed the different types of businesses that use Schedule C and its simplified version known as Schedule C-EZ. We also reviewed the record-keeping requirements that apply to Schedule C businesses and the reporting obligations that apply to Form 1099 and the accounting method used by a business enterprise.



Chapter 1 Review Questions

1. Mark is a self-employed consultant in a cash-based business. He made \$28,500 in income for the year and has business expenses of \$3,700. He has no employees and no inventory. Which of the following forms does Mark have the choice of using to report his business income and expenses?
 - A. Schedule C-EZ
 - B. Schedule C
 - C. either a or b
 - D. Form I-9
2. Schedule C requires the preparer to answer questions about the business in all of the following areas EXCEPT:
 - A. business code
 - B. names of any employees
 - C. filing of Form 1099
 - D. accounting method



Answers to Chapter 1 Review Questions

1.

- A. This answer is incorrect. Mark's business meets the conditions to be able to use Schedule C-EZ to report his activities, but he could also report his operations on the longer version of the form.
- B. This answer is incorrect. Schedule C is normally used to report the activities of a business such as Mark's. However he also meets the conditions to use the simplified version of Schedule C.
- C. That's correct! Mark meets the conditions to be able to use Schedule C-EZ to report his business activities. However he could use Schedule C instead if he so desired.
- D. This answer is incorrect. As a sole proprietor Mark must report his business activities on a form designed for that purpose. Form I-9 is used for verifying the identity and employment authorization of individuals who are hired as employees in the United States.

2.

- A. This answer is incorrect. The preparer is required to enter a Business code corresponding to the type of business being operated.
- B. That's correct! Schedule C only requires the preparer to indicate expenses related to employees. The names of the employees are reported on a different form that is unrelated to Schedule C.
- C. This answer is incorrect. The proper completion of Schedule C requires the preparer to both indicate whether or not the business made any payment that would require the filing of Form 1099, and whether or not those forms were actually filed.
- D. This answer is incorrect. The preparer is required to indicate which type of Accounting Method the business used for the year being reported, i.e. whether it was Cash, Accrual or some other method.

Chapter 2

Income, and Expenses Part 1

Now that we have discussed the types of businesses that use Schedule C, we can now proceed to working our way through the form line-by-line. We will begin by discussing in this chapter the section of the form in which gross income is reported, and then proceed to the first part of the section in which expenses are reported.

Chapter Objectives

After completing this chapter you will be able to:

- ✓ identify the types of items that are reported as gross receipts or sales, and the locations for reporting returns and cost of goods sold
- ✓ identify the two methods used to calculate automobile and truck expenses and correctly calculate the amounts that can be claimed by individual businesses
- ✓ identify expenses incurred by a business that can be categorized as start-up costs, and the two methods that may be used to deduct those costs
- ✓ identify the most commonly used methods for calculating depreciation

Gross Income

Include on Schedule C, Part 1, line 1 the gross receipts or sales from the client's business. Gross receipts are business income and include income shown on the following items (IRS Pub. 583):

- ✓ cash register tapes
- ✓ bank deposit slips
- ✓ receipt books
- ✓ invoices
- ✓ credit card charge slips
- ✓ 1099-MISC forms

Any returns or allowances should be reported on line 2, and cost of goods sold would be carried from page 2 and reported on line 4.

Tax Preparer Tip

Clients who underreport their income can incur stiff penalties. If unreported income is more than 25% of the client's gross income shown on the tax return, the IRS can request to see the client's records for six years back instead of three. And the IRS can go back indefinitely if they suspect a fraudulent return was filed.

Business Expenses

This section covers some of the common and not-so-common business expenses that are ordinary and necessary in a taxpayer's business (Figure 9, below).

Figure 9: Business Expenses

Part II Expenses. Enter expenses for business use of your home only on line 30.							
8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions).	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion	12		b	Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions).	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel	24a	
b	Other	16b		b	Deductible meals and entertainment (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	
				27a	Other expenses (from line 48)	27a	
				b	Reserved for future use	27b	

Start-up Costs

Start-up costs include any amounts paid or incurred in connection with creating an active trade or business or investigating the creation or acquisition of an active trade or business. A start-up cost is an expense that your client incurs before the business opens. You can handle start-up costs in one of two ways:

- ✓ by amortizing the costs over 15 years (180 months), starting with the month business begins
- ✓ by deducting up to \$5,000 in start-up costs in the first year of business and amortizing the remaining costs over 15 years (180 months)

A business does not need to make a formal election to amortize the start-up costs. Start-up costs include amounts paid for the following (IRS Pub. 535):

- ✓ an analysis or survey of potential markets, products, labor supply, transportation facilities, etc.
- ✓ advertisements for the opening of the business
- ✓ salaries and wages for employees who are being trained, as well as their instructors
- ✓ travel and other necessary costs for securing prospective distributors, suppliers, or customers
- ✓ salaries and fees for executives and consultants or for similar professional services

Your clients are able to deduct up to \$5,000 of qualifying start-up costs, although the first year deduction starts to phase-out (is reduced dollar for dollar but not below zero) when your client's cumulative startup costs reach \$50,000. If the startup costs cannot be deducted, then they will be amortized over 180 months.

Example: In September, Maryann and Kurt decide to open a retail store that sells mainly Christmas and novelty items. They hire a consultant to analyze the business plan and possible locations. The cost for hiring the consultant is \$2,450. They pay an attorney \$1,200 for setting up the business and have travel costs to suppliers of \$450. These costs are incurred during September and October, and on November 1 they open for business. Maryann and Kurt's total start-up costs are \$4,100. Because the start-up costs are under \$5,000, they can expense the entire amount. If Maryann and Kurt don't need or want to take the expenses this year, they may instead choose to amortize the expenses over 15 years.

Example: In February and March of 2018, Sara and Betsy start a business selling ice cream in their local town. They hire an attorney for \$1,500 to find out if there is a potential liability for them and spend another \$2,300 on advertising. The grand opening of their ice cream store is May 1, 2018. Since the costs of \$3,800 were incurred prior to the start of the business, Betsy and Sara have two options: they can amortize the \$3,800 over 15 years, or they can take the entire \$3,800 as a deduction. If they amortize, they would fill out Form 4562 (Figure 10, below).

Figure 10: Amortizing Start-up Costs

Part VI Amortization					
(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
42 Amortization of costs that begins during your 2018 tax year (see instructions):					
START-UP COSTS	05/01/2018	3800	197	15.00 YRS	170
43 Amortization of costs that began before your 2018 tax year					43
44 Total. Add amounts in column (f). See the instructions for where to report					44

Form **4562** (2018)

Tax Preparer Tip

A client may not want to take the full amount of the deduction for start-up costs. For example, clients who are not going to be profitable in the first year may decide to amortize the cost over 15 years and minimize their taxes in future years when they will be profitable.

Start-up costs do **not** include the following (IRS Pub. 535):

- ✓ deductible interest
- ✓ taxes
- ✓ research and experimental costs

Advertising

Your clients can generally deduct reasonable advertising expenses that are directly related to their business activities. Advertising, if done correctly, can significantly improve the sale of your client's products and services, but advertising is still no guarantee of success.

What can advertising do for your client's business? It can:

- ✓ remind current customers and inform prospective customers about the benefits of your client's product or service
- ✓ establish and maintain your client's distinct identity
- ✓ enhance your client's reputation
- ✓ encourage existing customers to buy more of your client's product/service
- ✓ attract new customers and replace lost ones
- ✓ slowly build sales to boost your client's bottom line
- ✓ promote your client's business to customers, investors, and others

What is not a likely outcome when your client advertises? It may **not**:

- ✓ create an instant customer base

- ✓ cause an immediate, sharp increase in sales
- ✓ solve cash flow or profit problems
- ✓ substitute for poor or indifferent customer service
- ✓ sell useless or unwanted products or services

Social media (e.g., Facebook, Twitter, and LinkedIn) is the newest forum for advertising. Small businesses are tapping into the power of social media for giving product recommendations or advice on what to do and where to go. A big advantage of social media is the low cost to advertise, a big advantage to anyone starting a business.

Example: Julie and Jeanne, who understand the power of social media, start a fitness studio. Most of their advertising is done through Facebook and LinkedIn, with only \$750 spent on advertising in newspapers. Julie and Jeanne tell you that they have spent 275 hours during the year updating their social media. They charge \$25.00 per hour and want to take an advertising deduction of \$6,875 ($\25×275 hours) based on time spent. Unfortunately, a client's labor is not deductible. They can deduct only the \$750 in advertising expenses.

Car and Truck Expenses

Your clients who use their vehicles for business activities can deduct the expenses using the standard mileage rate or actual expenses. Although most tax preparation software will automatically select the best method if you input all the information correctly, you can take additional steps to identify the best method.

Consider the cost of the car, as well as repairs and insurance. Your client faces limits on how much can be depreciated or expensed under Section 179, which we will describe in the section on depreciation, below. The limits are \$10,000 in the first year, \$16,000 in the second, \$9,600 in the third, and \$5,760 in subsequent years. Thus, the depreciation for a car costing about \$50,000 will be the same as one costing \$100,000, at least for the first few years. However, a \$100,000 auto is likely to incur far higher insurance premiums and repair costs.

The depreciation numbers are different if your client is leasing the vehicle. A \$100,000 car may lease for about \$800 a month, which would be much more than a leased car costing about \$18,000. Thus, your client's deductible amount for an expensive leased car could be much higher than for a purchased car.

Before doing any detailed calculations, estimate your client's total business miles during the year, and then multiply that number by the IRS standard mileage rate. Next, figure your client's actual costs by adding the depreciation or lease payments, insurance, and repairs. Multiply that number by the business usage percentage. Compare the numbers for each calculation to see which method is best.

Standard Mileage Rate

The standard mileage rate is 54.5 cents per mile in 2018. Many clients do not want to be bothered with keeping receipts, so they opt for the standard mileage rate. If they choose to use the standard mileage rate, they cannot take any other expenses except the business percentage of their personal property taxes, auto loan interest, and business parking and tolls. A client **cannot** use the standard mileage rate if he or she:

- ✓ owns or leases five or more cars that are used for business at the same time (as in fleet operations)
- ✓ claims the depreciation deduction for the car using any method other than straight line (e.g., MACRS)

- ✓ claims a section 179 deduction on the car
- ✓ claims the special depreciation allowance on the car
- ✓ claimed actual car expenses after 1997 for a leased car still in service
- ✓ is a rural mail carrier who received a qualified reimbursement (IRS Pub. 463)

Tax Preparer Tip

A client who wants to use the standard mileage rate must use it the first year the vehicle is available for use in the business. If the vehicle is leased, the client must use it for the entire period of the lease.

Example: Karin, a real estate agent, drove her car 25,000 miles in 2018. She keeps a detailed log book and tells you that she drove 13,750 business miles during the year. She also paid \$60 in parking and tolls. Karin wants to take the standard mileage rate because she did not keep any receipts. Her total deduction would be \$7,554 ($13,750 \times 54.5$ cents per mile plus \$60 in parking and tolls).

Example: Paul, who works in sales, does a lot of driving in his leased car. He is not good with keeping receipts but does keep a detailed log book in his car. Even though he knew that the actual expenses would be a better deduction, Paul chose to use the standard mileage rate the first year because he didn't keep the receipts. Paul was not your client in that year. In year two, Paul asks you to do his taxes and wants to take the actual expenses he paid since he kept perfect records that year. Unfortunately, you must tell Paul that he is required to continue using the standard mileage rate since he started with that method and the vehicle is leased.

Example: Kathy owns three trucks and two cars that she uses at different times to do business. Kathy is allowed to take the standard deduction for all the vehicles because she does not use them all at the same time.

Example: Patty owns a restaurant. She has two cars that she alternates for business and three cars that her employees use to deliver orders. Patty can use the standard mileage rate deduction because she never uses more than four cars at the same time.

Actual Expenses

The client can deduct the business use percentage of **all** of the following when taking the actual expenses of the vehicle:

- ✓ depreciation
- ✓ garage rent
- ✓ gas
- ✓ insurance
- ✓ interest on vehicle loan
- ✓ lease payments
- ✓ licenses
- ✓ oil
- ✓ registration fees
- ✓ repairs and tires

Parking fees and tolls are also eligible business deductions. These two expenses are 100% deductible.

Whether using actual expenses or the standard mileage rate, the client needs to keep a log book that lists the date, reason for the business trip, start and end points of the trip, and the number of miles driven for that date. To use the standard mileage rate for a car, the client must choose this method in the first year the car is available for business use. Then, in later years, the client can choose to use the standard mileage rate **or** actual expenses.

Tax Preparer Tip

If a client qualifies for both methods, you may want to figure the deduction both ways to see which method produces the higher deduction. Don't forget that your client can also include the business percentage of personal property taxes, auto loan interest, and **all** business parking fees and tolls.

A client will commonly use a vehicle for both business and personal use. You must apportion the expenses based on the number of miles driven for business and the number of miles driven for personal use.

Example: The example is the same as above, except Karin the real estate agent has been using the actual expenses she incurred as the method for expensing her vehicle costs. Her vehicle is fully depreciated, and her total expenses for the year (including insurance, gas, and repairs) are \$6,400, along with the \$60 in tolls and parking. Karin drove her car 55% for business (13,750/25,000). Therefore, Karin's total deduction is \$3,580 ($55\% \times \$6,400$ plus the \$60 for parking and tolls).

Example: Larry keeps a mileage log and tabulates all his vehicle expenses. Larry drives his vehicle a total of 10,000 total miles, of which 8,000 miles were for business. Larry's business use was 80%, and his actual expenses were \$6,000, including depreciation. This is the first year that Larry has used his vehicle for business and wants to know which method is best for this year.

- ✓ actual expenses: $\$6,000 \times 80\% = \$4,800$
- ✓ standard mileage rate: $8,000 \times 54.5 \text{ cents} = \$4,360$

The actual expense method increases Larry's deduction by \$440 dollars. Larry is in the 25% tax bracket and pays self-employment tax of 15.3%. By electing the actual method, Larry realizes approximately \$177 in tax savings on his federal return. Depending on the state that he lives in, he may incur even further tax savings by using the actual expense method.

Depreciation

Depreciation is defined as a decline in value of an asset over a specific period. The IRS allows a taxpayer to depreciate or take a deduction each year for the decline in value over the asset's expected life. The deduction is an annual allowance for the wear and tear, deterioration, or obsolescence of the property.

For your client to be allowed to take a depreciation deduction, the property must meet **all** of the following requirements (IRS Pub. 946):

- ✓ The client must own the property. Clients may also depreciate any capital improvements for property they lease.
- ✓ The client must use the property in business or in an income-producing activity. Clients who use a property for business and for personal purposes can deduct only depreciation based on the business use portion of that property.
- ✓ The property must have a determinable useful life of more than one year.

Even a client who meets the preceding requirements for a property cannot depreciate the following property:

- ✓ property placed in service and disposed of in the same year
- ✓ equipment used to build capital improvements—A client must add otherwise allowable depreciation on the equipment during the period of construction to the basis of the improvements.
- ✓ Section 197 intangibles
- ✓ certain term interests (an interest in a property for a stipulated number of years)

Depreciation begins when the asset has been placed in service for use in the client's business and stops being depreciated when the client has fully recovered the cost of the asset or when the client sells or retires the asset from service, whichever occurs first.

For tax purposes, *basis* refers to the taxpayer's investment in the property. Basis generally means the taxpayer's cost, including the purchase price of the property as well as shipping, installation, and other services associated with the property.

Example: Nancy, an enrolled agent, purchased a new computer for her tax practice. She paid \$2,000 for the computer plus an additional \$75 for shipping and \$150 for installation. Nancy's basis in the computer for depreciation purposes is \$2,225.

To calculate depreciation, you need the following information:

- ✓ the date the asset was placed in service
- ✓ the cost or basis in the asset (i.e., what the client paid for the asset)
- ✓ the depreciation method you will use (discussed below)
- ✓ the recovery period or class life of the asset (discussed below)
- ✓ whether the client elects to expense any portion of the asset (Section 179, which we discuss below)

Depreciation Methods

Straight-Line Depreciation

The most basic type of depreciation is straight-line depreciation.

Example: A client has a landscaping business and buys a lawn mower for \$1,000. The expected life of the lawn mower is five years. The deduction allowed would be \$200 per year for five years.

Modified Accelerated Cost Recovery System (MACRS)

Straight-line depreciation is the most recognizable and easiest method of depreciating an asset. However, MACRS is the prescribed method of depreciating assets for tax purposes and is the most often used in preparing taxes. MACRS is used for property placed into service after 1986. Generally, a client depreciating property placed in service before 1987 must use the Accelerated Cost Recovery System (ACRS) or the same method used in the past.

MACRS provides four depreciation methods. There are three methods under the general depreciation system (GDS) and one method under the alternative depreciation system (ADS) (IRS Pub. 946):

- ✓ the 200% declining balance method over a GDS recovery period
- ✓ the 150% declining balance method over a GDS recovery period
- ✓ the straight-line method over a GDS recovery period
- ✓ the straight-line method over an ADS recovery period

You can use three types of conventions to depreciate an asset:

- ✓ Half-year convention applies to all property placed into service or disposed of on the midpoint of that tax year. Exceptions to that rule include residential and nonresidential real property and property subject to the mid-quarter convention.
- ✓ Mid-quarter convention generally applies if the total cost of the business assets placed in service during the last three months of the tax year exceeds 40% of the total assets placed in service during the entire year. Do not include residential and nonresidential property and assets placed in service and disposed of during the same year.
- ✓ Mid-month convention applies to residential and nonresidential real property. This method treats all property placed into service or disposed of during the month it was actually placed in service or disposed of.

Once you know the method of depreciation, the class life or number of years over which the client will depreciate the property, the cost or basis of the property, and the date the asset was placed into service, you can calculate the depreciation deduction.

The chart below, taken from the IRS, shows the depreciation method used, the type of property, and, most importantly, the benefit of each method.

Note. The declining balance method is abbreviated as DB, and the straight line method is abbreviated as SL		
Method	Type of Property	Benefit
GDS using 200% DB	✓ Nonfarm 3-, 5-, 7-, and 10-year property	✓ Provides a greater deduction during the earlier recovery years Changes to SL when that method provides an equal or greater deduction
GDS using 150% DB	✓ Nonfarm 3-, 5-, 7-, and 10-year property	✓ Provides a greater deduction during the earlier recovery years Changes to SL when that method provides an equal or greater deduction ¹

Note. The declining balance method is abbreviated as DB, and the straight line method is abbreviated as SL

GDS using SL	✓ Nonresidential real property ✓ Qualified leasehold improvement property placed in service before January 1, 2018 ✓ Qualified restaurant property placed in service before January 1, 2018 ✓ Qualified retail improvement property placed in service before January 1, 2018 ✓ Residential rental property ✓ Trees or vines bearing fruits or nuts ✓ Water utility property ✓ All 3-, 5-, 7-, 10-, 15-, and 20-year property* ✓ Property for which you elected section 168(k)***	✓ Provides for equal yearly deductions (except for the first and last years)
ADS using SL	✓ Listed property used 50% or less for business ✓ Property used predominantly outside the U.S. ✓ Tax-exempt property ✓ Tax-exempt bond-financed property ✓ Farm property used when an election not to apply the uniform capitalization rules is in effect ✓ Imported property** ✓ Any property for which you elect to use this method*	✓ Provides for equal yearly deductions (except for the first and last years)

The MACRS percentage tables on the IRS website have the switch to the straight-line method built into their rates.

**See section 168(b) (5) of the Internal Revenue Code.*

***See section 168(g)(6) of the Internal Revenue Code*

****See section 168(g)(7) of the Internal Revenue Code*

Most tax preparers use software programs to figure out the depreciation deduction. They input the type of asset, cost, class life, and date the asset was placed in service. The software program does the rest of the work. The following example steps you through the manual process of depreciating an asset.

Example: Roberta purchased equipment for her office on July 15, 2018. The cost of the equipment was \$10,000. She chooses to depreciate the computer. The asset has a class life of 7 years, and the method used for depreciation will be MACRS 200DB and half-year convention. Below is an illustration to see how the depreciation method works. The percentages are taken from the MACRS percentage tables on the IRS website and Form 4562 (as shown in Figure 11, below).

Year	Basis	Percentage	Deduction
2018	\$10,000	14.29	\$1,429
2019	\$10,000	24.49	\$2,449
2020	\$10,000	17.49	\$1,749
2021	\$10,000	12.49	\$1,249
2022	\$10,000	8.93	\$893
2023	\$10,000	8.92	\$892
2024	\$10,000	8.93	\$893
2025	\$10,000	4.46	\$446

Figure 11: Reporting Depreciation on Form 4562

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (Business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property		10,000.	7.0	HY	200 DB	1,429.
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			27.5 yrs.	MM	S/L	
			39 yrs.	MM	S/L	
				MM	S/L	
Section C—Assets Placed in Service During 2014 Tax Year Using the Alternative Depreciation System						
20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	
Part IV Summary (See instructions.)						
21 Listed property. Enter amount from line 28						21
22 Total. Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions						22 1,429.

As you'll see when looking back to the IRS chart, the benefit of taking the 200DB is that the client gets a greater deduction in the earlier years than in the later years. Understanding the benefits of each method will enable you to give the best advice to your client.

Section 179

Section 179 is an alternative to the other methods of depreciation that we discussed earlier. With section 179, your client can elect to recover all or part of the cost of certain qualifying property, up to a limit, by deducting it in the year the taxpayer places the property in service. The taxpayer can elect the section 179 deduction instead of recovering the cost over multiple years.

In the example above, Roberta could have expensed the entire \$10,000 in 2018 instead of depreciating it. The advantages are great since Roberta pays less in taxes up front and has more money to invest in her business. Some properties qualify for this deduction, while some do not. Property that qualifies includes tangible personal property such as machines, equipment, and furniture. The IRS provides charts in Publication 946 showing which properties qualify. **To qualify for Section 179, the property must be used more than 50% in a taxpayer's trade or business and must be acquired from an unrelated party.**

For 2017 the maximum Section 179 expense deduction was \$510,000. This limit was reduced by the amount by which the cost of Section 179 property placed in service during the tax year exceeded \$2,030,000. The Section 179 Expense deduction was modified by the Tax Cuts and Jobs Act of 2017 (TCJA), which was signed into law on December 22, 2017.

Under the terms of TCJA, beginning with tax years starting in 2018 the maximum amount a taxpayer may expense under section 179 is increased to \$1,000,000, and the phase-out threshold amount is increased to \$2,500,000. These threshold amounts will be indexed for inflation for tax years beginning after 2018.

The new law also expands the definition of Section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. Property used predominantly to furnish lodging or in connection with furnishing lodging generally includes beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided.

The new law also expands the definition of qualified real property eligible for Section 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:

- ✓ roofs
- ✓ heating, ventilation, and air-conditioning property
- ✓ fire protection and alarm systems
- ✓ security systems

Tax Preparer Tip

You should inform clients about the amount of tax they would pay with and without the Section 179 deduction. In some cases, a client may think it's better to take the deduction up front. But a client anticipating high income in the next several years may be better off depreciating the asset over its useful life.

Business Vehicle Deduction Limits

Section 280F (a) sets a specific annual dollar limitation (adjusted each year for inflation) on the amount of depreciation allowed for any "passenger automobile"—generally referred to as the "luxury automobile" limitations. The limitations apply to four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways, and that are rated at 6,000 pounds gross vehicle weight (GVW) or less. (Except for trucks and vans, a vehicle's "unloaded" GVW rating is used.)

The IRS places higher annual "luxury automobile" depreciation limitations on vans and trucks than on other passenger automobiles. For this purpose, "vans and trucks" are passenger automobiles that are built on a truck chassis, including some minivans and sport utility vehicles.

These limitations do not apply to "qualified nonpersonal use vehicles," i.e., vans and light trucks whose design makes them "not likely to be used more than a *de minimis* amount for personal purposes."

Example: Dave runs a painting business and owns a van that is used strictly for his business. He carries ladders on the truck and has his logo printed on both sides of the van. Dave is not likely to use this vehicle for anything but business.

Tax Preparer Tip

The total section 179 expense plus MACRS depreciation may not exceed the Section 280F limit.

Passenger Automobiles

The general inflation-adjusted limitations for passenger automobiles (other than trucks and vans) placed in service during 2018 are:

Passenger Automobiles: Year Placed in Service	
1st tax year	\$10,000
2nd tax year	\$16,000
3rd tax year	\$9,600
Each succeeding tax year	\$5,760

For an automobile being depreciated under the modified accelerated cost recovery system (MACRS)—subject to a five-year recovery period and a half-year convention—the \$10,000 cap serves to limit the first-year depreciation.

Example: Tom purchases a car for \$80,000 and uses it 100% for business. MACRS depreciation (using the half-year convention) is \$16,000 ($\$80,000 \times .20$ for the first year). Since the maximum deduction for the first year is \$10,000, Tom can claim only \$10,000.

Example: The same as above, except that Tom uses the vehicle only 80% for business. Tom's deduction is \$8,000. He must multiply the maximum amount by the business percentage ($\$10,000 \times 80\%$).

Example: The same as above, except this is the second year that Tom owns the vehicle. He uses it 100% for business. The second year percentage using the half-year convention is 32%. MACRS depreciation is \$25,600 ($\$80,000 \times .32$ for the second year). Since the maximum deduction for the second year is \$16,000, Tom can claim only \$16,000.

Example: The same as above, except this is the third year that Tom owns the vehicle. He uses it 100% for business. The third year percentage using the half-year convention is 19.20%. MACRS depreciation is \$15,360 ($\$80,000 \times .192$ for the third year). Since the maximum deduction for the third year is \$9,600, Tom can claim only \$9,600.

Trucks and Vans

For trucks and vans placed in service during 2018, the general inflation-adjusted limitations are as follows:

Trucks and Vans: Year Placed in Service	
1st tax year	\$10,000
2nd tax year	\$16,000
3rd tax year	\$9,600
Each succeeding tax year	\$5,760

Example: Tom purchases a van for \$80,000 and uses it 100% for business. MACRS depreciation (using the half-year convention) is \$16,000 ($\$80,000 \times .20$ for the first year). Since the maximum deduction for the first year is \$10,000, Tom can claim only \$10,000, the same as the passenger automobile limitations.

Employee Benefit Programs

These expenses are deducted on line 14 of the Schedule C and include:

- ✓ group term life insurance
- ✓ accident and health plans
- ✓ dependent care benefit programs
- ✓ company contributions to employee retirement plans (e.g., SEP, SIMPLE match, 401K match)

On line 14 of Schedule C, you may deduct the health insurance premiums your client paid on behalf of a spouse who is also an employee of the business. The sole proprietor can be covered under the plan as part of the employee's family.

of the employee's family.

Tax Preparer Tip

Your clients who can deduct health insurance premiums on Schedule C will be able to reduce their self-employment tax. If a spouse is a bona fide employee and does provide services to the business, deducting premiums on Schedule C is a great way to reduce taxes.

Self-Employed Health Insurance

You may be able to deduct premiums paid for medical and dental insurance and qualified long-term care insurance for the taxpayer, spouse, and their dependents. The insurance can also cover a child who was under age 27 at the end of 2018, even if the child was not the taxpayer's dependent. A child includes a son, daughter, stepchild, adopted child, or foster child. A foster child is any child placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction (IRS Pub. 535).

The cost for self-employed health insurance **does not** go on line 14 of Schedule C but is 100% deductible as an adjustment from gross income on Schedule 1 (Form 1040), line 29. The deduction does not require your client to itemize.

Example: Eric is self-employed and paid \$11,000 in health insurance premiums during the year. His net income is \$75,000. Eric can deduct the \$11,000 on Schedule 1, line 29. The \$11,000 reduces Eric's taxable income but does not reduce his self-employment tax.

The deduction is limited to the net profit from Schedule C minus the SE tax deduction and any contribution your client may have made to a SEP, SIMPLE, or 401(k) plan. Include on Schedule A as a medical deduction any excess premiums that are not allowed as an adjustment to income.

Example: Same as above, except that Eric has \$8,000 in net income. Eric also has W-2 wages of \$30,000. Eric is allowed to deduct only \$7,435 (\$8,000 - \$565) for self-employed health insurance and \$565 for half of the self-employment tax that he owes. Those two numbers total his net income of \$8,000. The difference of \$3,000 that he paid for health insurance would be deductible on Schedule A as a medical expense subject to the 7.5% threshold (Figures 12 and 13, below)

Figure 12: Schedule 1 (Form 1040)

Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27	565	
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29	7435	
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid b Recipient's SSN ▶	31a		
	32	IRA deduction	32		
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35	36		8000

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Figure 13: Schedule A, Medical Expenses

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others.		
1	Medical and dental expenses (see instructions)	1	3,565
2	Enter amount from Form 1040, line 7 2 30,000	2	30,000
3	Multiply line 2 by 7.5% (0.075)	3	3,000
4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-	4	565

Tax Preparer Tip

Clients who are self-employed **and** collecting social security **and** paying Medicare Part B premiums can add those premiums to line 29 of Form 1040 and take them as an adjustment to income. This adjustment does not include the premiums paid for the self-employed spouse if he or she is also collecting social security. The spouse's portion of the Medicare premiums would be deductible on Schedule A as a medical expense.

Example: Same as above except Eric, who is single is 68 years old and collecting social security and on Medicare. He pays \$1,500 for a supplemental health insurance policy and \$1,260 for his Medicare Part B premiums. Eric will be able to deduct both the supplemental policy and Medicare Part B premiums of \$2,760 (\$1,260 + \$1,500) on the front of the tax return (Figure 14, below).

Figure 14: Schedule 1 (Form 1040)

Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the Armed Forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27	565	
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29	2760	
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid b Recipient's SSN ▶	31a		
	32	IRA deduction	32		
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35	36		3329

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COBRA Payments

After losing a job, your client may request to continue health care coverage with the former employer as required by the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985. Your client may be required to pay for some or all of the premiums. However, even if your client starts working as an independent contractor or has other self-employment income, the COBRA payments won't qualify for the self-employed health insurance deduction.

To qualify for the self-employed health insurance deduction, an insurance plan must be created under your client's trade or business name. Because COBRA continues your client's existing coverage under a previous employer's plan, a client making COBRA payments can't deduct those premiums on the front of the tax return as an adjustment to income. They would be required to take the deduction on Schedule A as a medical deduction.

Tax Preparer Tip

A client who is self-employed and paying for COBRA may want to consider dropping COBRA and getting health insurance under the individual name or business name. That way, the client can deduct the premiums as an adjustment to income.

Insurance

Your clients can generally deduct the following kinds of insurance related to a trade or business. The cost is deducted on line 15 of Schedule C (IRS Pub. 535):

- ✓ insurance that covers fire, storm, theft, accident, or similar losses
- ✓ credit insurance that covers losses from business bad debts
- ✓ group hospitalization and medical insurance for employees, including long-term care insurance
- ✓ liability insurance
- ✓ malpractice insurance that covers the personal liability for professional negligence resulting in injury or damage to patients or clients
- ✓ workers' compensation insurance
- ✓ contributions to a state unemployment insurance fund (deductible as taxes if they are considered taxes under state law)

- ✓ overhead insurance that pays for business overhead expenses during long periods of disability caused by an injury or sickness
- ✓ life insurance covering officers and employees if they are not directly or indirectly a beneficiary under the contract
- ✓ business interruption insurance that pays for lost profits if the business is shut down due to a fire or other cause
- ✓ car and other vehicle insurance that covers vehicles used in the business for liability, damages, and other losses, if your client did not deduct these expenses under vehicle expenses on line 9

Example: Richard is self-employed and has two employees. He pays \$1,200 in worker's compensation, \$1,400 in state unemployment, \$870 in liability insurance, \$950 in life insurance for himself, and \$350 in renter's insurance for the business. Richard can deduct everything except the life insurance. Life insurance premiums are not deductible.

Tax Preparer Tip

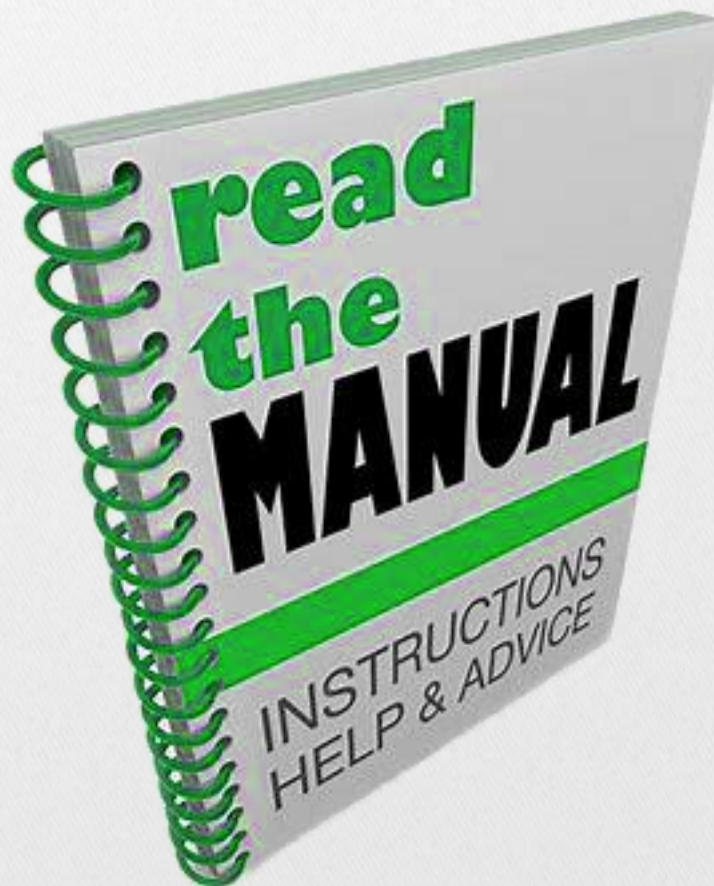
If a client operates a vehicle partly for personal use, deduct only the portion of the insurance premium that applies to the business use of the vehicle. A client who uses the standard mileage rate to figure car expenses cannot deduct any car insurance premiums.

Summary

In this chapter we reviewed the items that together comprise the gross receipts or sales of a business, and noted that returns and allowances, and cost of goods sold are subtracted from gross receipts to arrive at gross income. We then went on to discuss some of the expenses that relate to the operation of a business, beginning with start-up costs.

Chapter 2 Review Questions

1. Which of the following would *not* be considered a start-up cost for a business?
 - A. the cost of training employees before the business opened
 - B. advertising costs for the opening of the business
 - C. research and experimental costs
 - D. travel for seeking out potential suppliers and customers
2. Barry is a computer consultant who owns and operates his own company. In 2018 he drove 7,500 miles in his own car for business purposes and 3,500 miles for personal use. During the year he paid \$500 for new tires and spent a total of \$350 in parking and tolls while travelling to his business appointments. How much can Barry claim as a vehicle expense for 2018 if he uses the Standard Mileage rate?
 - A. \$4,438
 - B. \$4,938
 - C. \$2,811
 - D. \$3,161



Answers to Chapter 2 Review Questions

1.

- A. This answer is incorrect! Training employees to be able to work in a new business is considered a start-up cost.
- B. This answer is incorrect! The cost of advertising related to the opening of a new business is considered to be a start-up expense.
- C. That's correct! Research and experimental costs are specifically excluded from being deductible start-up costs.
- D. This answer is incorrect! Travel related to finding suppliers and potential customers for a new business is an expense that is considered to be a start-up cost.

2.

- A. That's correct! Barry calculates his deduction as follows: $7,500 \times 54.5 \text{ cents} = \$4,088$. The additional \$350 cost of business-related parking and tolls brings his 2018 deduction to a total of \$4,438.
- B. This answer is incorrect! Barry's deduction is based on 7,500 miles at a rate of 54.5 cents per mile, and he then adds his \$350 in business related parking and tolls. However the tires are not deductible because they can only be claimed with the Actual Expenses method.
- C. This answer is incorrect! Barry's deduction is based on 7,500 miles at a rate of 54.5 cents per mile. He also can claim his business-related parking and tolls. Because he is using the Standard Mileage method, there is no need to consider his business use percentage.
- D. This answer is incorrect! Barry is using the Standard Mileage method to calculate his deduction. For that reason, there is no need to consider his business use percentage. He simply claims 54.5 cents for each business mile and then adds his business-related parking and tolls.

Chapter 3

Expenses Part 2

While we began our line-by-line review of the business expenses that can be reported on Schedule C, in this chapter we will proceed to discuss the remainder of the expenses that businesses can report on the form.

Chapter Objectives

After completing this chapter, you will be able to:

- ✓ identify business expenses that can be deducted under categories including legal and professional fees, meals and entertainment, repairs and maintenance, taxes and licenses, utilities, wages and costs of goods sold
- ✓ identify the two methods available for calculating the home office deduction and determine which method is more advantageous to individual clients in given cases

Legal and Professional Fees

You can deduct on line 17 of Schedule C the fees paid to an attorney or tax preparer that is ordinary and necessary in a client's business.

You can deduct the cost of preparing that part of the tax return relating to the business as a sole proprietor. The remaining cost is not deductible.

You can also deduct an amount paid or incurred in resolving tax deficiencies for a business as a sole proprietor.

Example: Denise is a sole proprietor. She hired an attorney to go over her insurance policy for her business for \$250 and paid her tax preparer \$400 to do her tax return. She can deduct the full amount paid to the attorney but must prorate the \$400 paid to her tax preparer. Her tax preparer charged \$300 for the Schedule C, but the remaining \$100 is not deductible. The \$550 will be deducted on line 17 of Schedule C.

Office Expenses

This deduction tends to be a catch-all for some clients. Office expenses include office supplies such as toner cartridges, paper, file folders, and postage. The expenses are deducted on line 18.

Rent or Lease

Line 20a is for the lease payments made for machinery and equipment used in a business. Line 20b is for the rent or lease payments made for office space in a building or leasing a property.

Repairs or Maintenance

You can deduct the costs of repairs and maintenance that do not add value to the asset or do not add any years to the life of the asset. Do not deduct amounts spent to restore or replace property; they must be capitalized. Repairs and maintenance expenses are deducted on line 21 of Schedule C.

New IRS regulations governing how taxpayers deduct repairs and improvements to business property went into effect on January 1, 2014. Generally, under code section 162 your clients can deduct all ordinary and necessary business expenses, including amounts paid for incidental repairs and maintenance. The expenses for repairs and maintenance are deducted in the year they are paid or incurred. Under code section 263(a) your clients must capitalize or depreciate any amounts that were paid to acquire, produce, or improve property.

Under new and final regulations that generally take effect January 1, 2014, the ceiling in the *de minimis* rule has been eliminated and replaced with a new safe harbor rule determined at the invoice or item level and based on the policies used by the taxpayer for financial accounting books and records.

The new regulations (§1.263(a)-1(f)) include a *de minimis* safe harbor for your clients who lack an applicable financial statement, provided that they have accounting procedures to deduct amounts paid for property costing less than a specified amount, or amounts paid for property with an economic useful life of 12 months or less. The specified amount for your clients in this category is \$500. If the cost is \$500 or more per invoice (or item), then no portion of the property cost will fall within the safe harbor.

The *de minimis* safe harbor is elected annually by including a statement on your client's tax return for the year elected. It is not a change in accounting method. To use the *de minimis* safe harbor, your client must have written accounting procedures in place at the beginning of the tax year that treat as an expense for financial accounting purposes the amounts paid for property costing less than a certain dollar amount. These procedures are applicable to tax years beginning on or after January 1, 2014.

Note

Any clients without written accounting procedures who choose to elect the *de minimis* safe harbor for their 2018 tax years need to have appropriate procedures in place prior to December 31, 2017.

Clients electing to apply the *de minimis* safe harbor must include in the cost of the property all additional costs (for example, delivery fees, installation services, or similar costs) of acquiring or producing the property if these costs are included on the same invoice with the tangible property.

If an invoice includes amounts paid for multiple tangible properties as well as costs related to multiple properties, then your clients must allocate the additional invoice costs to each property using a reasonable method. Additional costs consist of the transaction costs of acquiring or producing the property and the costs for work performed prior to the date that the unit of tangible property was placed in service.

If your client elects the *de minimis* safe harbor under Reg. §1.263(a)-1(f), you must apply the rule to all eligible materials and supplies. Clients who do not elect the *de minimis* safe harbor must treat amounts paid for materials and supplies in accordance with Reg. §1.162-3.

Example: Janet owns a seasonal restaurant that sells seafood and ice cream. She did a lot of repairs to the property and bought some new appliances. Her expenses were:

- ✓ eight new picnic tables for \$2,800 (each costing \$350)
- ✓ a new fryer for \$3,500
- ✓ air conditioner for \$860
- ✓ microwave for \$480

As long as Janet has the proper written procedures in place by December 31, 2017, she can expense all eight picnic tables and the microwave. Janet would need to depreciate the fryer and air conditioner since these items cost more than \$500. If Janet qualifies, she can also take a section 179 deduction for the air conditioner and fryer and deduct all of it in this year.

The IRS is very clear that the taxpayer must have written procedures in place. You should make sure that your clients have a signed, written policy. An example of the policy is in Figure 15, below.

Figure 15: Sample Safe Harbor Policy

Safe Harbor Policy	
Name(s) of Business: _____	
Signed: _____	Date: _____
Name of Rental property: _____	
Signed: _____	Date: _____

Definition

As of January 1, 2018

1. If the cost of a piece of equipment and/or other personal property is five hundred dollars or more and the anticipated life or useful value of the equipment or property is more than one year, then the equipment or other personal property should be capitalized.
2. If the cost of a piece of equipment and/or personal property is less than five hundred dollars, or its useful life is less than one year regardless of cost, then the equipment or other personal property shall be treated and recorded as material or inventory.

The following table summarizes some of the factors in determining whether a cost can be expensed or must be depreciated.

Capital	Repair
Puts property in a better operating condition	Keeps property in efficient operating condition
Restores property to a "like new" condition	Restores property to its previous condition
Adds new or replaces the components or material subcomponents to property	Protects underlying property through routine maintenance
Adds upgrades or modifications to property	Occurs incidentally
Enhances the value of property in the nature of a betterment	
Extends the useful life of property	
Improves the efficiency of property	
Improves the quality of property	
Increases the strength of property	
Increases the capacity of property	
Ameliorates a material condition or defect	
Adapts property to a new use	

Supplies

This category can cause confusion. Use line 22 for the cost of materials and supplies used to the extent the client actually consumed them and used them for business. This category is **not** to be used for inventory.

Example: Bernadette runs a spa and uses oils and lotions on her clients during their massages. She also sells the same oils and lotions to her clients if they wish to purchase them for use at home. Bernadette can deduct on line 22 only the cost of the oils and lotions used during the massage. Those are the products consumed in her business. The products sold to her clients separately would be considered inventory. Those costs are considered cost of goods sold and are included on lines 33-42 of Part III, Schedule C.

Taxes and Licenses

Your clients can deduct the following taxes and licenses on line 23 (IRS Pub. 535):

- ✓ real estate and personal property taxes on business assets
- ✓ licenses and fees for the trade or business
- ✓ federal unemployment tax paid
- ✓ federal highway use tax
- ✓ contributions to state unemployment insurance fund
- ✓ employer's match for Social Security and Medicare taxes paid on behalf of the employee's wages—**If your client is on the cash basis method of accounting, deduct only the amount that was actually paid to the government in that year.**

Do not deduct the following (IRS Pub. 535):

- ✓ estate and gift taxes
- ✓ taxes assessed to pay for improvements, such as paving and sewers, which are instead added to the basis of the asset
- ✓ taxes on a client's home or personal use property
- ✓ federal income taxes, including self-employment taxes
- ✓ state and local sales **taxes imposed on the buyer** that the client was required to collect and pay to state and local governments—**These taxes are not included in gross receipts or sales, nor are they a deductible expense.** However, if the state or local government allowed the client to retain any part of the collected sales tax, she or he must include that amount as income on line 6 of Schedule C.

Example: Gina runs a café and is required to collect a 6.25% meals tax on her pastries. During the year, she sells \$125,000 in pastries and collects \$7,813 in sales tax. Gina's total deposits for the year are \$132,813. She is required to remit the \$7,813 to the state government. Gina will declare \$125,000 of gross income on line 1 of Schedule C and will **not deduct** the \$7,813 of sales tax.

Travel, Meals and Entertainment

On line 24a, enter the client's expenses for lodging and transportation for overnight business travel. Some examples would be travel by airplane, train, bus, car, and hotel expenses. The cost of travel expenses paid in connection with employment away from home is not deductible if that period of employment exceeds or is expected to exceed one year.

Meals and Entertainment

Your client can deduct as business meal expenses any food and beverage purchases that are directly related to the active conduct of a trade or business, as long as the purchases are not lavish and extravagant. Deductible expenses include meals while traveling away from home for business and meals that are business related.

Report the client's deductible meals and entertainment on line 24b. When reporting meals, you can use either the actual cost method or the per diem method. Regardless of which method you use, the deductible expense is generally limited to 50% of the cost of the meals. Meals that are 50% deductible include those:

- ✓ directly related to business meetings of employees, stockholders, agents, and directors
- ✓ occurring as part of office meetings and partner meetings
- ✓ with clients, customers, and vendors that will benefit the business
- ✓ while traveling for business
- ✓ while attending a business seminar, convention, or any other form of meeting

Some meal expenses are 100% deductible. Report them in the other expense line of Schedule C rather than on line 24b. Meals that are 100% deductible include those:

- ✓ provided as part of recreational events, such as business holiday parties or company picnics, held primarily for employees who are not highly compensated
- ✓ provided as snacks to employees at the office
- ✓ provided on the employer's premises to more than half of the employees for the convenience of the employer, meaning meals provided to employees to keep them working late or on weekends for the employer's convenience
- ✓ made available to the public, usually for advertising and promotional purposes
- ✓ for which the business is reimbursed for the expense
- ✓ includible in income of persons who are not employees

Example: Kerry has a tax practice. During tax season, her employees work many hours. During tax season, Kerry buys all the employees' lunches, which total \$750 for the year. During the year, Kerry also takes several clients out for meals (for a total of \$450) at which business is discussed. She also traveled to Florida for a week-long seminar, spending \$560 on meals and entertainment. Kerry can deduct 100% of the employees' lunches since the expense was for the convenience of Kerry but can deduct only 50% of the other meals and entertainment.

Tax Preparer Tip

Advise your clients to create two separate meals accounts (such as meals—50% deductible and meals—100% deductible) in their accounting books, and to book them separately when they occur. Separating meal expenses in this way will make preparing their taxes easier and more efficient.

Actual Cost

Clients who use the actual cost method must keep good records. They should write down on the receipt the people who took part in the business meal and the nature of the business discussion. The business must be directly before or after the meal.

Per Diem

Sole proprietors can use the standard meal allowance or per diem rates as an alternative to the actual cost of business meals and incidental expenses (M&IE). This method allows the client to use a set amount of money daily for M&IE instead of keeping records of their actual costs. The set amount varies depending on where and when the client travels.

The IRS sets the per diem rates based on where a person travels. Obviously, the rates would be higher in New York City than they would be in Kansas City. The per diem rate is the Federal M&IE rate and can be found at www.gsa.gov or IRS Publication 1542.

Only the M&IE per diem rate applies to a sole proprietor. A sole proprietor cannot take a per diem allowance for lodging; actual expenses must be used for lodging. Most self-employed individuals will use the actual cost of their meals. The chart below summarizes expenses that a taxpayer can deduct when traveling away from home for business purposes (IRS Pub. 463).

IF the taxpayer has expenses for...	THEN the taxpayer can deduct the cost of...
Transportation	Travel by airplane, train, bus, or car between the home and the business destination. If the taxpayer was given a complimentary ticket or rode free as a result of a frequent traveler or similar program, the cost is zero.
Taxi, commuter bus, and airport limousine	Fares for these and other types of transportation between: The airport or station and the hotel The hotel and the work location of the customers, the business meeting place, or the temporary work location
Baggage and shipping	Sending baggage and sample or display material between the regular and temporary work locations
Car	Operating and maintaining a car when traveling away from home on business. The taxpayer can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If the taxpayer rents a car while away from home on business, only the business-use portion of the expenses is deductible.
Lodging and meals	Lodging and meals if the business trip is overnight or long enough that a stop is needed for sleep or rest to properly perform duties. Meals include amounts spent for food, beverages, taxes, and related tips.
Cleaning	Dry cleaning and laundry while traveling
Telephone	Business calls while on a business trip. This deduction includes business communication by fax machine or other communication devices.
Tips	Tips paid for any expenses in this chart
Other	Other similar ordinary and necessary expenses related to business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

Example: Suzanne sells business supplies and travels periodically. She flew to Chicago for two nights and brought her husband along. Her flight was \$300, her hotel bill was \$450, and her meals totaled \$280. Her husband's flight was \$300 and his meals totaled \$250. Suzanne did not pay any additional amount by having her husband stay with her in the hotel room. If the hotel had charged her more for bringing her husband, she would be able to deduct only the price of the single room vs. a double room. She can take \$750 on line 24a as a full travel deduction, but her \$280 meal expense will be reduced by 50% to a deduction of only \$140 on line 24b.

2018 Changes

The Entertainment Expense deduction was modified by the Tax Cuts and Jobs Act of 2017 (TCJA), which was signed into law on December 22, 2017.

Under the terms of TCJA, beginning with tax years starting in 2018 no deduction will be allowed with respect to:

- ✓ an activity generally considered to be entertainment, amusement or recreation
- ✓ membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes
- ✓ a facility or portion thereof used in connection with any of the above items

In addition, expenses incurred by an employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer will only be 50% deductible rather than 100% deductible.

Utilities

You are allowed to deduct only utility expenses that relate to the client's trade or business. The telephone can be one of the most difficult expenses to keep a handle on, especially for the client who works out of a home office. A client **cannot** take the home line as a business deduction even if the line is used for business. However, clients can take any toll calls that are separately stated on the bill and for business use. Clients with a separate business line can fully deduct that cost.

Cell phones can also be tricky. Many clients have plans that include the entire family. Little Joey and Suzie, along with the spouse, are on the plan, and the client wants to deduct the entire cost. The client must break out the costs of the phone that is used only for business purposes, which is easier said than done since most companies do not itemize each call. However, most companies do itemize the number of minutes used for each phone. The client must prorate those amounts.

Example: Jackie is an attorney. Her cell phone plan includes her son's and husband's phones, a less than ideal situation. Jackie tells you that the monthly bill for her husband and son totals an extra \$50 per month. Jackie also says that she uses her phone only 80% for business.

- ✓ total bill for the year: \$3,800
- ✓ total expense for son and husband: -\$600
- ✓ personal use: \$640 ($\$3,800 - \$600 = \$3,200 \times 20\%$)

Jackie's total cell phone business expense for the year would be \$2,560 ($\$3,800 - \$600 - \640).

Tax Preparer Tip

When it comes to cell phones, make it a habit to ask clients if their total cell phone bills include any other phones. Many people have children and spouses on their plans. Obviously, personal use is not deductible.

Wages

On line 26, enter the total salaries or wages that were paid in the **tax** year. If the client took advantage of any employment credits, you need to reduce the wages by the amount claimed on the credit. The total amount that you should put on this line is gross wages, which includes the employee's portion of FICA taxes as well as withheld federal and state taxes. On line 23, enter the employer's portion of FICA and other payroll related expenses for which the employer is responsible.

Tax Preparer Tip

Gross wages claimed on line 26 should match the total gross wages on Form W-3. Form W-3 is the summary form submitted to the IRS that totals all the employee W-2 wages for the tax year. The W-3 and W-2 forms need to be filed with the IRS by January 31st of the following year.

Cost of Goods Sold (COGS)

Cost of goods sold refers to the inventory **costs** of those goods a business has sold during the year or particular period of time the taxpayer is tracking. Inventory needs to be used when the purchase and sale of merchandise is a factor in producing income. The cost of those goods not yet sold would be the ending inventory. Only the cost of the items sold can be deducted as COGS.

Example: Jeanne is in the business of selling t-shirts. Since the sales of the t-shirts are an income-producing factor in her business, she must keep track of her inventory. She started the business in 2018 and purchased 2,000 t-shirts from a wholesaler at a cost of \$10 per shirt. The shipping was free, she did not have any employees, and she personally embroiders business names on the shirts. She sells the t-shirts for \$20 each. The cost of the thread is incidental in the total cost of the t-shirts, so the cost is deducted on line 22 of Schedule C under supplies. Jeanne can deduct only the actual cost of each t-shirt sold. The total cost of the shirts was \$20,000. Unfortunately, Jeanne did not anticipate the sluggish economy and sold only 100 shirts to a small restaurant. Jeanne can deduct only the cost of the 100 t-shirts, or \$1,000 (Figure 16, below).

Figure 16: Schedule C, Page 2

Part III Cost of Goods Sold (see instructions)	
33	Method(s) used to value closing inventory: a ☒ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation 35
36	Purchases less cost of items withdrawn for personal use 36 20,000.
37	Cost of labor. Do not include any amounts paid to yourself 37
38	Materials and supplies 38
39	Other costs 39
40	Add lines 35 through 39 40 20,000.
41	Inventory at end of year 41 19,000.
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4 42 1,000.

Other expenses normally included in Part III of the Cost of Goods section would be shipping costs to receive inventory items and direct cost of labor for workers who produce the product.

In many cases, it is easy to value ending inventory. In the example above, Jeanne bought 2,000 shirts, each of which cost \$10. On December 31, 2018, Jeanne determines that she has 1,900 shirts remaining. The value of her ending inventory is \$19,000. That method of valuing is actual cost.

Example: Let's expand on the example. In 2019, the economy has picked up, and Jeanne is doing well. She has sold the 1,900 shirts that she had remaining in 2018 and has purchased an additional 5,000. But the cost has increased to \$11 per t-shirt. At the end of 2019, she has sold 4,900 shirts and has 2,000 t-shirts left in the ending inventory.

Jeanne has two options for how to value the ending inventory:

- ✓ **First-in first-out (FIFO)**—This method is exactly what it says: the first items purchased are considered the first items sold. Be aware that other factors can come into play under the FIFO method. If, for example, the inventory decreases in value, your client would need to value the ending inventory at either cost or FMV, whichever is lower.

In the example above, if Jeanne used FIFO, her ending inventory would be 2,000 at a cost of \$11 per shirt; thus, her ending inventory would be \$22,000.

- ✓ **Last-in first-out (LIFO)**—This method is the opposite of FIFO: the items that came in last or were purchased last would be the first to be sold. In most cases, this method would cause the cost of goods sold (COGS) to be higher, which is probably why the IRS requires the taxpayer to file a special Form 970, Application to Use LIFO Inventory Method.

In the example above, if Jeanne used the LIFO method, her ending inventory of 2,000 would be valued the following way: 1,900 of the t-shirts had a cost of \$10 each, and the last 100 had a cost of \$11. Her ending inventory would be lower (\$21,100), which would make the cost of goods sold higher.

Tax Preparer Tip

Be aware that you must check off the method used in valuing closing inventory on line 33 of Part III. In addition, the cost of any inventory used for personal purposes needs to be subtracted from the purchases and not included in the cost of goods sold section of the Schedule C. Your clients need to keep good records.

Example: Joyce sells lobsters. During the summer months, she purchases \$50,000 in lobsters, and her family eats \$1,000 worth. Her purchases on line 36 of the cost of goods sold section would be \$49,000 and not \$50,000 (Figure 17, below).

Figure 17: Cost of Goods Sold

Part III Cost of Goods Sold (see instructions)		
33	Method(s) used to value closing inventory: a ☒ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)	
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No	
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35
36	Purchases less cost of items withdrawn for personal use	36 49,000.
37	Cost of labor. Do not include any amounts paid to yourself	37
38	Materials and supplies	38
39	Other costs	39
40	Add lines 35 through 39	40 49,000.
41	Inventory at end of year	41
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42 49,000.

Other Expenses

This category is for any items that just don't fit in the above categories. Some businesses may have expenses that are ordinary and necessary in their business but are not that ordinary for other businesses. A dog trainer, for example, could deduct items like dog treats or dog toys. The "other" expense category is the place for those items.

Home Office Deduction

Use Form 8829 to record these expenses. When a client enquires about taking the home office deduction, your first question should be:

"Was the office used regularly and exclusively for business?"

For your client to qualify for this deduction, the area in the home must have been used "regularly" and "exclusively" for business **and** as the principal place of business or a place to meet with clients. A home office can also be a separate structure on the client's property, like a garage.

You can calculate the home office deduction using the regular method or a simplified option, using either for any taxable year. You choose a method by using that method on your client's timely filed, original federal income tax return for the taxable year. Once you have chosen a method for a taxable year, you cannot later change to the other method for that same year. If you use the simplified option for one year and the regular method for any subsequent year, you must calculate the depreciation deduction for the subsequent year.

The following chart (IRS Revenue Procedure 2013-13) compares the regular method with the simplified option.

Simplified Option	Regular Method
Deduction for home office use of a portion of a residence allowed only if that portion is exclusively used on a regular basis for business purposes	Same
Allowable square footage of home use for business (not to exceed 300 square feet)	Percentage of home used for business

Simplified Option	Regular Method
Standard \$5 per square foot used to determine home business deduction	Actual expenses determined and records maintained
Home-related itemized deductions claimed in full on Schedule A	Home-related itemized deductions apportioned between Schedule A and business schedule (Sch. C or Sch. F)
No depreciation deduction	Depreciation deduction for portion of home used for business
No recapture of depreciation upon sale of home	Recapture of depreciation on gain upon sale of home
Deduction cannot exceed gross income from business use of homeless business expenses	Same
Amount in excess of gross income limitation may not be carried over	Amount in excess of gross income limitation may be carried over
Loss carryover from use of regular method in prior year may not be claimed	Loss carryover from use of regular method in prior year may be claimed if gross income test is met in current year

Calculating the Home Office Deduction Using the Regular Method

First determine the square footage of the area used exclusively for business. You should consider using the square footage method as opposed to the 'number of rooms' method, because auditors have been known to pull up the client's house plan on the internet, and square footage is more accurate.

Example: Brad is an engineer and has seven rooms in his home. He tells you that he uses one of the rooms as a home office. The room is 12 × 11 or 132 square feet, and the entire house is 1,800 square feet. Under the number of rooms method, the percentage of Brad's house used as a home office would be 14.29%. Under the square footage method, the percentage of Brad's house used as a home office is only 7.33%. If the rooms were all the same size, then the room method would be fine to use. But, as you can see, the square footage method is more accurate (Figure 18, below)

Figure 18: Form 8829

Part I Part of Your Home Used for Business		Engineering Services	
1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)	1	132
2	Total area of home	2	1,800
3	Divide line 1 by line 2. Enter the result as a percentage	3	7.33 %
For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.			
4	Multiply days used for daycare during year by hours used per day	4	hr
5	Total hours available for use during the year (365 days x 24 hours) (see instructions)	5	8,760 hr
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3	7	7.33 %

Once you know the percentage, you can then apply those percentages to the client's mortgage interest, real estate taxes, house insurance, utilities, etc. Expenses directly related to the home office are fully deductible. **You must also depreciate the home office over 39 years.** The basis for depreciating the property is the lesser of the home's cost or FMV. As always, the cost or FMV of the land is not depreciated.

Example: Sally has worked as a tailor for many years. She decides to open her own business, using an empty bedroom in her house as a home office. She purchased her home in 2006 (when the market was high) for \$450,000. She tells you that the house is worth only \$400,000. You must depreciate the house using \$400,000 as a basis since it is the lesser amount.

Tax Preparer Tip

You should always take depreciation on a home office. Even a client who does not use the depreciation will have been deemed to have taken it by the IRS when selling the home; a client must recapture the allowable depreciation on the gain of the sale even if the home office was not depreciated. For this reason, always take the depreciation.

Certain expenses are deductible whether or not the client uses a home for business. If the client qualifies for the home office deduction, use the business percentage of these expenses to figure the total business use of the home deduction. Using these deductions on Schedule C instead of Schedule A is more advantageous because doing so reduces the amount of self-employment tax a client has to pay. These expenses include the following:

- ✓ real estate taxes
- ✓ qualified mortgage insurance premiums
- ✓ deductible mortgage interest
- ✓ casualty losses

Other expenses are deductible if the home is used for business. Use the business percentage for these expenses to figure the total business use deduction for the home office. These expenses generally include, but are not limited to, the following:

- ✓ depreciation
- ✓ insurance
- ✓ rent paid for the use of property a client does not own but uses in a trade or business
- ✓ repairs
- ✓ security system
- ✓ utilities and services

Example: Michelle is a writer and maintains an office in her home. She does not see any clients in her office. She gives you all of her expenses related to the office and wants to deduct a percentage of the lawn care and landscaping on her property. Michelle will have a difficult time convincing the IRS that landscaping should be a business expense, especially since she does not see any clients at her home office. A daycare provider would have a much better argument since the children use the lawn to play on.

Calculating the Home Office Deduction Using the Simplified Option

You may use a simplified option when figuring the deduction for business use of a client's home. This simplified option does not change the criteria for who may claim a home office deduction but merely simplifies the calculation and recordkeeping requirements of the allowable deduction.

When using the simplified option, you:

- ✓ use the standard deduction of \$5 per square foot of home used for business (with a maximum of 300 square feet)

- ✓ claim the deduction, along with other allowable home-related itemized deductions (e.g., mortgage interest, real estate taxes), in full on Schedule A
- ✓ cannot deduct home depreciation or later recapture depreciation for the years the simplified option is used

Example: Lauren is a new client and has been taking a home office deduction for the last several years. She finds it hard to maintain all the records. You explain to her that now she has an option to take a standard \$5 per square foot deduction for up to 300 square feet. Her home office is 245 square feet. The deduction would be \$1,225 ($\5×245). Lauren is very excited that it's so easy to calculate and is happy to use this method going forward. She also gets to take the full amount of her real estate taxes and mortgage interest on her Schedule A.

Comparing the Two Methods

Example: Adam is self-employed and has an office in his home. His home is 2,000 square feet, and his home office is 360 square feet. He has net income from self-employment of \$105,000, and he files single. His expenses are as follows:

- ✓ mortgage interest: \$5,600
- ✓ real estate taxes: \$3,200
- ✓ house insurance: \$800
- ✓ utilities: \$1,450
- ✓ depreciation: \$500
- ✓ state estimated taxes: \$4,000
- ✓ charity: \$500

Deduction using the **regular method**: \$2,489 ($\$11,050 (\$5,600 + \$3,200 + \$800 + \$1,450) \times 18\%$ plus \$500 in depreciation)

Deduction using the **simplified option**: \$1,500 ($300 \times \5)

Take care to do the calculation rather than just looking at the numbers. If Adam chooses the regular method for deducting his home office, he would owe \$15,888 in income taxes and \$14,484 in self-employment taxes, for a total of \$30,372. If Adam instead chooses the simplified option, he would pay income taxes of \$15,713 and self-employment taxes of \$14,624, for a total of \$30,337.

Your first reaction might be to tell Adam to use the regular method since it is a larger deduction by \$989, but Adam will pay \$35 less in taxes by using the simplified option. Notice that Adam pays less income tax and more social security tax but saves an overall \$35. In this case, the simplified option is a better choice since Adam will not have to recapture the depreciation and since more money goes into his social security account than if he uses the regular method.

	Regular Method	Simplified Option
Income tax paid	\$15,888	\$15,713
Self-employment tax paid	\$14,484	\$14,624
Total tax paid	\$30,372	\$30,337
Difference in tax paid	\$35 more	\$35 less

Tax Preparer Tip

Even though one method may seem better initially, you should calculate the taxes using all the information that you have. You may be surprised with the outcome.

Self-Employment Tax

Self-employment tax consists of Social Security and Medicare taxes primarily for individuals who work for themselves. Self-employment tax is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners.

You figure self-employment tax (SE tax) using Schedule SE (Form 1040). For self-employment income earned in 2018, the self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for social security (old-age, survivors, and disability insurance) and 2.9% for Medicare (hospital insurance).

For 2018, the maximum net self-employment earnings subject to the social security part of the self-employment tax is \$128,400. All of your client's earnings above \$128,400 in the current year are subject to the 2.9% Medicare part of self-employment tax. There is no cap on the Medicare part.

An additional Medicare tax also applies to wages, compensation, and self-employment income above a threshold amount. The rate is 0.9 percent.

Your client is liable for additional Medicare tax if his or her wages, compensation, or self-employment income (together with that of a spouse if filing a joint return) exceed the threshold amount for the client's filing status, as shown in the following chart:

Filing Status	Threshold Amount
Married filing jointly	\$250,000
Married filing separately	\$125,000
Single	\$200,000
Head of household (with qualifying person)	\$200,000
Qualifying widow(er) with dependent child	\$200,000

Hobby Losses

For tax purposes, a hobby is an activity engaged in primarily for a purpose other than to make a profit. Classic examples of hobbies are fun activities such as making arts and crafts, collecting things like coins and stamps, writing, collecting antiques, and photography. Even if your client occasionally makes money doing such an activity, it is a hobby if your client's prime motivation is having fun and not earning a profit. The following criteria help determine your client's intent to make a profit:

- ✓ whether your client keeps clear records of expenses and their purposes
- ✓ whether your client generates income
- ✓ your client's financial status
- ✓ whether your client has employees
- ✓ your client's expertise in that business
- ✓ time and effort spent by your client in carrying on the activity

An activity is considered a for-profit business if gross income exceeds deductions for three or more years out of five consecutive years. (For horse breeding, training, showing, or racing, the rule is two or more out of seven consecutive years.) A client who does not make a profit in at least three out of the last five years **may** have a hobby and therefore **might** not be allowed to file a Schedule C.

If the income from the business is a hobby, your client cannot deduct expenses from the hobby. Up until the passing of the Tax Cuts and Jobs Act these expenses could be deducted in a way that was less advantageous (and more complicated) than regular business deductions on Schedule C. Hobby income was reported on Form 1040, line 21 and hobby expenses were deductible only as a miscellaneous itemized deduction on Schedule A and are subject to 2% of your client's adjusted gross income.

But for tax years beginning in 2018 onwards, hobby income is reported on Schedule 1 (Form 1040), line 21, and expenses that were subject to the 2% AGI limit for miscellaneous itemized deductions under prior law are no longer deductible.

Keep an eye out for clients who continually show a loss on Schedule C.

Example: Maryann is a new client. She has a W-2 and also has a small business buying and selling antiques. She provides the last four years of tax returns at your request. Each year shows a loss on the return. You then start asking her more detailed questions about her business. She does not keep a separate checking account, she works on the business when she feels like it, and she doesn't advertise. These facts point to Maryann not being in business to make a profit. Maryann just loves antiques and buys and sells them as a hobby. You would not file a Schedule C for Maryann. You would put her income on line 21 of the Schedule 1 and inform her that her expenses are not deductible.

Summary

As you can see, Schedule C has many types of deductions and many rules that need to be followed. But now you have additional information to help you prepare a complete and accurate tax return for your clients.

Chapter 3 Review Questions

1. Your client runs a small business and has only one employee. At the end of the year, she had paid her employee \$10,000 in gross wages. A total of \$765 was withheld for social security and Medicare taxes from the employee's wages, and \$765 was paid by the employer. A total of \$500 in state taxes and \$1,500 in federal taxes was also withheld from the employee's wages. Your client is also responsible for paying an additional \$800 for state unemployment and worker's compensation. What amount should be put on line 26 for wages?
 - A. \$10,800
 - B. \$10,000
 - C. \$11,365
 - D. \$13,930
2. Your client is in the business of selling high-end dog shampoo to specialty stores around the country. Each bottle of shampoo costs \$3.10 to make. Your client produces 3,000 bottles. At the end of 2018, 400 bottles are left in inventory. What is the cost of goods sold?
 - A. \$9,300
 - B. \$1,240
 - C. \$3,100
 - D. \$8,060



Answers to Chapter 3 Review Questions

1.

- A. This answer is incorrect! Line 26 should contain only the \$10,000 in gross wages. The \$800 for state unemployment and worker's compensation should be included in the amount shown on line 23.
- B. That's correct! The gross wages of \$10,000 are entered on line 26. The employer's portion of FICA and other payroll related expenses for which the employer is responsible are entered on line 23.
- C. This answer is incorrect! Line 26 should contain only the \$10,000 in gross wages. The portion of the FICA and other payroll related expenses for which the employer is responsible are entered on line 23.
- D. This answer is incorrect! Line 26 should contain only the \$10,000 in gross wages. Line 23 should contain the FICA and other payroll related expenses for which the employer is responsible.

2.

- A. This answer is incorrect! The cost of producing each bottle is \$3.10. A total of 3,000 bottles were produced, and all but 400 were sold. The cost of goods sold is thus the cost of producing the 2,600 bottles ($3,000 - 400$) that were sold during the year. This calculation results in an amount lower than \$9,300.
- B. This answer is incorrect! The cost of goods sold is the cost of the bottles that are no longer in inventory because they were sold. 2,600 bottles were sold ($3,000 - 400$) and it is the cost of these bottles that the questions is asking about, not the cost of the bottles remaining to be sold.
- C. This answer is incorrect! A total of 2,600 bottles were sold ($3,000 - 400$), and the cost of each bottle was \$3.10. The cost of goods sold is thus greater than \$3,100.
- D. That's correct! The client sold a total of 2,600 bottles ($3,000 - 400$). The cost of goods sold for the year is thus the cost of producing those 2,600 bottles that were sold. Calculation: $2,600 \times \$3.10 = \$8,060$.

Glossary

at risk limits—The at-risk rules limit your losses from most activities to your amount at risk in the activity. You treat any loss that is disallowed because of the at-risk limits as a deduction from the same activity in the next tax year. If your losses from an at-risk activity are allowed, they are subject to recapture in later years if your amount at risk is reduced below zero. A loss is the excess of allowable deductions from the activity for the year (including depreciation or amortization allowed or allowable and disregarding the at-risk limits) over income received or accrued from the activity during the year. Income does not include income from the recapture of previous losses.

basis—A measure of an individual's investment in property for tax purposes.

capital asset—Includes virtually everything that is owned and used by the taxpayer for personal purposes, pleasure, or investment, such as stocks and bonds, household furnishings, automobiles, real property, and gems, jewelry, gold, and silver.

capitalized—Expended or treated as an item of capital nature. A capitalized amount is not deductible as a current expense and must be included in the basis of property.

commuting—Travel between a personal home and work or job site within the area of an individual's tax home.

convention—A method established under the Modified Accelerated Cost Recovery System (MACRS) to determine the portion of the year to depreciate property both in the year the property is placed in service and in the year of disposition.

declining balance method—An accelerated method to depreciate property. The General Depreciation System (GDS) of MACRS uses the 150 percent and 200 percent declining balance methods for certain types of property. A depreciation rate (percentage) is determined by dividing the declining balance percentage by the recovery period for the property.

depreciation—An annual deduction that allows taxpayers to recover the cost of property used in a trade or business or held for the production of income. The amount of depreciation depends on the basis of the property, its recovery period, and the depreciation method.

employer-paid health insurance—Health insurance coverage covering an employee that is paid for by an employer.

facts and circumstances—In making the distinction between a hobby or business activity, all facts and circumstances with respect to the activity are taken into account. No one factor alone is decisive. The most common factors that should normally be considered to establish that the activity is a business engaged in making a profit are the following:

- ✓ Whether you carry on the activity in a businesslike manner.
- ✓ Whether you, or your advisors, have the knowledge needed to carry on the activity as a successful business.
- ✓ Whether the time and effort you put into the activity indicate you intend to make it profitable.
- ✓ Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

- ✓ Whether you were successful in making a profit in similar activities in the past.
- ✓ Whether the activity makes a profit in some years, and how much profit it makes.
- ✓ Whether you depend on income from the activity for your livelihood.
- ✓ Whether your losses are due to circumstances beyond your control (or are normal in the startup phase of your type of business).
- ✓ Whether you change your methods of operation in an attempt to improve profitability.

ordinary and necessary expenses—In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit.

placed in service—Ready and available for a specific use whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

recapture—The requirement that a tax credit or deduction be repaid.

recovery period—The number of years over which the basis of an item of property is recovered.

repairs—A repair keeps a rental property in good operating condition. It does not materially add to the value of the property or substantially prolong its life.

Savings Incentive Match Plan for Employees—A plan better known as SIMPLE that enables employers with no more than 100 employees to establish and maintain a tax-favored retirement plan at minimal administrative cost. Although the employer is required to make annual contributions (rather than discretionary contributions as under a SEP), it is allowed a certain flexibility to make either matching or nonelective contributions.

self-employment income—Self-employment income is earned income from a trade, business, farming, or profession that is not paid by an employer. For example, seamstresses and lawn care workers who work for themselves (and not for someone else) are considered self-employed.

Simplified Employee Pension (SEP)—A plan comprised of employee-owned individual retirement accounts to which an employer may make discretionary contributions.

standard mileage rates—Per-mile amounts that a taxpayer may use to deduct car expenses in lieu of deducting the actual expenses incurred by the taxpayer.

straight line method—A way to figure depreciation for property that ratably deducts the same amount for each year in the recovery period. The rate (in percentage terms) is determined by dividing by the number of years in the recovery period.

tangible personal property—Any property other than land or buildings that can be seen or touched. It includes furniture, books, jewelry, paintings, and cars.

unadjusted basis—The same basis used to figure gain on a sale but without reducing the original basis by any MACRS depreciation taken in earlier years. However, the original basis is reduced by other amounts claimed on the property, including:

- ✓ any amortization
- ✓ any Section 179 deduction
- ✓ any special depreciation allowance



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