2023 Navigating Form 1040 Schedule C

INSTRUCTOR: Chris Nadeau

- Chris Nadeau, CMA, CPA, CVA
  Forensic and Valuation Services Manager
  WithumSmith+Brown PC ("Withum")

-18 Years in the accounting industry;
-Most of those years spent in regional accounting firms working with individuals and closely-held businesses;
-Current practice focuses on:
  -Business valuations for estate and gift tax purposes, succession planning, divorce, and shareholder disputes;
  -Economic damage calculations
  -Forensic accounting

Introduction

There is little doubt in the minds of many observers that the world of work—an environment in which a legion of wage earners commute to an employer's office or worksite to toil from 9 to 5—is changing, and that impression is bolstered by recent studies. Among those studies is a Gallup report titled "The Gig Economy and Alternative Work Arrangements." The changing nature of work for many taxpayers is likely to have an effect on tax preparers' need to prepare Schedule C.

Introduction (cont.)

The gig economy, an economy characterized by multiple types of alternative work arrangements including independent contractors, online platform workers, contract firm workers, on-call workers, and temporary workers, engages 36% of U.S. workers. Gallup, in its report, also estimates that 29% of all workers in the U.S. have an alternative work arrangement as their primary job.

Introduction (cont.)

Whether the strength of the gig economy is due to the flexibility and freedom it affords, the fewer limits on income it exerts compared to being a wage earner or results from some other advantage it offers, it seems clear that, barring a cataclysmic event affecting the economy, the gig economy is here to stay and intent on growing larger with each year. With that growth is the likely growth of tax preparers' need to be familiar with preparation of Schedule C.

Course Learning Objectives

- Identify the types of income reported on Schedule C;
- Determine proprietors' installment sale income when using the installment method;
- Describe the business expenses deductible on Schedule C;
- List the differences between a business and a hobby; and
- Apply the rules governing the deduction for business use of a taxpayer's home.

Chapter 1 – Elements of Proprietor Income

Examining Part I of Schedule C (Form 1040), the components of sole proprietors' income:

- The common law test used in determining the nature of a taxpayer's employment status;
- The tax treatment of one-owner limited liability companies;
- Completion of Schedule SE (Form 1040);
- Independent contractors treated as employees for purposes of employment tax;
- Determining proprietors' installment sale income under the installment method; and
- Installment sale imputed interest income

Learning Objectives

- Identify the factors included in the common law test used to determine a taxpayer's status as self-employed;
- Recognize what constitutes business income;
- List the categories of taxpayers generally identified as "statutory employees";
- Describe the tax treatment of installment sales whose gain is recognized under the installment method; and
- Identify the role of the applicable federal rates (AFRs) in connection with the installment method.

- **When is a Taxpayer Considered Self-Employed** Under the common-law test, the taxpayer is considered an employee if the employer has the right to direct him or her in regard to what to do, how, when, and where to do the job. If that control does not exist, the taxpayer should normally be deemed a self-employed person.
  - Taxpayer is also considered a sole proprietor for income tax purposes if he or she is an individual and the only member of a domestic limited liability company (LLC) unless the taxpayer has elected to have the LLC treated as a corporation.

- People who provide a service generally associated with the gig (or on-demand, sharing, or access) economy, such as ride-sharing—taxpayers who are drivers for Lyft or Uber, for example—may be treated as independent contractors, depending on the facts in each case. The general rule followed to determine the nature of the employment is the common law control test.
- One-owner LLCs are treated as a sole proprietor for tax purposes.

- **Business Income Defined** If there is a connection between any income the taxpayer receives and the taxpayer's business, the income is considered business income.
  - A connection exists between a taxpayer's income and the taxpayer's business if it is clear that the payment of income would not have been made if the taxpayer did not have the business.
  - Income from work the taxpayer performs in addition to his or her regular job can be business income and includes amounts the taxpayer received that were properly shown on Forms 1099-NEC as nonemployee compensation in box 1 of the form.

- A self-employed taxpayer must file Form 1040 Schedule SE, Self-Employment Tax, if:
  - Net earnings from self-employment, excluding church employee income, were $400 or more; or
  - The taxpayer had church employee income of $108.28 or more.

- **Completing Schedule C** The gross income of a self-employed taxpayer includes:
  - The amount on Schedule C (Form 1040), Profit or Loss From Business;
  - The amount on Schedule C–EZ (Form 1040), Net Profit From Business; and
  - The amount on Schedule F (Form 1040), Profit or Loss From Farming.

- **Statutory Employees** Taxpayers who are independent contractors under the common law test but treated as employees (rather than independent contractors) for employment tax purposes are referred to as "statutory employees."
  - Social Security and Medicare taxes of statutory employees are withheld from their earnings by the payer.

- Taxpayers considered statutory employees fall within one of the following four categories –
  1. A driver who –
     i. Distributes beverages or meat, vegetable, fruit, or bakery products; or
     ii. picks up and delivers laundry or dry cleaning, if the driver is the payer's agent or is paid on commission;
  2. A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company;

3. An individual who works at home on materials or goods that the payer supplies and that must be returned to the payer or to a person named by the payer, if the payer also furnishes specifications for the work to be done; and
4. A full-time traveling or city salesperson who works on the payer's behalf and turns in orders to the payer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the payer must be the taxpayer's principal activity.

- In addition to falling into certain categories, taxpayers must also meet the following conditions to be considered statutory employees:
  - The service contract between the payer and the taxpayer states or implies that substantially all the services are to be performed personally by the taxpayer;
  - The taxpayer does not have a substantial investment in the equipment and property used to perform the services for the payer other than an investment in transportation facilities (typically a personally-owned vehicle); and
  - The services are performed on a continuing basis for the same payer.

- Report statutory employee income from box 1 of Form W-2 on line 1 of the Schedule C and check the box on that line. Social security and Medicare tax would have been withheld from the taxpayer's earnings. As a result, the taxpayer doesn't owe self-employment tax on these earnings received as a statutory employee.
  - Because of the different tax treatment of the income for self-employment taxes, a taxpayer who had both self-employment income and statutory employee income, must file two Schedules C.

- **Installment Sales** A taxpayer who sells property for which he or she receives payment over more than a single year—an installment sale, in other words—will recognize income under the installment method unless –
  - The installment method is unavailable; or
  - The taxpayer elects out of recognizing income under the installment method by recognizing the income in the year of the sale;

- The taxpayer's total gain on an installment sale is generally the amount by which the selling price of the property the taxpayer sold exceeds the taxpayer's adjusted basis in that property.
- The selling price of property sold by the taxpayer includes:
  - The money and the fair market value of property the taxpayer received for the sale of the property;
  - Any of the taxpayer's selling expenses paid by the buyer; and
  - Existing debt encumbering the property that the buyer pays, assumes, or takes subject to.

- Under the installment method, the taxpayer includes in income each year only part of the gain the taxpayer receives or is considered to have received.
- The taxpayer doesn't include in income the part of the payment that's a return of the taxpayer's basis in the property.

- Each payment received in an installment sale normally consists of –
  - Interest income;
  - Return of the seller's adjusted basis in the property; and
  - Gain on the sale.
- An installment sale contract may provide that:
  - Each deferred payment on the sale includes interest; or
  - There will be an interest payment in addition to the principal payment.

- **Determining Installment Sale Income** Interest provided in the installment sale contract is called stated interest.
- **Applicable Federal Rate** If an installment sale contract doesn't provide for payment of interest or provides for interest that is less than adequate, part of the stated principal amount of the contract may be recharacterized as interest.
  - An installment sale contract doesn't provide for adequate stated interest if the stated interest rate is lower than the test rate, a 3-month rate based on the applicable federal rates (AFRs).

- **Reporting Interest** The taxpayer must include in income any stated or imputed interest in connection with an installment sale as ordinary income.

- **Cost of Goods Sold (COGS)**—the amount appearing on Schedule C, line 4, is the cost incurred to make or buy goods to sell.
  - COGS is deducted from a Schedule C taxpayer's gross receipts to determine gross profit shown on Schedule C, line 5.
- **Figuring COGS for Merchant Clients** Calculating COGS for a merchant taxpayer is done on Schedule C in Part III, lines 35 through 42.

- **Beginning Inventory** For a merchant taxpayer, beginning inventory is the cost of merchandise on hand at the beginning of the year that is available to be sold to customers and is usually identical to the closing inventory of the year before.
- **Trade Discounts** A trade discount is the reduction in the retail price at which a manufacturer sells goods to a reseller.

- **Cash Discounts** A cash discount is an amount a merchant taxpayer's suppliers permit the merchant to deduct from their purchase invoices for prompt payments.
- **Cost of Labor** The only kinds of labor costs properly chargeable to the taxpayer's cost of goods sold are the direct or indirect labor costs and certain other costs treated as overhead expenses.

Chapter 2 – Elements of Proprietor Part II Expenses

Examining the expenses, other than those associated with the business use of a taxpayer's home, that a sole proprietor may deduct on Part II of Schedule C (Form 1040) and will discuss:

- The nature of business expenses and the criteria for their deductibility;
- The business expenses that may be deducted on Schedule C;
- The various taxes that may be deducted and those that are non-deductible; and
- The expenses for business travel and meals.

Learning Objectives

- Identify the requirements that business expenses must meet to be deductible;
- Recognize the insurance expenses that a Schedule C taxpayer may deduct;
- Describe the difference between a business and a hobby; and
- List the taxes and licenses that are deductible on Schedule C.

- **Business Expenses** Business expenses are the costs of operating the taxpayer's business that can be deducted on Schedule C in the current year.
  - To be deductible, a business expense must be ordinary, and necessary.
  - Schedule C is used to report a taxpayer's income or loss from a business operated or profession practiced as a sole proprietor.
  - A hobby, for tax purposes, is an activity not engaged in for profit or income.

- **Business vs. Hobby Considerations:** To determine if an activity engaged in by the taxpayer is a business or hobby, the following factors should be considered:
  -Does the time and effort put into the activity indicate the taxpayer intended to make a profit?
  -Does the taxpayer depend on income from the activity?
  -If the activity results in losses, are the losses due to circumstances beyond the taxpayer's control, or did they occur in the start-up phase of the business?
  -Has the taxpayer changed methods of operation to improve profitability?
  -Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
  -Has the taxpayer made a profit in similar activities in the past?
  -Does the activity make a profit in some years?
  -Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

- A hobby, for tax purposes, is an activity not engaged in for profit or income. Any income from a hobby is reported on Form 1040 as "Other Income."

  Because the TCJA eliminated miscellaneous itemized deductions, hobby expenses are no longer deductible.

- **Completing Schedule C** Schedule C, lines 8 through 27 call for a self-employed taxpayer to identify and report the expenses, other than the expenses for business use of the taxpayer's home, that may be deducted from gross income.
  - A sole proprietor's costs must be ordinary and necessary to be tax deductible, i.e., common and accepted in the industry, and deemed to be helpful and appropriate for the trade or business.
- **Advertising** The tax law allows businesses to deduct expenses (Schedule C, line 8) that help them bring in new customers and keep existing ones. These costs may include expenses for advertising and marketing.

- **Car and Truck Expenses** The taxpayer can deduct (Schedule C, line 9) the actual expenses of operating a car or truck or take the standard mileage rate when used in the taxpayer's business.
  -If standard milage rate method is selected, multiple the number of business miles driven in 2023 by $.655 and add to the taxpayer's parking fees and tolls.

- **Depreciation & Section 179 Expense Deduction** Depreciation is an allowance (Schedule C, line 13) for the wear and tear, deterioration, or obsolescence of the property used in a business.
- **Bonus Depreciation** Prior tax law permitted businesses to take a tax deduction – generally referred to as first-year bonus depreciation – equal to 50% of qualified properties' adjusted basis.
  -The TCJA extended bonus depreciation and increased it. A business may take a 100% first year deduction equal to the adjusted basis of qualified property purchased and placed in service after 9/27/2017 and before 1/1/2023

- **Eligible Property** Property eligible for 100% bonus depreciation was expanded under the TCJA to include used qualified property provided that all the following conditions apply:
  -The property was not used by the taxpayer at any time before its acquisition;
  -The property was not acquired by the taxpayer from a related party;
  -The taxpayer did not acquire the property from a component member of a controlled group of corporations;
  -the taxpayer's basis of the acquired used property is not figured by reference to the adjusted basis of the property in the hands of the seller or transferor; and
  -The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.

- The 100% expensing permitted under the TCJA declines by 20% each year for qualified property purchased and placed in service after December 31, 2022. Accordingly, the bonus depreciation deduction is reduced to:
  - -80% for property placed in service in 2023;
  - -60% for property placed in service in 2024;
  - -40% for property placed in service in 2025; and
  - -20% for property placed in service in 2026.

  Bonus depreciation under the TCJA ends after 2026. The term "qualified property," as it is used in connection with 100% expensing, means property having a recovery period of 20 years or less an which is:
  - -Computer software;
  - -A qualified film or television production; or
  - -A qualified live theatrical production.

- **Luxury Auto Depreciation Limits** The additional "bonus" first year depreciation deduction does not apply to a passenger car placed in service by the taxpayer if the taxpayer:
  -Did not use the passenger automobile during 2023 more than 50% for business purposes;
  -Elected out of the additional first-year depreciation deduction for the class of property including passenger automobile;
  -Acquired the passenger automobile used and the acquisition of it failed to meet the acquisition requirements of section 168(k)(2)(e)(ii); or
  -Acquired the passenger automobile before September 28, 2017 and placed it in service after 2019.

  The luxury auto limits applicable are shown on page 26 of the course text.

- **Section 179 Expense Limits** The TCJA increased the amount a business is permitted to expense rather than being required to depreciate and made further enhancements under Code Section 179 with respect to section 179 property the taxpayer places in service in tax years beginning after December 31, 2017. Under the TCJA:
  -The dollar limitation on the value of property that may be expensed in the year in which it is placed in service is $1,160,000 (2023);
  -The phaseout threshold for a taxpayer's ability to expense eligible property is $2,890,000 (2023);
  -The definition of Code Section 179 property is expanded to include –
  -depreciable tangible personal property used principally to furnish lodging
  -certain improvements to nonresidential real property such as roofs, heating, ventilation and air-conditioning property, fire protection and alarm systems, and security systems.

- **Listed Property** The term "listed property"-types of property used in a business that have both personal and business uses – generally includes but isn't limited to:
  -Passenger automobiles weighing 6,000 pounds or less;
  -Any other property used for transportation if the nature of the property lends itself to personal use, such as motorcycles, pickup trucks, etc.; and
  -Any property used for entertainment or recreational purposes (such as photographic, phonographic, communication, and video recording equipment).

  Exception to listed property – Listed property doesn't include photographic, phonographic, communication or video equipment used exclusively in the taxpayer's trade or business or at the taxpayer's regular business establishment.

- **Employee Benefit Programs** Deduct contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan included on line 19. Benefit programs whose contributions would be reported on line 14 are programs such as:
  -accident and health plans
  -group-term life insurance; and
  -dependent care assistance programs.

  The taxpayer cannot deduct contributions made on his or her own behalf as a self-employed person for group-term life insurance or to an accident and health plan on Schedule C.

- **Insurance** The taxpayer can deduct premiums paid for certain kinds of insurance related to the taxpayer's trade or business on Schedule C, line 15 but not for –
  - Self-insurance reserve funds, i.e. the reserve set up for self-insurance;
  - Loss of earnings resulting from the insured's sickness or disability;
  - Life insurance or annuities under which the taxpayer is a beneficiary; or
  - Insurance to secure a loan.

- **Interest** Tax treatment of interest, which may be deducted on Schedule C, line 16, varies depending on the type of interest and the manner in which borrowed funds are used.
- **Legal and Professional Services** Fees charged by accountants and attorneys that are ordinary and necessary expenses directly related to operating the taxpayer's business are entered on Schedule C, line 17.
- **Office Expenses** Costs incurred for postage and office supplies are shown on Schedule C, line 18.

- **Pension and Profit Sharing Plan** Contributions made for the benefit of the taxpayer's employees, but not for the self-employed person, to a pension, profit-sharing, or annuity plan are shown on Schedule C, line 19.
- **Rent or Lease of Property or Equipment** Leased business vehicle expenses entered on Schedule C, line 20a can be determined using the standard mileage rate or actual expenses.
- **Repairs and Maintenance** Enter on Schedule C, line 21 the cost of incidental repairs to and maintenance of property used in the taxpayer's business.

Deductible on Line 23

- State and local sales taxes;
- Real estate and personal property taxes on business assets;
- Most license and regulatory fees;
- Matching employee Social security and Medicare taxes;
- Federal unemployment tax;
- Federal highway use tax;
- Contributions to state unemployment insurance fund or disability benefit fund if considered taxes under state law.

Not deductible on Line 23

- Federal income taxes;
- Estate and gift taxes;
- Taxes assessed to pay for improvements;
- Taxes on taxpayer's home or personal use property;
- State and local sales taxes;
- Other taxes and license fees not related to the taxpayer's business.

- **Travel** Taxpayer's expenses incurred for business travel are entered on Schedule C, line 24a, but not for spouse unless employee and trip has bona fide business purpose.
- **Deductible Meals** 100% of cost for business meals in a restaurant entered on Schedule C, line 24b through 2022; otherwise deduction generally limited to 50%. Entertainment costs disallowed through 2025.
- **Utilities** Utility expenses incurred in taxpayer's trade or business are entered on Schedule C, line 25.

- **Wages** The total of wages paid to employees during the year, reduced by certain credits payable to the taxpayer, is entered on Schedule C, line 26.
- **Other Expenses** The total of other ordinary and necessary business expenses not deducted elsewhere on Schedule C is entered on line 48 of Schedule C, part V and reported on line 27a.

Chapter 3 – Business Use of a Home

A taxpayer who qualifies for a home-office deduction may use actual expenses or a simplified method to determine the deduction, each of which are subject to a deduction limit. This chapter will examine how home-office deductions are figured using both regimes.

Learning Objectives

- Distinguish between the actual expense method and simplified method of figuring the home-office deduction;
- List the expenses normally deductible by taxpayers using a home for business purposes who use the actual expense method; and
- Recognize the limits applicable to a home-office deduction.

- **Business Use of a Home** A taxpayer who qualifies for a home-office deduction may calculate that deduction using the actual expense method or the simplified method.
- **Actual Expense Method** Using the actual expense method of determining the home-office deduction requires that the taxpayer's expenses be identified as a) direct expenses, b) indirect expenses, and c) unrelated expenses.

- **Nature of the Expense**
  - Direct expenses apply to and affect only the business part of the taxpayer's home. Generally, these expenses are deductible in full.
  - Indirect expenses are incurred by the taxpayer for keeping up and running his or her entire home and are deductible under the home-office deduction based on the percentage of the taxpayer's home used for business purposes.

- **Calculating Percentage of Home Used for Business** A taxpayer may use any reasonable method to determine the percentage of the home used for business purposes.
  - Two methods are commonly used to determine the percentage of a home used for business purposes:

    a) dividing the square footage of the home used for business purposes by the total square footage of the home, and

    b) dividing the number of rooms used for business by the total number of rooms in the taxpayer's home.

- **Expenses Deductible by All Homeowners** Deductible expenses under the home-office deduction include expenses that are deductible by all homeowners whether or not the home is used for business purposes—real estate taxes, deductible mortgage interest and federally-declared disaster area casualty losses, for example—and expenses that are deductible by the taxpayer only if the taxpayer uses the home for business.
- **Expenses Deductible only by Taxpayers Using a Home for Business** Additional deductible expenses by homeowners who use their homes for business purposes include depreciation, insurance, rent paid for the use of unowned property used in the taxpayer's trade or business, repairs, security system maintenance and monitoring expenses, and expenses for utilities and services.

- **Deduction Limit** A taxpayer who uses the actual expense method for claiming a home-office deduction is limited as to the deduction of otherwise nondeductible expenses.
  - The limitation applicable to the deduction of otherwise nondeductible expenses by a taxpayer using the actual expense method is equal to the taxpayer's gross income from the business minus the sum of –
    - the business portion of expenses the taxpayer could deduct even if he or she did not use the home for business purposes, and
    - the business expenses that relate to the business activity in the home but not to the home itself.

- In applying the limit to a taxpayer's home-office deduction, the depreciation deduction should be taken last.
- If the taxpayer's home-office deduction in any year is reduced by the deduction limit, the taxpayer may carry over the excess to the next year in which he or she uses the actual expense method in claiming a home-office deduction. The carried-over expenses are subject to the deduction limit for the year to which they are carried over, whether or not the taxpayer lives in the same home during that year.

- When a taxpayer derives his or her gross income from more than one trade or business and a portion of the gross income comes from business use of part of the taxpayer's home and a portion from a place other than the taxpayer's home, the tax return preparer must determine how much of the taxpayer's gross income is attributable to the business use of the taxpayer's home—based on the time the taxpayer spends at each location, the business investment in each location and any other relevant facts and circumstances—before figuring the limit that applies to the home office deduction.

- **Simplified Method** When calculating the home-office deduction using the simplified method, the deduction is equal to the area of the taxpayer's home used for a qualified business use (not exceeding 300 ft.²) multiplied by the "prescribed rate," currently $5.
  - A taxpayer electing to use the simplified method of determining the home-office deduction cannot deduct depreciation or any actual expenses other than those deductible expenses not related to use of the home.

- The home-office deduction of a taxpayer who has a qualified business use only for part of the taxable year or who changes the square footage of the home office during the year is based on the average monthly allowable square footage used.
- In the case of a taxpayer using the simplified method, the home-office deduction is limited to an amount equal to the taxpayer's gross income derived from the qualified business use of the home reduced by the business deductions that are unrelated to the use of the taxpayer's home.

Chapter 4: General Information Pertaining to the Schedule C

As tax practitioners, we should realize that the Schedule Cs we prepare for our clients may be looked at and used by others beyond the IRS and the client;

-Bankers
-Potential buyers; future partners;
-Forensic accountants; litigation support, divorce cases;

Remember to keep good workpapers that reconcile the information provided by clients to the Schedule C as filed. Remember your work papers could be subpoenaed.

Schedule C requires the following information pertaining to your client be disclosed:

-Business name and address
-Tax identification number: Social Security Number or EIN
-Business code: Six-digit industry code from the North American Industry Classification System (NAICS) that best describes the industry your client operates in;
-Accounting Method: Reporting method your client uses for to determine reportable income and expenses; Generally Cash or Accrual;
-Business participation: Whether your client is actively participating in the business or is passive;
-Started Business: Disclosure whether the business was started or acquired in the current year;
-1099 reporting: Indicate whether your client was required to file Form 1099-NEC, and if those forms were appropriately filed.

Accounting Methods

Cash method: Your client reports income when it is actually or constructively received (whether your client had "control" over the funds or not)

Timing issues: Sometimes 1099s will include payments near year end that your client received in January of the subsequent year. If a corrected 1099 can not be obtained, report the income and make an adjustment. Be sure to record the income the following year.

Prepayments: Generally prepayments that relate to services or subscriptions beyond 12 months are not deductible.

-Generally all income derived from the business must be reported as gross income on the Schedule C;
-IRS has identified industries that are cash receipt heavy; i.e. convenience stores, restaurants, beauty shops;
-Income from bartering is required to be reported;
- Cash payments received in excess of of $10,000 should be reported on Form 8300, Report of Cash Payments of $10,000 Received in a Trade of Business; form must be filed no later than 15 days after the receipt of the cash;
-Prepayments such as retainers are generally not includable in income until your client has earned the funds are no longer restricted.

Accrual Method: Income is reported as it is earned. Expenses are deducted when incurred rather than when they are paid.

Other:
Percentage-of-completion method: Generally used by contractors when projects cannot be completed within one year. Income and expenses are estimated based on the work done to date.

Spousal Partnerships
-Can jointly elect to be treated as a qualified joint venture instead of a partnership;
-Both spouses must materially participate in the business;
-Eliminates the need for a 1065;
-Enables each spouse to receive credit for Social Security;
-Each spouse files a separate Schedule C and Schedule SE.

When an individual operates two separate businesses, two Schedule Cs should be filed.

Other Forms

Other forms that may need to be filed in addition to Schedule C may include:
- -Form 4562, Depreciation and Amortization;
- -Form 4797, Sales of Business Property;
- -Form 8829, Expenses for Business Use of Your Home;
- -Form 3800, General Business Credit.

Chapter 5 – Deductions: A Deeper Dive

Business travel/driving

Clients with a home office may deduct driving to and from home for business driving. Deductible travel may include such destinations as:
- -Customers meetings/sales calls
- -Networking events
- -Stores to purchase supplies
- -Post office/UPS store

If your client works from an office location, their commute back and forth to the office and home is not deductible. Once your client is at the office, they may deduct travel to and from business destinations.

Tracking Auto Expenses: Clients should maintain a mileage log that includes the number of miles travelled, the destination and the purpose of the trip.

For actual expenses, clients should keep receipts that substantiate deductions is the actual expenses method is elected.

Business gifts

Clients can deduct up to $25 in gifts to each person (the same limit that's been in place since 1962). This does not include the cost of shipping.

Record keeping for gifts:
-Cost of the gift
-Date of the gift
-Description of the gift
-Business purpose of the gift
-Relationship of the recipient to your business

Chapter 6 – Other Tax Saving Strategies for Self-Employed Individuals

Health Savings Accounts

Clients who have high deductible health plans may also take advantage of Health Savings Accounts (HSAs). Potential tax advantages include:
- -Tax deductible contributions
- -Tax deferred earnings
- -Withdrawals to pay qualified medical expenses are tax free

Eligibility: An individual may enroll in an HSA the first day the month in which they are covered by a high-deductible health plan.

Self-Employed Health Insurance Deduction

Self-employed individuals can generally deduct the premiums paid to cover themselves and their families.

These are deducted as a personal expense on Schedule 1, Form 1040, not as a deductible business expense. Thus, it does not reduce self-employment tax.

However, the premiums reduce the client's Qualified Business Income when calculating the Qualified Business Income Deduction.

To qualify, the client's premiums can not exceed business income.

Your client must have net earnings from the business from the sole proprietorship.

Self-employed people are not eligible to take the deduction when they are eligible to participate in any employer-subsidized health plan (including their spouse's).

Chapter 5 - Advising our Self-Employed Clients

Being a trusted advisor to our clients bolsters our relationships and makes us more value-adding.

Be proactive with our client communication;
-A lot of projects can come out of phone calls and lunches with your existing client list;
-These touches help to instill trust and build the relationship
-These touches also help you be in their mind throughout the year, when referrals come up

-Have your client apply for an EIN so they don't have to use their SSN; easy to do online on the IRS's website;

EINs are required when your client has:
-Bank accounts
-Payroll
-Retirement plan

To obtain an EIN:
-Go to IRS website; or
-File Form SS-4, Application for Employer Identification Number

-Open a bank account just for the business (often your client will need an EIN to do this);
-Consider a credit card just for business use
-A separate bank account and credit card strictly for business creates in itself, a separate "accounting system" where deposits are generally income and withdrawals expenses
-This is helpful if the client gets audited

-Set up some form of accounting system – QuickBooks, Quicken, Excel; something electronic;
-Set up a filing system for paper documents, receipts, etc.; have them keep these files for a minimum of 3 years

Chapter 6 - Out Growing the Schedule C

While many companies may never be more than a "side hustle" its not uncommon that sole proprietorships may "outgrow" the Schedule C

Common reasons for changing to another entity structure include:
-Partnership with another individual(s)
-By default, this creates a Partnership which is required to file a form 1065
-Desire for limited liability – may create an LLC, or decide to incorporate
-Tax savings on self-employment tax
-Potential for future "capital raises"

- Considerations for Selecting the Proper Entity
  - -Flexibility of distributions to owners
  - -Limited liability protection
  - -Tax rates
  - -Character of business income
  - -Business losses
  - -Employment taxes
  - -State taxes

- Introduction to Other Entity Selections

  1. Partnerships

  -Entity is not subject to Federal income tax

  -Partnership files a Form 1065 and the income is reported to partners using a Schedule K-1, then reported on individual partners' income tax returns

  -Income, gains, loses and deductions keep their "attributes"

  -Individual partners can claim the Qualified Business Income Deduction to offset partnership income

  -Partners do not take a salary; Partners take "Guaranteed Payments" for their services to the Partnership

- Partnerships are governed by Subchapter K of the Internal Revenue Code.

  General partners: participate in managing the partnership; Limited partners: generally not permitted to participate in management;

  General partnerships, limited partnerships and limited liability partnerships (LLP)

  LLPs partner is not liable for any malpractice committed by other partners;

•Formation of a Partnership: Tax Effects

Generally, neither the partner nor the partnership recognizes any realized gain or loss arising on contribution of property to a partnership. Realized gain or loss is deferred.

Example: John transfers assets to the Partnership A on the day the entity is created in exchange for a 70% profit and loss interest worth $100,000. He contributes assets with a tax basis of $70,000 and a fair market value of $100,000. While John realizes a $30,000 gain, the gain is not recognized in the year of contribution. John has not received an economic benefit from the transaction that would allow him to pay tax on the gain. (Wherewithal to pay concept).

Exceptions to the non-recognition principal apply, including:
1. Appreciated stocks contributed to an investment partnership;
2. Disguised sales or exchanges of properties; or
3. Partnership interests received in exchange for services rendered by the partner;

Partnership takes a carryover basis in the contributed assets it receives. Partner's basis in asset becomes partnership's basis.

-The partner takes the substituted basis in the partnership interest.
-Partner's basis in the contributed assets become the partner's outside basis in the partnership.

-The partner's holding period in the asset(s) contributed carry's over to partnership and generally depreciated using the same remaining estimated useful life.

- Corporations

Corporations are governed by Subchapter C or Subchapter S of the Internal Revenue Code;

C-Corporations:
-Tax paying entities
-File form 1120
-Subject to a flat 21% income tax; regardless of character of business income
-Corporate losses are retained at the entity level and used to offset past and/or future corporate income;
-Corporate form of business generally used when capital raising is anticipated;
-Subject to double taxation

- S Corporations
-Similar to partnerships in that they are not a taxpaying entity;
-Income flows through to individuals via Schedule K-1;
-Distributions to owners must be in proportion of ownership %;
-Often used by sole proprietors to save on self-employment tax.

- Contributions of Assets to Corporations
-Governed by Section 351 of the IRC:
-Shareholder gain or loss is deferred when property is transferred to a controlled corporation in exchange of stock.

Example: Alex is contemplating the incorporation of his sole proprietorship to benefit from the limited liability provided by the corporate structure. Recognizing that, depending on state regulations, his personal liability would be restricted to the business debts he explicitly guarantees, Alex intends to transfer equipment with a tax basis of $320,000 and a fair market value of $420,000. In this process, Alex would establish a $320,000 basis in the stock, deferring the recognition of a $100,000 gain.

- Limited Liability Companies
  - -Provides the benefit of limited liability
  - -Qualifying businesses may be treated as proprietorships or partnerships for tax purposes
    - -LLCs with only one member are by default "disregarded entities for tax purposes"
  - -By default, a multi-member LLC is taxed as a partnership
  - -May elect to be taxed as an S-Corporation

Questions