**Chapter Three**

**Business Income and Expenses, Part I**

**Learning Objective 3.1 Schedule C**

A taxpayer who operates a sole-proprietorship must file either a Schedule C (long form) or a Schedule C-EZ (short form). To be able to use the short form, the following conditions must be met:

1. Business expenses must be $5,000 or less
2. No inventory is maintained
3. The business did not result in a net loss
4. Only one business is owned by the taxpayer
5. The business had no employees
6. No depreciation is taken
7. No home office deduction is taken
8. No prior year disallowed passive losses exists
9. The cash method of accounting is used

If a taxpayer has a farm or farming activity, the taxpayer should report the information on a Schedule F instead of Schedule C. Schedule C income contains the calculation of the taxpayer’s gross income from the business. Expenses are listed on Part II of the Schedule C. For businesses with inventories, the cost of goods sold is computed in Part III of Schedule C. Information related to business vehicles is listed in Part IV and other expenses are detailed in Part V of Schedule C. Self-employment tax must be reported on any Schedule C income over $400.

**Learning Objective 3.2 Inventories**

The cost of inventory (or cost of goods sold) can be the largest expense of a taxpayer. Inventory cost is calculated as follows:

Beginning Inventory + Purchases = Costs of Goods Available for Sale

Costs of Goods Available for Sale – Ending Inventory = Cost of Goods Sold

Since businesses purchase items throughout the tax year at various prices, the taxpayer must choose a method of inventory valuation. The two most common methods are first in, first out (FIFO) and last in, first out (LIFO). The method does not have to represent the way the business really operates, but is a tool to evaluate the inventory and the cost of goods sold. Once a taxpayer makes the election of inventory valuation, no change can be made without the consent of the Internal Revenue Service.

**Learning Objective 3.3 Transportation**

Certain transportation expenses are deductible for taxpayers. Travel by airplane, rail, bus and the cost of operating and maintaining an automobile are deductible. If a taxpayer has two or more jobs during the same day, the distance from location to location is deductible. The standard mileage rate is 56 cents per mile for 2014. To use the standard rate, the taxpayer must:

1. own or lease an automobile,
2. not operate a fleet of automobiles using five or more at the same time,
3. not have claimed depreciation on the automobile using any method other than straight-line and
4. not have claimed Section 179 deprecation or bonus depreciation on the automobile.

If the taxpayer chooses to use actual cost for the deduction, the costs must be substantiated. The expenses must be prorated between personal and business miles.

**Learning Objective 3.4 Travel Expenses**

Travel expenses are defined as ordinary and necessary expenses incurred in traveling away from home in pursuit of the taxpayer’s trade or business. These expenses should be substantiated and not extravagant. Most travel expenses are fully deductible but only 50 percent of the cost of meals is deductible. To deduct travel expenses, the taxpayer must stay “overnight.”

**Learning Objective 3.5 Meals and Entertainment**

Taxpayers who are self-employed and employees are allowed a deduction for up to 50% of their meals and entertainment costs in connection to a business or trade. The costs of entertainment facilities, such as a yacht, are strictly limited. The costs of depreciation, maintenance and other fees with these entertainment facilities are not deductible. Typically, club dues are not deductible; however, dues to professional organizations and certain civic or public organizations are deductible.

**Learning Objective 3.6 Educational Expenses**

Educational expense may be deductible if one of two tests is met. The first test is that the education expense must be paid to meet the requirements of the taxpayer’s employer or the requirements of law or regulation for keeping the taxpayer’s salary, status or job. The second test states that the educational expenses must be paid to maintain or improve existing skills required in performing the duties of the taxpayer’s present work. Travel expenses associated with qualified educational expenses are also deductible. However, travel as a form of education is not deductible.

**Learning Objective 3.7 Dues, Subscriptions and Publications**

Professionals, such as doctors, lawyers, accountants, engineers and teachers, may deduct certain dues, certain subscriptions and publications.

**Learning Objective 3.8 Special Clothing and Uniforms**

To receive a deduction, clothing or uniforms must be specialized. The clothing must be required for employment and not suitable for everyday use. If specialized, the costs of purchase, alterations, laundry and maintenance are deductible. Uniforms for police officers, fire fighters, nurses and letter carriers qualify for the deduction. Other uniforms are deductible if they are used only for work. Taxpayers who are in the armed forces may deduct any unreimbursed cost of their uniforms. Additionally, protective clothing, such as steel-toed shoes, hard hats and rubber boots that are required by the employer are deductible if the employer does not provide the clothing.

**Learning Objective 3.9 Business Gifts**

Taxpayers are allowed a deduction for business gifts. The limit is $25 per year per donee. For tax purposes a husband and wife are considered one donee unless both spouses are clients. Gift-wrapping and shipping are fully deductible. Gifts made to a taxpayer’s supervisor are not deductible. To make the deduction, taxpayers must be able to substantiate the gifts in four ways: the amount, the time and place, the business purpose and the business relationship.

**Learning Objective 3.10 Bad Debts**

When accounts become uncollectible, taxpayers are allowed to deduct the bad debt against the previously recorded income. Taxpayers must be able to prove the worthlessness of the debt. Taxpayers are not allowed to have a bad debt deduction greater than their income for the tax year. Bad debts are considered to be business or nonbusiness. Business bad debts are those bad debts that arise from the results of normal operations, while nonbusiness bad debts are all other bad debts. According to tax regulations, business bad debts are treated as ordinary deductions and nonbusiness bad debts are treated as short-term capital losses, of which only $3,000 may be deducted against ordinary income in one tax year.

**Learning Objective 3.11 Office in the Home**

Taxpayers who operate their businesses from their homes may qualify for certain deductions for the use of their home. The tax law is very strict on this particular deduction. Only four scenarios are offered for a deduction to be taken by the taxpayer. The first scenario is that the taxpayer regularly uses his primary residence as the exclusive place of business. The second scenario is that a deduction may be allowed if clients, patients or customers in meetings or dealings use the home office exclusively and on a regular basis with the taxpayer in the normal course of the taxpayer’s business. This would include an accountant who maintains a small office that functions as file storage but the accountant actually meets his clients at the home office. The third scenario is the home office is a separate structure and used exclusively and on a regular basis for conducting the taxpayer’s business. The fourth scenario is that the home office is the storage place of business inventory or product samples held for use in the taxpayer’s trade or business of selling products. A full deduction will not be allowed, regardless of meeting one of the four scenarios above, if the income is less than the deduction. No deduction is allowed if the office is for both personal and business purposes. To calculate the deduction, the number of square feet of the office is divided by the total square footage to establish a rate. In 2013, a simplified method based on $5 per square foot of space with a maximum deduction of $1,500 deduction is available to taxpayers.

**Learning Objective 3.12 Net Operating Losses**

Net operating losses (NOLs) incurred by a taxpayer can be used to reduce income in other tax years. Typically, NOLs can be carried back two tax years and carried forward twenty tax years. The NOL is first carried back to the earliest prior year and then to the next prior year or until the NOL is used in full. The taxpayer must file a Form 1040X or a quick claim for refund Form 1045. If the taxpayer makes an election, the NOL will be only carried forward. When a NOL is carried forward, the taxpayer reduces their taxable income by the NOL.

**Learning Objective 3.13 Hobby Losses**

If taxpayers have a hobby without a profit motive, the tax law limits the amount of deductions available. However, if the hobby is profitable, then the profits are included in taxable income. Taxpayers can avoid hobby loss rules if they can show the activity has a profit motive. These factors help determine the motive:

1. If the activity is conducted as a business
2. The skill-level and expertise of the taxpayer
3. The amount of time and effort expended
4. Previous success of the taxpayer in similar activities
5. Income and loss history from the activity
6. Relationship of income to losses in the activity
7. Financial status of the taxpayer, and
8. Elements of personal reaction in the activity.

If the activity is deemed a hobby, the expenses can be deducted only up to the amount of income from the activity.