**Chapter Three**

**Business Income and Expenses, Part I**

**Learning Objective 3.1 Schedule C**

A taxpayer who operates a sole-proprietorship must file either

* Schedule C (long form) or
* Schedule C-EZ (short form)

To use Schedule C-EZ 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 yield 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

* 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.
* *Note*: gambling winning are not reported on Schedule C unless taxpayer is a professional gambler.
* If a taxpayer has a farm or farming activity, should report on a Schedule F

**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*

Taxpayer must choose a method of inventory costing.

* The two most common methods are
  + First in, first out (FIFO)
  + Last in, first out (LIFO)
* Method does not have to represent the way the business operates, it’s cost allocation tool.
* Once a taxpayer makes the election of inventory valuation, no change can be made without IRS consent

**Learning Objective 3.3 Transportation**

Certain transportation expenses are deductible for taxpayers.

* Travel by airplane, rail, bus, and the cost of operating/maintaining an auto 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 54 cents per mile for 2016.
  + 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 depreciation or bonus depreciation on auto

* If the taxpayer uses actual cost for the deduction, the costs must be substantiated.
* The expenses must be *prorated* between personal and business miles.
* A taxpayer must choose standard or actual in the first year.
  + If the taxpayer does not use the standard mileage method in the first year, it is not available for subsequent years.

**Learning Objective 3.4 Travel Expenses**

Travel expenses are defined as *ordinary and necessary expenses incurred in traveling away from the tax home* in pursuit of the taxpayer’s trade or business.

* These expenses should be substantiated and not extravagant.
* To deduct travel expenses, the taxpayer must stay “overnight”
  + Defined as “a period of time longer than the work day in which rest/relief is needed”
* Most travel expenses are fully deductible, *but only 50% of the cost of meals is deductible*.

Instead of recording actual expenses*, per diem methods* are available

* *Regular Rate* – This federal per diem rate is available on the US General Services Administration (GSA) website. They are different for each area.
* *High-Low Method* - This method designates a small number of locations as high-cost localities and all other are “low” areas
  + 2016 rates = $275/day for high areas
  + All other areas are considered low-cost and per diem = $185/day
* *Meals and Incidental Expenses (M&IE) Method*
  + Self-employed taxpayers *must* use this method.
    - Requires that *actual lodging* be substantiated and a *per diem amount is for M&IE*.
      * 2016 per diem amounts are $68/day for high-cost localities
      * $57 for low-cost localities

**Learning Objective 3.5 Meals and Entertainment**

Self employed taxpayers and employees are allowed a deduction for up to 50% of their meals and entertainment costs incurred in connection to a business or trade.

* The costs of entertainment facilities, such as a yacht or hunting lodge, are strictly limited.
* Typically, club dues are not deductible - dues to professional organizations and certain civic or public organizations are deductible.
* To be deductible*, the expenses must serve a specific business purpose*
* If entertainment, *must occur immediately before or after the business event or meeting*.

**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 a law/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. .*Note:* The expense may not lead to qualification in a new trade or business.

Eligible K-12 educators may deduct up to $250 for classroom materials such as books and supplies to arrive at AGI and is indexed annually for inflation.

**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.
* Protective clothing, such as steel-toed shoes, hard hats and rubber boots that are required 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 done, unless both spouses are clients.
  + Gift-wrapping and shipping are fully deductible.
  + Gifts made to supervisor are not deductible.
  + Must substantiate the gifts in four ways
    - the amount, the time/place, business purpose and 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.

* Must be able to prove the worthlessness of the debt.
* No bad debt deduction greater than income for the tax year is allowed.
* Bad debts are considered to be business or nonbusiness.
  + Business bad debts are those bad debts that arise *from the results of normal operations*
    - Treated as ordinary deductions
  + Nonbusiness bad debts are *all other bad debts.*
    - Treated as short-term capital losses, and only $3,000 per year deduction allowed

**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.

* *Strictly regulated, only four exceptions allow deduction:*
  + Taxpayer regularly uses his primary residence as the exclusive place of business.
  + If clients, patients or customers in meetings or dealings use the home office exclusively, and on a regular basis,and in the normal course of the business
  + If home office is a separate structure that is *used exclusively and on a regular basis* for conducting the taxpayer’s business.
  + If office is the storage place of business inventory or product samples

*Note:* The deduction cannot exceed net income from business unless due to portion attributable to mortgage interest and taxes

* + - No deduction is allowed if the office is for both personal & business
* To calculate the deduction get P*ercentage = home office sq footage/sq footage of home*
  + Multiply % by indirect expenses and add direct home office expenses

or

* + can use simplified method based on $5 per square foot of space with a maximum deduction of $1,500 deduction
    - Taxpayers employing this method may itemize mortgage interest and property taxes on their Schedule A.

**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 2 tax years and carried forward 20 tax years.
  + Carried back to the earliest prior year and then to the next prior year or until the NOL is used in full.
  + 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 his/her 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 deduction 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.

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