**Chapter Three**

**Business Income and Expenses**

**2020**

**Learning Objective 3.1 Schedule C**

A trade or business is not specifically defined in the Internal Revenue Code, but is generally an activity conducted for a profit.

* For an expense to generally be considered deductible for a trade or business, it must:
  + Be ordinary and necessary
  + Have a legitimate business purpose
  + Be reasonable, in light of the fees that are generated, as a result of the expense
* Specifically excluded are personal expenses, capital expenditures, expenses to generate tax-exempt income, bribes, kickbacks, fines, penalties, lobbying expenses, and settlement or attorney fees.

Schedule C income contains the calculation of the taxpayer’s gross income (profit or loss) from the sole proprietorship.

* + Part I: Income
  + Part II: Expenses
  + Part III: Cost of Goods Sold
  + Part IV: Vehicle Information
  + Part V: Other Expenses

Taxpayers with net earnings of $400 or more are required to pay self-employment tax.

* They must file Schedule SE with Form 1040.
* Self-employment tax equals:
  + Social Security tax (12.4% on the first $132,900) plus
  + Medicare tax (2.9% of all net earnings)
* Taxpayer gets a deduction for AGI equal to half of the self-employment tax.

**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

The taxpayer must choose a method of inventory costing.

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

*Note:* Taxpayers with gross receipts of less than $25 million (calculated over 3 years) are not required to keep inventory on the accrual method.

**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 58 cents per mile for 2019.
  + To use the standard rate, the taxpayer must:
* Own or lease the automobile,
* Not operate a fleet of automobiles, using five or more at the same time,
* Not have claimed depreciation on the automobile using any method other than straight-line depreciation, and
* Not have claimed Section 179 depreciation or bonus depreciation on the automobile.
* 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.
* Actual expenses include business portion of:
  + Gas, oil, repairs, and maintenance
  + Depreciation
  + Personal property taxes
  + Interest on car if self-employed
* Business-related parking and tolls are fully deductible.
  + Not multipliedby business-use percentage
* Taxpayers, other than self-employed, should report vehicle expenses on Form 2106, which carries to Schedule A.

**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.”
  + Overnight is defined as “a period of time longer than an ordinary work day in which rest or relief from work is required.”
* Most travel expenses are fully deductible, but only 50% of the cost of meals is deductible.

Deductibility is dependent on whether a trip is classified as business, pleasure, or a combination.

* If primarily business trip inside United States:
  + All travel costs (to/from) are deductible.
  + Travel expenses are split between business and personal.
* If primarily business trip outside United States:
  + Travel costs (to/from) are split between business and personal based on number of days.
  + Other travel costs are deductible, if associated with business.
* If primarily pleasure trip (in or outside United States):
  + Travel costs (to/from) are not deductible.
  + Meals, lodging, local transportation, and incidental expenses are split between personal and business.

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

* Standard Federal Rate Method: This federal per diem rate is available on the U.S. General Services Administration (GSA) website. Rates are different for each area.
* High-Low Method: This method designates a small number of locations as high-cost localities and all other locations are low-cost areas.
  + 2019 rate for high-cost areas is $287 per day.
  + 2019 rate for low-cost areas is $195 per day.

**Learning Objective 3.5 Meals and Entertainment**

Only entertainment costs related to recreation, social, or similar activities for the benefit of employees remain deductible.

* + Dues paid to professional organizations or civic or public organizations are legitimate business deductions.
  + A meal related to an entertainment event is only deductible if the meal is purchased separately.

**Learning Objective 3.6 Educational Expenses**

Tax law for educational expenses has become very complex so this section of the text covers primarily continuing education expenses incurred by taxpayers.

The suspension of the deduction for miscellaneous expenses subject to 2% of AGI has effectively eliminated the deduction of unreimbursed educational costs for employees.

Educational expense may be deductible if one of two tests is met:

* The education expense must be paid to meet the requirements of the taxpayer’s employer or the requirements of a law or regulation for keeping the taxpayer’s salary, status, or job.
* 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.

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

Professionals, such as doctors, lawyers, accountants, engineers, and teachers, may deduct certain dues and the cost of 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.

**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 supervisor are not deductible.
  + Taxpayer must substantiate the gifts in four ways:
    - Amount, date and description, business purpose, and business relationship
* A deduction for tangible noncash personal property up to $400 is allowable.
  + Up to $1,600 is allowable if gift is made in conjunction with a “qualified plan.”

**Learning Objective 3.10 Bad Debts**

When accounts become uncollectible, taxpayers are allowed to deduct the bad debt against the previously recorded income.

* Taxpayer 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.

* Such deductions are strictly regulated.
* There are four exceptions to the general rule under which a deduction may be allowed. This deduction is allowed if:
  + Taxpayer regularly uses primary residence as the exclusive place of business.
  + Clients, patients, or customers in meetings or dealings use the home office exclusively and on a regular basis and in normal course of business.
  + Home office is a separate structure that is used exclusively and on a regular basis for conducting the taxpayer’s business.
  + 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 and business use.
* To calculate the deduction, first calculate allocable percentage:

Percentage = Home office square footage ÷ Total home square footage

* + Then multiply this percentage by indirect expenses and add direct home office expenses

or

* + Use simplified method based on $5 per square foot of space (max = $1,500).
    - Taxpayers employing this method may itemize mortgage interest and property taxes on their Schedule A.

**Learning Objective 3.12 Hobby Losses**

If taxpayers have a hobby without a profit motive, the tax law limits the deduction available.

* If 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.
* Factors that help determine the profit motive are as follows:
* Whether the activity is conducted as a business
* The skill level and expertise of the taxpayer
* The amount of time and effort expended
* Dependence on income for livelihood
* Previous success of the taxpayer in similar activities
* Attempts to change methods of operation to improve profitability
* Whether activity makes profit in some years
* Whether losses are due to circumstances beyond control
* Whether activity is expected to make future profit

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