**Chapter Three**

**Business Income and Expenses**

**2020**

**Learning Objectives (Slides 2-3)**

* The Learning Objectives provide students with a brief overview of what they will learn in this chapter.
	+ LO 3.1 Complete a basic Schedule C (Profit or Loss from Business).
	+ LO 3.2 Describe the tax treatment of inventories and cost of goods sold.
	+ LO 3.3 Identify the requirements for deducting transportation expenses.
	+ LO 3.4 Identify the requirements for deducting travel expenses.
	+ LO 3.5 Determine the requirements for deducting meals.
	+ LO 3.6 Identify the requirements for claiming business education expenses.
	+ LO 3.7 Identify the tax treatment of dues and subscriptions.
	+ LO 3.8 Determine which clothing and uniforms may be treated as tax deductions.
	+ LO 3.9 Explain the special limits for business gift deductions.
	+ LO 3.10 Explain the tax treatment of bad debt deductions.
	+ LO 3.11 Ascertain when a home office deduction may be claimed and how the deduction is computed.
	+ LO 3.12 Apply the factors used to determine whether an activity is a hobby, and understand the tax treatment of hobby losses.

**Learning Objective 3.1 Schedule C (Slides 4-9)**

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, expenditures related to the sale of illegal drugs, 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 $137,700) plus
	+ Medicare tax (2.9% of all net earnings)
* Taxpayer gets a deduction for AGI equal to half of the self-employment tax.

The discussion on slides 8-9 asks students to consider whether or not the expenses incurred by a business owner who takes a client, who is also a friend, out for a weekly business dinner are deductible. In the case described, the expenses would not be considered reasonable. Students should come up with some examples of expenses that would be reasonable.

**Learning Objective 3.2 Inventories (Slides 10-12)**

The cost of inventory (or cost of goods sold) can be the largest expense of a taxpayer.

Businesses with receipts less than $26 million can use the cash method to account for inventory, using one of three options:

* Treat it as non-incidental materials and supplies
* Treat it the same as on the applicable financial statements of the business
* Treat it as conforms with the business books and records

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)
* A taxpayer may adopt the LIFO method by using it in a tax return and attaching Form 970.
* If the LIFO election is made for reporting taxable income, it must also be used for preparing financial statements.

The poll on slide 12 asks students to consider whether a particular business should use the FIFO or LIFO method of inventory flow. There is no correct answer based on the information presented. In order to make an informed decision, the business owner would need to consider the cost of inventory at each purchase point. For example, during periods of rising inventory prices, taxpayers have lower taxable income and pay less tax if they use the LIFO inventory valuation method.

**Learning Objective 3.3 Transportation (Slides 13-20)**

Certain transportation expenses are deductible for taxpayers.

* Travel by airplane, rail, bus, and the cost of operating/maintaining an auto are deductible.
* Commuting is deductible only in these three circumstances:
	+ Travel between taxpayer’s home and work locations outside the metro area where taxpayer lives and normally works
	+ Travel between taxpayer’s home and temporary work locations if taxpayer has regular place of business
	+ Travel between taxpayer’s home and other regular or temporary locations if taxpayer’s home is his or her principal place of business
* The standard mileage rate is 57.5 cents per mile for 2020.
	+ The standard rate accounts for gasoline and oil, insurance, repairs and maintenance, and depreciation.
	+ Deductions for parking and toll fees, interest on car loans, and personal property taxes are determined separately.
	+ 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. Actual cost is calculated by multiplying actual expenses by the business-use percentage, where business-use percentage is the number of business miles driven divided by total miles driven.
* 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 C or other forms.

The Knowledge Check on slides 19-20 asks students to recall which of the costs listed is built in to the standard mileage rate.

**Learning Objective 3.4 Travel Expenses (Slides 21-31)**

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.

* Most travel expenses are fully deductible, but only 50% of the cost of meals is deductible.
* 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.”
* Expenses of temporary assignments are deductible if it is not practical to return home at the end of each day’s work.
* Long-term or indefinite assignments (generally more than 1 year) may require reclassification of new tax home for taxpayer.

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.

Slides 26-27 walk students through an example of someone who takes a business trip within the United States but also engages in personal outings during the trip.

In order to deduct for travel expenses, the taxpayer must keep proper records that substantiate the amounts of each expenditure, dates of travel, travel destination, and business reason for the travel.

Instead of recording actual expenses, employers can reimburse using a per diem method of substantiation.

* Employers can use per diem for all travel expenses (lodging, meals, and incidentals) or only for meals and incidentals.
* Self-employed taxpayers may only use per diem for meals and incidentals.
* 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.
		- 2020 rate for high-cost areas is $297 per day.
		- 2020 rate for low-cost areas is $200 per day.

**Learning Objective 3.5 Meals and Entertainment (Slide 32)**

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 (Slides 33-36)**

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.

Slides 35-36 walk students through an example of a paralegal who attends law school at night and also has certain continuing education requirements to maintain her paralegal certification. Only those expenses incurred to meet the requirements to maintain her existing job would be tax deductible.

**Learning Objective 3.7 Dues, Subscriptions, and Publications (Slide 37-39)**

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

The Knowledge Check on slides 38-39 asks students to determine which of the listed items would be deductible.

**Learning Objective 3.8 Special Clothing and Uniforms (Slide 40)**

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 (Slides 41-43)**

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.”

The discussion on slides 42-43 asks students to consider what portion of the gifts that a salesperson gives to his clients are deductible, and also to suggest any ways that the salesperson might be able to maximize the deductible amount of his gift expenditures.

**Learning Objective 3.10 Bad Debts (Slides 44-48)**

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

* No bad debt deduction greater than income for the tax year is allowed.
* Taxpayer must be able to prove the worthlessness of the debt.
* 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

The example on slides 46-47 walks students through the case of an individual who loaned money to her friend to start a business. The example considers whether this is a business or nonbusiness debt as well as how much can be deducted in the current year.

The poll on slide 48 shares the case of a couple who loaned money to their son. They believe the son will not repay the loan, and want to claim it as a loss to offset capital gains. Students are asked whether or not they would sign the Paid Preparer's declaration. There is no correct answer to this question. It sounds somewhat questionable, but if the parents have documentation that payment dates have been missed and that they have tried collecting on the loan, that would help support a decision to sign the form.

**Learning Objective 3.11 Office in the Home (Slides 49-54)**

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.

Slides 51-52 take students through an example determining the home office deduction amount for a part-time cartographer who maintains a home office.

The calculation of home office expenses involves the allocation of the total expenses of a self-employed taxpayer’s dwelling between business and personal 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 (Slides 55-57)**

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.

**Case Studies (Slides 58-59)**

Case Study 1 considers the case of a self-employed caterer. He uses his personal van when delivering catered meals to his customers. He doesn't keep track of his miles, but estimates the number of miles he drove for the business in the previous year. Students are asked, as a tax preparer, how to respond to the client.

In Case Study 2, the student is asked to research a potential tax deduction for a client who travels from Maine to Mexico for a trade show. Students are asked to use IRS Publication 463 for guidance when preparing a letter to the client describing the issues that he will face when attempting to deduct the cost of attending the show.

**Summary (Slides 60-61)**

The Summary slides review the 12 Learning Objects, covering what the students should have learned in this lesson.