Navigating Form 1040 Schedule C

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Introduction to the Course

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.

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.

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

Upon completion of the course, the student should be able to:

- 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

Introduction

The IRS reports that the number of Schedule C filers is about 28 million and accounts for approximately $2.5 trillion in income. Comprising about 20% of total tax returns, these Schedule C filers, because of the increased complexity of their tax returns, are more likely than other taxpayers to seek professional tax return assistance. In this chapter we will examine Part I of Schedule C (Form 1040), the components of sole proprietors' income. In doing so, the following will be discussed:

- 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

When you have completed this chapter, you should be able to:

- 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

Sometimes it is difficult to determine whether income received by a taxpayer is earned by the taxpayer as an employee or as a self-employed person who is required to include that income on Schedule C, *Profit or Loss from Business*. To make that determination, the "common law" test is normally used.

The common law control test is the basic test under which the common law rules—rules developed in the English courts on which much of American law is based—are used for determining whether an employee-employer relationship exists between the taxpayer and the person or firm for which the taxpayer works. Under the common-law control test, a taxpayer is considered an employee rather than an independent contractor 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.

Self-employed taxpayers report earnings on Schedule C. Schedule C (Form 1040), *Profit or Loss From Business*, is the supplemental form attached to Forms 1040, 1040NR or 1041 and is used to calculate the net profit or loss for self-employed taxpayers.

A self-employed taxpayer is one who:

- Carries on a trade or business as a sole proprietor;

- Is an independent contractor;
- Is a member of a partnership; or
- Is in business for himself or herself in any other way.

A sole proprietor is someone who owns an unincorporated business by himself or herself. The 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 such as doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, or auctioneers who are in an independent trade, business, or profession in which they offer their services to the general public are generally independent contractors. Also, 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. However, whether they are independent contractors or employees depends on the facts in each case. The general rule followed to determine the nature of the employment is the common law control test discussed earlier. The earnings of a person who is working as an independent contractor are subject to self-employment tax.

As noted earlier, the IRS treats one-owner LLCs as a sole proprietor for tax purposes. An LLC is an entity under which the taxpayer's liability for claims against the firm is generally limited to the assets of the firm rather than the assets of the LLC member. An LLC is formed under state law by filing articles of organization. Generally, for income tax purposes, a single-member LLC is disregarded as an entity separate from its owner and reports its income and deductions on its owner's federal income tax return. For example, if the single-member LLC is not engaged in farming and the owner is an individual, he or she may use Schedule C.

Schedule C, Profit or Loss from Business

Schedule C is the form on which a taxpayer reports the revenue from his or her business and the types of expenses incurred to run it. The taxpayer's business income minus his or her business expenses is the taxpayer's net profit (or loss) and constitutes the income on Form 1040. It is divided into five sections:

1. Income,
2. Expenses,
3. Cost of Goods Sold,
4. Information on a vehicle used in the business, and
5. Other expenses.

We'll consider the requirements for appropriately completing each section and begin that discussion with a definition of just what income is deemed to be "business income."

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 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 on the side in addition to his or her regular job can be business income. It includes amounts the taxpayer received in his or her business that were properly shown on Forms 1099-NEC as nonemployee compensation in box 1 of the form.

The amount of time spent by the taxpayer carrying on the activity is unimportant for tax purposes. Thus, an individual is considered self-employed if the person spends all his or her working hours as a self-employed individual or works as a self-employed person only in addition to other duties performed as an employee. Regardless of the amount of time a taxpayer spends in a self-employed activity, the taxpayer must file a tax return if his or her gross income is at least as much as the filing threshold for the individual's filing status and age. In addition, a self-employed taxpayer must also 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.

If the taxpayer is self-employed, his or her gross income 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.

Completing Schedule C

Completion of Part 1 of Schedule C provides the taxpayer's gross income from self-employment shown on line 7 of the form.

Gross Receipts or Sales – Line 1

To determine the gross income, enter the gross receipts from the taxpayer's trade or business on line 1. As stated on Schedule C, the amount entered on line 1 is the total revenue the taxpayer received from the sales of the company's products or services, **unreduced by any refunds due to product returns or price reductions** given to buyers to compensate for damaged goods, etc.**.**

For example, suppose the sole proprietor sold 10,000 items, each priced at $10, and had 20 returns and aggregate price reductions of $1,000. The gross receipts or sales that should appear on Part I, line 1 is $100,000 (10,000 x $10 = $100,000).

Be sure to check any Forms 1099 the taxpayer received for business income that must be reported on this line. If the taxpayer received one or more Forms 1099-NEC, be sure that line 1 of Schedule C includes all amounts properly shown on the 1099 forms. If the sum of the amounts reported in box 1 of Forms 1099-NEC received by the taxpayer is greater than the total shown on Schedule C, line 1, attach a sheet to Schedule C explaining why the amounts differ from one another.

Statutory Employees

In some cases, taxpayers can be independent contractors under the common law test but still be treated as employees (rather than independent contractors) for employment tax purposes. These hybrid [author's characterization] type taxpayers are referred to as "statutory employees." As statutory employees, Social Security and Medicare taxes would have been withheld from their earnings by the payer.

Taxpayers considered statutory employees fall within one of the following four categories:

- A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is the payer's agent or is paid on commission;
- 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;
- 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

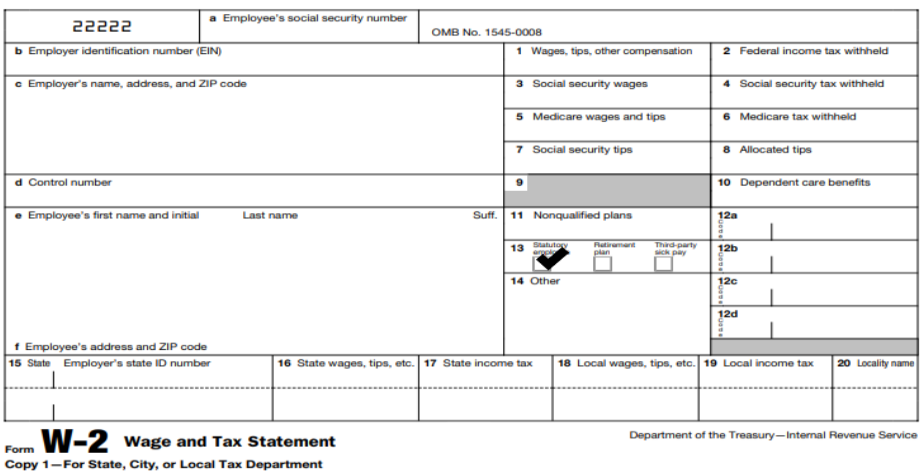
specifications for the work to be done; and

- 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, taxpayers must also meet the following three conditions to be considered statutory employees:

1. 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;
2. 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
3. The services are performed on a continuing basis for the same payer.

If the taxpayer received a Form W-2 and the "Statutory employee" box in box 13 of that form was checked, report the taxpayer's income and expenses related to that income on Schedule C.


22222
a Employee's social security number
OMB No. 1545-0008
b Employer identification number (EIN)
1 Wages, tips, other compensation
2 Federal income tax withheld
c Employer's name, address, and ZIP code
3 Social security wages
4 Social security tax withheld
5 Medicare wages and tips
6 Medicare tax withheld
7 Social security tips
8 Allocated tips
d Control number
9
10 Dependent care benefits
e Employee's first name and initial Last name Suff.
11 Nonqualified plans
12a
13 Statutory employee Retirement plan Third-party sick pay
12b
14 Other
12c
12d
f Employee's address and ZIP code
15 State Employer's state ID number
16 State wages, tips, etc.
17 State income tax
18 Local wages, tips, etc.
19 Local income tax
20 Locality name
Form W-2 Wage and Tax Statement
Copy 1—For State, City, or Local Tax Department
Department of the Treasury—Internal Revenue Service

To do so, enter the taxpayer's statutory employee income from box 1 of Form W-2 on line 1 of 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 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, one Schedule C for income earned as an independent contractor and a second Schedule C for income earned as a statutory employee. The taxpayer cannot combine these amounts on a single Schedule C.

Installment Sales

A taxpayer may sell property for which he or she receives payment over more than a single year. In such cases involving multi-year payments, unless the installment method is unavailable (see **Situations Where the Installment Method isn't Permitted)** or the taxpayer elects out of recognizing income over the duration of the payment period rather than in the year the transaction occurs, the taxpayer must recognize the income received from the sale under the installment method.

A taxpayer choosing to "elect out" of the installment method must do so on or before the due date for filing the taxpayer's tax return (including extensions) for the year of the sale. The taxpayer may elect out by reporting all the gain as income in the year of the sale in accordance with the taxpayer's method of accounting. Information addressing reporting of the gain on other than the installment method may be found on Form 4797, Sales of Business Property, or on Schedule D (Form 1040), Capital Gains and Losses and Form 8949, Sales and Other Dispositions of Capital Assets.

Situations Where the Installment Method Isn't Permitted

Not all installment sales may be recognized under the installment method. The installment method rules:

- Don't apply to sales that result in a loss;
- Can't be used to report gain from the sale of inventory of personal property;
- Can't be used to report dealer sales, i.e., sales of personal property by a taxpayer that regularly sells or otherwise disposes of the same type of personal property; and
- Don't apply to the sale of stocks or securities traded on an established securities market. The taxpayer must report any portion of the gain from the sale of depreciable assets that's ordinary income under the depreciation recapture rules in the year of the sale.

For additional situations and information about when the taxpayer can't report payments on the installment method, see Publication 537, Installment Sales.

Decisional Factors in Selecting or Rejecting the Installment Method

Although it might seem obvious that choosing the installment method under which to recognize installment sale income would always be in your taxpayer's interest since it enables the taxpayer to defer the tax until the revenue is actually received, both pros and cons apply.

The principal advantages of electing out of the installment method—recognizing the revenue before all payments have been received, in other words—include the following:

- The selling taxpayer avoids the possibility that future tax rate increases will cause the selling taxpayer's tax liability on the transaction to increase; and
- The sec. 453a requirement that the selling taxpayer pay interest on the deferred tax liability is avoided.

The principal disadvantages of electing out of the installment method include:

- The tax on the gain is accelerated;
- Since the tax liability arises before the actual receipt of revenue, the selling taxpayer may experience difficulty raising the funds needed to pay the tax due; and
- The seller can incur losses if the buyer defaults on a future payment.

Determining The taxpayer's Installment Sale Total Gain

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 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.

Reporting the Sale on The taxpayer's Tax Return

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.

Use Form 6252, Installment Sale Income to report an installment sale in the year the sale occurs and for each year the taxpayer receives an installment payment. The taxpayer may need to attach Form 4797, Sales of Business Property and Schedule D (Form 1040) to the taxpayer's Form 1040, U.S. Individual Income Tax Return or Form 1040-SR, U.S. Tax Return for Seniors.

Determining Installment Sale Income

Each payment received in an installment sale usually consists of the following three parts.

- Interest income;
- Return of the seller's adjusted basis in the property; and
- Gain on the sale.

In each year the taxpayer receives a payment, the taxpayer must include in income both the interest part and the part that's gain on the sale. The taxpayer doesn't include in income the part that's the return of the taxpayer's basis in the property. Basis is the amount of the taxpayer's investment in the property for installment sale purposes.

An installment sale contract may provide that:

- Each deferred payment on the sale will include interest; or
- There will be an interest payment in addition to the principal payment.

Interest provided in the 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.

The test rate of interest for a contract is the 3-month rate. The 3-month rate is the lower of the following applicable federal rates (AFRs):

- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there's a binding written contract that substantially provides the terms under which the sale or exchange is ultimately completed.
- The lowest AFR (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.

Each month, the IRS provides these various prescribed rates for federal income tax purposes. These rates, known as Applicable Federal Rates (AFRs), are regularly published as revenue rulings.

The AFR depends on the month the binding contract for the sale or exchange of property is made or the month of the sale or exchange and the term of the instrument. For an installment obligation, the term of the instrument is its weighted average maturity, as defined in Regulations section 1.1273-1(e)(3). The AFR for each term is shown below.

- For a term of 3 years or less, the AFR is the federal short-term rate.
- For a term of over 3 years, but not over 9 years, the AFR is the federal mid-term rate.
- For a term of over 9 years, the AFR is the federal long-term rate.

The AFRs are published monthly in the Internal Revenue Bulletin (IRB). You can get this information on IRS.gov at *apps.irs.gov/app/picklist/list/federalRates.html*.

Representative mid-term AFRs* used for a term over 3 years, but not over 9 years, are as follows:

	Annual	Semiannual	Quarterly	Monthly
		Mid-term		
AFR	4.82%	4.76%	4.73%	4.71%
110% AFR	5.31%	5.24%	5.21%	5.18%
120% AFR	5.79%	5.71%	5.67%	5.64%
130% AFR	6.29%	6.19%	6.14%	6.11%
150% AFR	7.27%	7.14%	7.08%	7.04%
175% AFR	8.50%	8.33%	8.25%	8.19%

*Based on installment sales made in December 2023.

Reporting Interest

The taxpayer must also include in income any interest as ordinary income. The taxpayer generally reports interest on an installment sale as ordinary income in the same manner as any other interest income. As noted earlier, If the installment sales contract doesn't provide for adequate stated interest, part of the stated principal may be recharacterized as unstated interest or original issue discount for tax purposes, even if the taxpayer has a loss.

Determining Recognized Revenue using the Installment Method

After any interest in the installment sale is determined either as stated interest or recharacterized, three simple calculations are used to determine the reportable gain under the installment method. First, the gross profit must be calculated. That calculation is as follows:

(1) Selling price - Seller's adjusted basis = Gross profit

Then to obtain the gross profit percentage, divide the gross profit determined in calculation 1 by the selling price as follows:

(2) Gross profit ÷ Selling price = Gross profit percentage

To determine the taxable portion of each year's payments received by the seller, multiply the revenue received (other than interest) by the gross profit percentage determined in calculation 2 as follows:

(3) Revenue received x Gross profit percentage = Taxable amount

For example, consider the following installment sale for which the taxpayer chose the installment method of recognition. The taxpayer sold property for $500,000 for which her adjusted basis was $350,000. The agreement calls for payments of $100,000 in the year in which the sale was made and additional $100,000 payments each year for the following four years. We can determine the annual taxable amount, exclusive of interest, using the three calculations below.

Additionally, the seller would be required to charge interest of at least 3.15% (the appropriate AFR highlighted above) or part of the stated principal amount would be recharacterized as interest.

The gross profit, gross profit percentage and taxable amount are calculated as follows:

Gross Profit Amount Calculation:	$500,000	-	$350,000	=	$150,000
Gross Profit Percentage Calculation:	$150,000	÷	$500,000	=	.30
Taxable Amount Calculation:	$100,000	x	.30	=	$30,000

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service

Profit or Loss From Business
(Sole Proprietorship)
Attach to Form 1040, 1040-SR, 1040-SS, 1040-NR, or 1041; partnerships must generally file Form 1065.
Go to *www.irs.gov/ScheduleC* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see instructions) | **B Enter code from instructions**

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN)** (see instr.)

E Business address (including suite or room no.)
City, town or post office, state, and ZIP code

F Accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify)

G Did you "materially participate" in the operation of this business during 2024? If "No," see instructions for limit on losses . ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2024, check here . . . ☐

I Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions . . . ☐ **Yes** ☐ **No**

J If "Yes," did you or will you file required Form(s) 1099? . . . ☐ **Yes** ☐ **No**

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . ☐	**1**	
2	Returns and allowances . . .	**2**	
3	Subtract line 2 from line 1 . . .	**3**	
4	Cost of goods sold (from line 42) . . .	**4**	
5	**Gross profit.** Subtract line 4 from line 3 . . .	**5**	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) . . .	**6**	
7	**Gross income.** Add lines 5 and 6 . . .	**7**	

Returns and Allowances – Line 2

It is unusual that all sales of the proprietor's goods and services will result in happy customers. In the ordinary scheme of things, the proprietor can expect that some of the goods sold will be damaged, defective, or simply unwanted by the customer and result in their being returned to the proprietor. Similarly, services provided by the proprietor may fail to meet the customer's expectations and, to satisfy the customer, the proprietor may offer the customer a price reduction to compensate.

As noted in the earlier line 1 example of the sole proprietor whose gross receipts shown on line 1 were $100,000, the financial impact of the 20 returns and aggregate price reductions are shown on line 2. The refunds for the 20 returned sales and the price reductions amount to $3,000 (20 x $100 = $2,000; $2,000 + $1,000 = $3,000). Thus, the returns and allowances that should appear on Part I, line 2 is $3,000.

Continuing this example, the amount shown on line 3 would be the result of the subtraction of the amount on line 2, i.e., $3,000 from the amount on line 1, i.e., $100,000—$97,000.

Cost of Goods Sold (COGS) – Line 4

Part I, line 4 of Schedule C enables a taxpayer to deduct its Cost of Goods Sold (COGS), i.e., the costs incurred to make or buy goods to sell, from its gross receipts to determine gross profit to be shown on line 5. Since some businesses—principally businesses that sell services rather than products—do not make or purchase goods for sale to their customers, they will not normally have COGS. For merchant businesses, however, the answer is quite different.

Figuring COGS for Merchant Clients

The process for determining COGS is based on inventory, specifically the change in inventory over the tax period, and can be seen in the basic formula:

(Inventory at beginning of year + purchases made during year) - Inventory at year-end = COGS

Calculating COGS is done on Schedule C in Part III, lines 35 through 42. We'll look at what should be entered on each line.

Beginning Inventory - Line 35

If the taxpayer is a merchant, beginning inventory is the cost of merchandise on hand at the beginning of the year that is available to be sold to customers. If the taxpayer is a manufacturer or producer, it also includes the total cost of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods.

Beginning inventory will usually be identical to the closing inventory of the year before. Any difference between the previous year's closing inventory and the beginning inventory needs to be explained in a schedule attached to the taxpayer's return.

Purchases - Line 36

To fill in line 36 for a merchant taxpayer, enter the cost of all merchandise purchased for sale during the year. The cost of all raw materials or parts purchased for manufacture into a finished product should also be included If the taxpayer is a manufacturer or producer. The cost the taxpayer should show on line 36 can be affected by:

- Trade discounts,
- Cash discounts,
- Purchase returns and allowances, and
- Goods withdrawn for personal use.

Trade Discounts

A trade discount is the reduction in the retail price at which a manufacturer sells goods to a reseller rather than to a retail customer. In order to earn a profit, the merchant taxpayer would then charge its customers the retail price which may or may not be as high as the price at which the manufacturer sells the product to retail customers. Any trade discount given to the merchant taxpayer must be subtracted from the manufacturer's retail price.

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. Although a merchant taxpayer may treat cash discounts in the way trade discounts are treated in the COGS calculation—simply deducting them from the manufacturer's retail price—they may be credited to a separate discount account instead.

If cash discounts are credited to a separate account (rather than reducing the cost of purchases for the COGS calculation), the taxpayer must include this credit balance in the taxpayer's business income at the end of the tax year. If the taxpayer credits cash discounts to a separate account, the discounts should not be figured into the taxpayer's COGS.

However, regardless of the method used for cash discounts, it must be consistent from one year to the next. If the taxpayer wishes to change the method of figuring inventory cost, IRS Form 3115 *Application for Change in Accounting Method* must be filed.

Purchase returns and allowances and Merchandise Withdrawn from Sale

The taxpayer must deduct all returns and allowances from total purchases made during the year. Similarly, if the taxpayer withdrew merchandise for personal or family use, it must reduce the amount of merchandise purchased by the taxpayer. Do this by crediting the purchases or sales account with the cost of merchandise the taxpayer withdrew for personal use. The taxpayer must also charge the amount to his or her drawing account.

A drawing account is a separate account the taxpayer should keep to record the business income that he or she withdrew to pay for personal and family expenses. As stated above, the taxpayer also uses it to record withdrawals of merchandise for personal or family use. This account is also known as a withdrawals account or personal account.

Cost of Labor - Line 37

Labor costs are usually an element of cost of goods sold only in a manufacturing or mining business. Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold. In a manufacturing business, both the direct and indirect labor used in fabricating the raw material into a finished, saleable product are labor costs properly allocable to the cost of goods sold. Labor costs may be costs for:

- Direct labor;
- Indirect labor; or
- Other labor.

Direct labor costs are the wages the taxpayer pays to those employees who spend all their time working directly on the product being manufactured. They also include a part of the wages the taxpayer pays to employees who work directly on the product part time if the taxpayer can determine that part of their wages.

Indirect labor costs are the wages the taxpayer pays to employees who perform a general factory function that does not have any immediate or direct connection with making the saleable product, but that is a necessary part of the manufacturing process. For example, indirect costs that should be charged to COGS include the wages and benefit costs for:

- Supervisors,
- Quality assurance workers in the factory, and
- Security guards.

Although 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, labor costs not chargeable to the cost of goods sold can be deducted as selling or administrative expenses.

Materials and Supplies – Line 38

Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to COGS. Those costs for materials and supply that are not used in the manufacturing process are treated as deferred charges. The taxpayer should deduct them as a business expense when they are used.

Other Costs – Line 39

Multiple other costs may be charged to the taxpayer's cost of goods sold, including the costs of:

- Containers and packages that are an integral part of the product manufactured are a part of the taxpayer's cost of goods sold. If not an integral part of the manufactured product, the costs of such containers and packages are shipping or selling expenses;
- Freight-in, express-in, and cartage-in— the transportation cost associated with the delivery of goods from a supplier to the receiving entity—on raw materials, supplies the taxpayer use in production, and merchandise the taxpayer purchase for sale are all part of cost of goods sold; and
- Overhead expenses include expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. The overhead expenses the taxpayer have as direct and necessary expenses of the manufacturing operation are included in the taxpayer's cost of goods sold.

When appropriate information has been entered in Schedule C lines 35 through 39, the total of the lines equals the cost of the goods available for sale during the year and should be entered in line 40.

Inventory at Year End – Line 41

Subtract the value of the taxpayer's closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) from line 40. Inventory at the end of the year is also known as closing or ending inventory. The taxpayer's ending inventory will usually become the beginning inventory of the taxpayer's next tax year.

Cost of Goods Sold – Line 42

When the taxpayer subtracts the closing inventory (inventory at the end of the year) from the cost of goods available for sale, the remainder is the taxpayer's cost of goods sold during the tax year. What is being accomplished is the adding together the beginning inventory, purchases (minus any items used personally by the taxpayer), costs of labor (not counting the proprietor), materials and supplies. Subtract the closing inventory from this sum to figure COGS. For those of us who are better able to visualize using an equation, the following is offered:

(Beginning inventory) + (purchases + costs of labor + materials + supplies) - Closing inventory = COGS

The amount shown on line 42 should also be entered in Part I on line 4.

Gross Profit – Line 5

Subtracting the cost of goods sold—the amount just determined by completing Schedule C, lines 35 through 42 and entered on line 4—from the gross receipts or sales (less returns and allowances) yields the gross profit amount to be entered on line 5. To the income side of Schedule C, the taxpayer must add other business income on line 6.

Other Income – Line 6

Although the bulk of business income is normally included on Schedule C, line 5, business income may also be derived from other sources; that income must be included on line 6.

Schedule C, lines 1 through 5 enable the taxpayer to report income generated in the normal course of business; however, a business may also generate reportable income outside its normal business operations. Accordingly, a Schedule C taxpayer must report any business income that doesn't come from normal business operations—often listed as Other Income on the taxpayer's P&L statement—on Schedule C, line 6. Business income not reported elsewhere in Part I must be reported on line 6, including:

- Finance reserve income, i.e., income generated from reserves held by the taxpayer to finance goods purchased by a customer;
- Scrap sales, i.e., income derived from the sale of excess unusable material left over after a product has been manufactured;
- Bad debts the taxpayer recovered;
- Interest (such as on notes and accounts receivable);
- State gasoline or fuel tax refunds the taxpayer received during the year for eligible fuel uses, such as fuel –
    - Sold and delivered to a governmental entity for its exclusive use,
    - Sold and delivered to a non-profit 501(c)(3) organization, and
    - Sold and delivered for certain agricultural uses;
- Any amount of credit for biofuel claimed on line 3 of Form 6478;
- Any amount of credit for biodiesel and renewable diesel claimed on line 8 of Form 8864;
- Credit for federal tax paid on fuels claimed on the taxpayer's Form 1040 or 1040-SR;
- Prizes and awards related to the taxpayer's trade or business;
- Amounts the taxpayer received in the taxpayer's trade or business as shown on Form 1099-PATR (Taxable Distributions Received from Cooperatives); and
- Other kinds of miscellaneous business income.

Gross Income – Line 7

Schedule C, Part I concludes with line 7 on which the taxpayer's gross income is entered. Gross income is equal to the sum of the taxpayer's gross profit shown on Schedule C, line 5, and Other Income shown on Schedule C, line 6. The total of taxpayer's expenses, other than expenses for business use of the taxpayer's home, are deducted from the amount shown on line 7 to yield the taxpayer's tentative profit or loss. We will consider the sole proprietor's business expenses in Chapter 2.

Summary

The following summarizes the discussion of self-employed income:

- 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.
- 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.
- 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.
- 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.
- 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.
  - Interest provided in the installment sale contract is called stated interest.
  - 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).
  - 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.
- Calculating COGS for a merchant taxpayer is done on Schedule C in Part III, lines 35 through 42.
- 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.
- A trade discount is the reduction in the retail price at which a manufacturer sells goods to a reseller.
- A cash discount is an amount a merchant taxpayer's suppliers permit the merchant to deduct from their purchase invoices for prompt payments.
- 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 1 Review

1. Emily is a sole proprietor who owns a fabric retailer. If she sold 10,000 bolts of fabric, each priced at $20, had 200 returns and aggregate price reductions of $10,000, what were her gross receipts or sales shown on Schedule C, line 1?

   A. $186,000

   B. $190,000

   C. $196,000

   D. $200,000

2. Harry, a sole proprietor, had a $50,000 cost of goods sold, $10,000 in returns and $15,000 in allowances. If he had gross receipts of $500,000 and no other business income, what is his gross income shown on Schedule C, line 7?

   A. $425,000

   B. $450,000

   C. $485,000

   D. $490,000

3. Shirley, a sole proprietor, had gross profit of $800,000. If she recovered $15,000 in bad debts, earned $450 of interest on accounts receivable, was awarded $5,000 in prizes, and had $45,000 in returns and allowances, what amount is shown on Schedule C, line 7?

   A. $775,450

   B. $800,450

   C. $805,450

D. $820,450

Chapter 2 – Elements of Proprietor Part II Expenses

Introduction

In this chapter we examine 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

When you have completed this chapter, you should be able to:

- 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. These expenses are costs the taxpayer does not have to capitalize or include in the cost of goods sold but can deduct in the current year.

In order to be deductible, a business expense must be:

- Ordinary, i.e., one that is common and accepted in the taxpayer's field of business, and
- Necessary[1], i.e., one that is helpful and appropriate for the taxpayer's business.

However, if any expense is partly for business and partly personal, the personal part of the expense must be separated from the business part. The personal part is not deductible.

Schedule C (Form 1040) is used to report a taxpayer's income or loss from a ***business*** operated or ***profession*** practiced as a sole proprietor. It is not used in connection with a taxpayer's hobby. An activity qualifies as a business if:

- The taxpayer's primary purpose for engaging in it is for income or profit; and
- The taxpayer is involved in the activity with continuity and regularity rather than sporadically.

The IRS presumes that an activity engaged in by a taxpayer's is carried on for a profit if:

- It makes a profit during at least three of the last five tax years, including the current year; or
- It primarily involves breeding, showing, training or racing horses ***and*** it makes a profit in at least two of the last seven years.

To determine if an activity engaged in by the taxpayer is a business or hobby, the following factors should be considered:

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[1] An expense does not have to be indispensable to be considered necessary.

- 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." However, because of the loss of the miscellaneous itemized deductions as a result of passage of the Tax Cuts and Jobs Act, hobby expenses not exceeding hobby income—at least through 2025—are no longer deductible.

Completing Schedule C, Part II – Expenses

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. Costs incurred by the taxpayer are considered ordinary and necessary if they meet two tests: they are (a) common and accepted in the industry, and (b) deemed to be helpful and appropriate for the trade or business.

We will consider each of these expenses that permit taxpayers to reduce their income for tax purposes.

Advertising – Line 8

The tax law allows businesses to deduct expenses that help them bring in new customers and keep existing ones. These costs may include expenses for advertising and marketing. Although not exhaustive, the following list of advertising costs would normally be tax deductible:

- Reasonable advertising expenses that are directly related to the business activities.
- An expense for the cost of institutional or goodwill advertising to keep the business name before the public if it relates to a reasonable expectation to gain business in the future. For example, the cost of advertising that encourages people to contribute to the Red Cross or to participate in similar causes is usually deductible.
- The cost of providing meals, entertainment, or recreational facilities to the public as a means of advertising or promoting goodwill in the community.

Generally, small businesses can't deduct amounts they pay to influence legislation, which includes advertising in a convention program of a political party, or in any other publication if any of the proceeds from the publication are for, or are intended for, the use of a political party or candidate.

Car and Truck Expenses – Line 9

The taxpayer can deduct the actual expenses of operating a car or truck or take the standard mileage rate when used in the taxpayer's business. This is true even if the taxpayer used the taxpayer's vehicle for hire (such as a taxicab). The taxpayer must use actual expenses if five or more vehicles are used simultaneously in the taxpayer's business (such as in fleet operations). The taxpayer cannot use actual expenses for a leased vehicle if the taxpayer previously used the standard mileage rate for that vehicle.

The taxpayer may take the optional standard mileage rate only if the taxpayer owned the vehicle and used the standard mileage rate for the first year the taxpayer placed the vehicle in service, or leased the vehicle and is using the optional standard mileage rate for the entire lease period.

To determine the amount to show on Schedule C, line 9, for a taxpayer taking a deduction for business travel using the optional standard mileage rate:

- Multiply the number of business miles driven in 2025 –
  - 70 cents per mile for business purposes, and
- Add to this amount the taxpayer's parking fees and tolls.

Enter the total of the business miles driven and the parking fees and tolls on line 9.

However, if the taxpayer deducts actual expenses rather than using the optional standard mileage rate, the amount to show on line 9 is the business portion of expenses for gasoline, oil, repairs, insurance, license plates, etc.. Then show depreciation on line 13 and rent or lease payments on line 20a.

If the taxpayer claims any car and truck expenses, information on use of the vehicle must be shown by completing one of the following:

1. Schedule C, Part IV, if -

- The taxpayer claims the standard mileage rate, leases the vehicle, or the taxpayer's vehicle is fully depreciated; and
- The taxpayer is not required to file Form 4562 for any other reason. If the taxpayer used more than one vehicle during the year, attach a statement with the information requested in Schedule C, Part IV, for each additional vehicle.

2. Form 4562, Part V, if the taxpayer is claiming depreciation on the vehicle or is required to file Form 4562 for another reason such as claiming:

- Depreciation on property placed in service during the current tax year;
- Depreciation on listed property, regardless of the date it was placed in service; or
- A section 179 expense deduction.

Listed property, as the term is used in #2 above, 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).

Commissions and Fees – Line 10

Enter the total commissions and fees paid by the taxpayer for the tax year, but don't include commissions or fees that are capitalized or deducted elsewhere on the taxpayer's return. The taxpayer must file Form 1099-NEC to report certain commissions and fees of $600 or more during the year.

Generally, commissions and other fees paid to facilitate the sale of property must be capitalized. However, if the taxpayer is a dealer in property—a person who regularly sells property in the ordinary course of their trade or business, in other words—enter the commissions and fees the taxpayer paid to facilitate the sale of that property on line 10.

Contract Labor – Line 11

Enter the total cost of contract labor for the tax year on Schedule C, line 11. Contract labor includes payments to persons the taxpayer does not treat as employees (for example, independent contractors) for services performed for the taxpayer's trade or business. Don't include contract labor deducted elsewhere on the taxpayer's return, such as contract labor includible on line 17, 21, 26, or 37. Also, don't include salaries and wages paid to the taxpayer's employees; instead, such employee wages should be entered on Schedule C, line 26. The taxpayer must file Form 1099-NEC to report contract labor payments of $600 or more during the year.

Depletion – Line 12

Enter the deduction for depletion on line 12. Depletion is the using up of natural resources extracted from a mineral property by mining, drilling, or quarrying stone, or, in the case of a stand of timber, by cutting it. The depletion deduction allows an owner or operator to account for the reduction of the property's value or basis as a result of the extraction of the natural resource.

There are two ways of figuring depletion: cost depletion and percentage depletion. For oil and gas wells, mines, other natural deposits (including geothermal deposits), and mineral property, the taxpayer must generally use the method that provides the larger deduction. For standing timber, the taxpayer must use cost depletion.

If the taxpayer has an economic interest in mineral property or standing timber, a deduction for depletion can be taken. More than one person can have an economic interest in the same mineral deposit or timber. In the case of leased property, the depletion deduction is divided between the lessor and the lessee.

Although a contractual relationship that allows the taxpayer an economic or monetary advantage from products of the mineral deposit or standing timber is not, in itself, an economic interest, the taxpayer has an economic interest if both the following apply:

1. The taxpayer acquired an interest in mineral deposits or standing timber by investment; and
2. The taxpayer has a legal right to income from the extraction of the mineral or cutting of the timber to which the taxpayer must look for a return of capital investment.

The taxpayer must reduce the basis of the property to not less than zero by the depletion allowed or allowable, whichever is greater.

Mineral Property Depletion

Mineral property includes oil and gas wells, mines, and other natural deposits (including geothermal deposits). For this purpose, the term "property" means each separate interest the taxpayer owns in each mineral deposit in each separate tract or parcel of land. The taxpayer can choose to treat two or more separate interests as one property or as separate properties.

There are two ways of figuring depletion on mineral property:

- Cost depletion; and
- Percentage depletion.

Generally, the taxpayer must use the method that provides the larger deduction. However, unless the taxpayer is an independent producer or royalty owner, the taxpayer generally cannot use percentage depletion for oil and gas wells.

Cost Depletion

To figure cost depletion, the taxpayer must first determine the following:

- The property's basis for depletion by subtracting all the following from the property's adjusted basis –
  - Amounts recoverable through:
    - Depreciation deductions,
    - Deferred expenses (including deferred exploration and development costs), and
    - Deductions other than depletion;
  - The residual value of land and improvements at the end of operations; and
  - The cost or value of land acquired for purposes other than mineral production;
- The total recoverable units of mineral in the property's natural deposit, determined by calculating the total of –
  - The number of units of mineral remaining at the end of the year (including units recovered but not sold); and
  - The number of units of mineral sold during the tax year (determined under the taxpayer's method of accounting); and
- The number of units of mineral sold during the tax year based on the taxpayer's method of accounting –
  - The units sold for which the taxpayer receives payment during the tax year (regardless of the year of sale) if using the cash method of accounting, or
  - The units sold based on the taxpayer's inventories and method of accounting for inventory if using an accrual method of accounting.

Adjusted Basis

The adjusted basis of the taxpayer's property is the taxpayer's original cost or other basis, plus certain additions and improvements, and minus certain deductions such as depletion allowed or allowable and casualty losses. The taxpayer's adjusted basis can never be less than zero.

To calculate the adjusted basis, increase the basis of the property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year. Rehabilitation expenses also increase basis. However, the taxpayer must subtract any rehabilitation credit allowed for these expenses before adding them to basis. If the taxpayer has to recapture any of the credit, increase basis by the recaptured amount.

If the taxpayer makes additions or improvements to business property, keep separate accounts for them. Also, the taxpayer must depreciate the basis of each according to the depreciation rules that would apply to the underlying property if the taxpayer had placed it in service at the same time the taxpayer placed the addition or improvement in service.

The following items increase the basis of property:

- The cost of extending utility service lines to the property;
- Impact fees;
- Legal fees, such as the cost of defending and perfecting title;

- Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements;
- Zoning costs; and
- The capitalized value of a redeemable ground rent.

In contrast, the following are some items that reduce the basis of property:

- Section 179 deduction;
- Nontaxable corporate distributions;
- Deductions previously allowed (or allowable) for amortization, depreciation, and depletion;
- Exclusion of subsidies for energy conservation measures;
- Certain vehicle credits;
- Residential energy credits;
- Postponed gain from sale of home;
- Investment credit (part or all) taken;
- Casualty and theft losses and insurance reimbursement;
- Certain canceled debt excluded from income;
- Rebates treated as adjustments to the sales price;
- Easements;
- Gas-guzzler tax;
- Adoption tax benefits;
- Credit for employer-provided childcare; and
- Partial disposition of MACRS property, whether the taxpayer elects to recognize the partial disposition or is required to recognize it.

Basis for Depletion

To figure the property's basis for depletion, subtract all the following from the property's adjusted basis.

- Amounts recoverable through:
  - Depreciation deductions,
  - Deferred expenses (including deferred exploration and development costs), and
  - Deductions other than depletion;
- The residual value of land and improvements at the end of operations; and
- The cost or value of land acquired for purposes other than mineral production.

Figuring the Cost Depletion Deduction

Once the property's basis for depletion, the total recoverable units, and the number of units sold during the tax year have been figured, the cost depletion deduction can be calculated by taking the following steps:

- Divide the taxpayer's property's basis for depletion by total recoverable units to obtain the depletion unit; and
- Multiply the depletion unit by the number of units sold during the tax year to obtain the cost depletion deduction.

Percentage Depletion

To figure percentage depletion, multiply the percentage specified for each mineral by the taxpayer's gross income for the tax year. (The specific rates to be used to determine percentage depletion and more information about the definition of gross income from the property are found in Publication 535.)

Gross income

When figuring percentage depletion, subtract the following amounts from the taxpayer's gross income from the property:

- Any rents or royalties the taxpayer paid or incurred for the property.
- The part of any bonus the taxpayer paid for a lease on the property allocable to the product sold (or that otherwise gives rise to gross income) for the tax year.

A bonus payment includes amounts the taxpayer paid as a lessee to satisfy a production payment retained by the lessor.

Use the following fraction to figure the part of the bonus the taxpayer must subtract:

$$\frac{\text{\# of units sold in tax year}}{\text{Recoverable units from property}} \times \text{Bonus payments} = \text{Part of bonus to be subtracted}$$

Taxable income limit

The percentage depletion deduction generally cannot be more than 50% (100% for oil and gas property) of the taxpayer's taxable income from the property figured without the depletion deduction and the domestic production activities deduction.

Taxable income from the property means gross income from the property minus all allowable deductions (except any deduction for depletion or domestic production activities) attributable to mining processes, including limited mining transportation. These deductible items include, but are not limited to, the following:

- Operating expenses;
- Certain selling expenses;
- Administrative and financial overhead;
- Depreciation;
- Intangible drilling and development costs;
- Exploration and development expenditures;
- Deductible taxes, but not taxes that the taxpayer capitalizes or takes as a credit; and
- Losses sustained.

The following rules apply when figuring the taxpayer's taxable income from the property for purposes of the taxable income limit:

- Do not deduct any net operating loss (NOL) deduction from the gross income from the property;
- Corporations do not deduct charitable contributions from the gross income from the property;
- If, during the year, the taxpayer disposes of an item of section 1245 property that was used in connection with mineral property, reduce any allowable deduction for mining expenses by the part of any gain the taxpayer must report as ordinary income that is allocable to the mineral property.

Depreciation & Section 179 Expense Deduction – Line 13

Depreciation is the annual deduction allowed to enable the taxpayer to recover the cost or other basis of business or investment property having a useful life substantially beyond the tax year. The taxpayer can also depreciate improvements made to leased business property. However, stock in trade, inventories, and land are not depreciable.

It is an allowance for the wear and tear, deterioration, or obsolescence of the property. The taxpayer can depreciate most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. The taxpayer also can depreciate certain intangible property, such as patents, copyrights, and computer software.

To be depreciable, the property must meet all the following requirements:

- It must be property the taxpayer owns;
- It must be used in the taxpayer's business or income-producing activity;
- It must have a determinable useful life; and
- It must be expected to last more than one year.

Depreciation starts when the taxpayer first uses the property in the taxpayer's business or for the production of income. It ends when the taxpayer takes the property out of service, deducts all the taxpayer's depreciable cost or other basis, or no longer uses the property in the business or for the production of income.

The taxpayer can also elect under section 179 to expense part of the cost of certain property the taxpayer bought in 2023 for use in the 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 (see **Qualified Property** below). In addition, under prior tax law, the bonus depreciation arrangement was scheduled to end for qualified property purchased and placed in service before January 1, 2020.

The TCJA, §13201, both extended bonus depreciation and increased it. Under the enhanced bonus depreciation provisions of the TCJA, a business may take a 100% first year deduction equal to the adjusted basis of qualified property purchased and placed in service after September 27, 2017 and before January 1, 2023. The bonus depreciation percentage for qualified property purchased before September 28, 2017 and placed in service before January 1, 2018 continues to be 50%.

Property eligible for 100% bonus depreciation was expanded under the TCJA to include used qualified property acquired and placed in service after September 27, 2017 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 purchased and placed in service during 2023;
- 60% for property purchased and placed in service during 2024;
- 40% for property purchased and placed in service during 2025; and
- 20% for property purchased and placed in service during 2026.

The 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 and 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 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 depreciation limits applicable to passenger automobiles acquired after September 27, 2017 and placed in service during calendar year 2024 are as shown below:

Year	Limits When 1st Year Bonus Depreciation Deduction Applies	Limits When no 1st Year Bonus Depreciation Deduction Applies
Placed in service	$20,400	$12,400
2	$19,800	$19,800
3	$11,900	$11,900
4 and later	$7,160	$7,160

A "luxury vehicle" is a four-wheeled vehicle, regardless the cost of the vehicle, used mostly on public roads, and which has an unloaded gross weight of no more than 6,000 pounds. It includes vehicles not normally considered "luxury" vehicles on the basis of their price.

Section 179 Expense Limits

The Tax Cuts and Jobs Act (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 $1,250,000 (2025);
- The phaseout threshold for a taxpayer's ability to expense eligible property is $3,130,000 (2025);
- The definition of Code Section 179 property is expanded to include –
  - depreciable tangible personal property used principally to furnish lodging, such as –
    - furniture,
    - appliances, and
    - other equipment for use in the living quarters, and
  - certain improvements to nonresidential real property, including –
    - roofs,
    - heating, ventilation and air-conditioning property,
    - fire protection and alarm systems, and
    - security systems.

It is important to note that improvements will not qualify if they are attributable to other than the building's interior. So, improvements attributable to:

- Enlarging the building;
- The internal structural framework of the building; or
- An escalator or elevator

… do not qualify for immediate expensing.

Attaching Form 4562

IRS Form 4562 must be completed and attached **only** if the taxpayer is claiming:

- Depreciation on property placed in service during 2023;
- Depreciation on listed property, regardless of the date it was placed in service; or
- A section 179 expense deduction.

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, SUVs, 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. For purposes of this exception, a portion of the taxpayer's home is treated as a regular business establishment only if that portion meets the requirements for deducting expenses for the business use of the taxpayer's home.

Employee Benefit Programs – Line 14

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.

If the taxpayer made contributions on his or her own behalf as a self-employed person to a dependent care assistance program, complete Form 2441, Parts I and III, to figure the taxpayer's deductible contributions to that program.

Not all contributions to employee benefit programs may be deductible: 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.

However, the taxpayer may be able to deduct on Schedule 1 (Form 1040), line 17, the amount the taxpayer paid for health insurance on behalf of the taxpayer, spouse, and dependents, even if the taxpayer does not itemize deductions. Unlike other taxpayers, whose health insurance costs are deductible only to the extent total medical and dental expenses exceed 7.5% of AGI, a sole proprietor's health insurance premiums for himself or herself, a spouse and dependents may be deductible in their entirety.

Be sure to reduce the line 14 deduction by the amount of any credit for small employer health insurance premiums determined on Form 8941, *Credit for Small Employer Health Insurance Premiums*.

Insurance – Line 15

The taxpayer can generally deduct premiums paid for the following kinds of insurance related to the taxpayer's trade or business:

- Insurance that covers fire, storm, theft, accident, or similar losses;
- Credit insurance that covers losses from business bad debts;
- Group hospitalization and medical insurance for employees, including long-term care insurance -
    - If a partnership pays accident and health insurance premiums for its partners, it can generally deduct them as guaranteed payments to partners, or
    - If an S corporation pays accident and health insurance premiums for its more-than-2% shareholder-employees, it can generally deduct them, but must also include them in the shareholder's wages subject to federal income tax withholding;
- Liability insurance;
- Malpractice insurance that covers the taxpayer's personal liability for professional negligence resulting in injury or damage to patients or clients;
- Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in the taxpayer's business, regardless of fault -
    - If a partnership pays workers' compensation premiums for its partners, it can generally deduct them as guaranteed payments to partners, or
    - If an S corporation pays workers' compensation premiums for its more-than-2% shareholder-employees, it can generally deduct them, but must also include them in the

shareholder's wages;

- Contributions to a state unemployment insurance fund are deductible as taxes if they are considered taxes under state law;
- Overhead insurance that pays for business overhead expenses the taxpayer has during long periods of disability caused by the taxpayer's injury or sickness;
- Car and other vehicle insurance that covers vehicles used in the taxpayer's business for liability, damages, and other losses. If the taxpayer operates a vehicle partly for personal use, deduct only the part of the insurance premium that applies to the business use of the vehicle. If the taxpayer uses the standard mileage rate to figure car expenses, the taxpayer can't deduct any car insurance premiums;
- Life insurance covering the taxpayer's officers and employees if the taxpayer isn't directly or indirectly a beneficiary under the contract; and
- Business interruption insurance that pays for lost profits if the taxpayer's business is shut down due to a fire or other cause.

However, the taxpayer can't deduct premiums paid for the following kinds of insurance:

- 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 direct or indirect beneficiary; or
- Insurance to secure a loan.

Interest – Line 16

The tax treatment given to interest expense incurred by a taxpayer varies depending on the type of interest and the manner in which borrowed funds are used. For example, the tax treatment given to home mortgage interest and investment interest are subject to different rules. Because of that variability, taxpayers should generally allocate interest expense by tracing how the loan proceeds are used.

Taxpayers that incur business interest must file IRS Form 8990, *Limitation on Business Interest Expense Under Section 163(j)* unless excluded from the requirement to file. A taxpayer is not required to file Form 8990 if the taxpayer:

- Is a small business taxpayer, i.e., a business taxpayer meeting the gross receipts test (average annual gross receipts not exceeding $29 million for the 3 prior years, subject to inflation adjustment after 2023) and is not a tax shelter; and
- Has no excess business interest from a partnership; or
- Has business interest expense only from –
    - The trade or business of providing services as an employee,
    - An electing real property trade or business,
    - An electing farming business, or
    - Certain regulated utility businesses.

A taxpayer required to file IRS Form 8990—a taxpayer not excluded, in other words—must figure the limit on business interest expense on the form before completing Schedule C, lines 16a and 16b. An excluded taxpayer having a mortgage on real property used in the taxpayer's business should enter:

- On line 16a the interest paid during the year to banks or other financial institutions for which the taxpayer received a Form 1098 (or similar statement); and

- On line 16b, the interest paid during the year to banks or other financial institutions for which no Form 1098 was received.

If the taxpayer paid more mortgage interest than shown on Form 1098, consult IRS Publication 535, Business Expenses, to determine if the taxpayer may deduct the additional interest.

Legal and Professional Services – Line 17

Include on Schedule C, line 17 fees charged by accountants and attorneys that are ordinary and necessary expenses directly related to operating the taxpayer's business. The taxpayer should Include fees for:

- Tax advice related to the taxpayer's business;
- Preparation of the tax forms related to the taxpayer's business; and
- Expenses incurred in resolving asserted tax deficiencies related to the taxpayer's business.

Legal fees paid by the taxpayer to acquire business assets usually aren't deductible but should normally be added to the basis of the property. Fees paid that include payments for work of a personal nature—drafting a will, for example—aren't allowed as a business deduction on Schedule C (Form 1040). If the invoice includes both business and personal charges, figure the business portion by multiplying the total amount of the invoice by a fraction, the numerator of which is the amount attributable to business matters, the denominator of which is the total amount paid. The result is the portion of the invoice attributable to business expenses. The portion attributable to personal matters is the difference between the total amount and the business portion.

The cost of hiring a tax professional, such as a certified public accountant (CPA), to prepare that part of your tax return relating to your business as a sole proprietor is deductible on Schedule C (Form 1040).

Office Expenses – Line 18

The aggregate costs incurred for postage and office supplies are shown on Schedule C, line 18. Office supplies are the traditional office items, like pens, staplers, paper clips, USB thumb drives, and printer ink cartridges that get used up by employees.

Also included in office supplies are:

- Record keeping supplies, like invoices and sales receipts;
- Janitorial and cleaning supplies;
- Bathroom tissue;
- Places to keep supplies, like fixing cabinets and storage lockers;
- Paper plates, paper towels, and plastic utensils; and
- Beverages for the employee break room.

Pension and Profit Sharing Plans – Line 19

The taxpayer's deduction for contributions made for the benefit of the taxpayer's employees to a pension, profit-sharing, or annuity plan (including SEP, SIMPLE, and SARSEP plans) are shown on Schedule C, line 19. If the plan also included the taxpayer as a self-employed person, enter the contributions made as an employer on the taxpayer's behalf on Schedule 1 (Form 1040), line 16, not on Schedule C. The deduction for plan contributions is subject to multiple limitations—applicable to maximum regular contributions, catch-up contributions, etc.—depending on the plan type and the applicable limits, some of which tend to increase annually. Additional information on applicable limitations may be found in IRS Publication 560, Retirement Plans for Small Business.

Rent or Lease of Property or Equipment – Line 20a & 20b

If the taxpayer leases a car, truck, or van that is used in the taxpayer's business, the deductible expense to be entered on Schedule C, line 20a can be determined using the standard mileage rate or actual expenses. If the taxpayer chooses to use actual expenses, the part of each lease payment that is for the use of the vehicle in the taxpayer's business is deductible, but no deduction is permitted for any part of a lease payment that is for personal use of the vehicle, such as commuting.

Any advance payments must be spread over the entire lease period. The taxpayer can't deduct any payments made to buy a car, truck, or van even if the payments are called "lease payments." If the taxpayer leases a car, truck, or van for 30 days or more, the taxpayer's lease payment deduction may be reduced by an "inclusion amount." The inclusion amount applied in the case of a leased vehicle has an effect similar to the limit on the depreciation deduction that would apply if the taxpayer owned the vehicle rather than leasing it. The inclusion amount to be used varies depending on the year of use and fair market value (FMV) of the vehicle when placed in service and can be found in the Appendix in IRS Publication 463, Travel, Gift and Car Expenses.

Enter the amounts paid to rent or lease other property used in the business on Schedule C, line 20b. Examples of amounts to be shown on line 20b include office space rental.

Repairs and Maintenance – Line 21

Repairs and maintenance are easily confused. Repairs are restorative work designed to fix a business asset when it breaks, gets damaged, or stops working. Maintenance refers to routine activities and corrective or preventive repair done on business assets to prevent damage and prolong their life expectancy. Simply stated, repairs have the goal of restoring functionality that was lost while maintenance looks to preserve functionality.

Enter on Schedule C, line 21 the cost of incidental repairs to and maintenance of property used in the taxpayer's business that does not add to the property's value or appreciably prolong its life. Do not deduct the value of the proprietor's own labor or amounts spent to restore or replace property; expense incurred to restore or replace property must be capitalized.

Supplies – Line 22

The cost of supplies used in the taxpayer's business is deducted on Schedule C, line 22. As a general rule, the taxpayer can deduct the cost of materials and supplies only to the extent they were consumed and used in the taxpayer's business during the tax year (unless the taxpayer deducted them in a prior tax year). However, if the taxpayer had incidental materials and supplies on hand for which no inventories or records of use were kept, the taxpayer can deduct the cost of supplies purchased during the tax year, provided that method clearly reflects income.

The taxpayer can also deduct the cost of books, professional instruments, equipment, etc., if the taxpayer normally uses them within a year. However, if their useful life extends substantially beyond a year, the taxpayer must generally capitalize the expenditure and recover their costs through depreciation.

Taxes and Licenses – Line 23

The taxpayer can deduct the following taxes and licenses on Schedule C, line 23:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services. However, if the taxpayer collected this tax from the buyer, the taxpayer must also include the amount collected in gross receipts or sales on Schedule C, line 1;

- Real estate and personal property taxes on business assets;
- Licenses and regulatory fees for the taxpayer's trade or business paid each year to state or local governments. (Note: some licenses, such as liquor licenses, may have to be amortized. Additional information can be found in IRS Publication 535, Business Expenses, chapter 8.);
- Social security and Medicare taxes paid to match required withholding from the taxpayer's employees' wages. Reduce the taxpayer's deduction by the amount shown on IRS Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*, line 4;
- Federal unemployment tax paid;
- Federal highway use tax; and
- Contributions to state unemployment insurance fund or disability benefit fund if they are considered taxes under state law.

However, the taxpayer cannot deduct the following;

- Federal income taxes, including the taxpayer's self-employment tax. However, the taxpayer can deduct one-half of the taxpayer's self-employment tax on Schedule 1 (Form 1040), line 15 (but if filing Form 1040-NR, then only when covered under the U.S. social security system due to an international social security agreement);
- Estate and gift taxes;
- Taxes assessed to pay for improvements, such as paving and sewers;
- Taxes on the taxpayer's home or personal use property;
- State and local sales taxes on property purchased for use in the taxpayer's business. Instead, treat these taxes as part of the cost of the property;
- State and local sales taxes imposed on the buyer that the taxpayer was required to collect and pay over to state or local governments. These taxes are not included in gross receipts or sales nor are they a deductible expense. However, if the state or local government allowed the taxpayer to retain any part of the sales tax the taxpayer collected, the taxpayer must include that amount as income on line 6; and
- Other taxes and license fees not related to the taxpayer's business.

Do not reduce the taxpayer's deduction for social security and Medicare taxes by the following amounts claimed on Form 944 or Form(s) 941 for the taxpayer's business employee(s):

- The nonrefundable and refundable portions of the employee retention credit, and
- The nonrefundable and refundable portions of the credits for qualified sick and family leave wages.

Travel – Line 24a

A taxpayer's expenses incurred for business travel are entered on Schedule C, line 24a. Enter the expenses for lodging and transportation incurred in connection with overnight travel for business while away from the taxpayer's tax home. In most cases, the taxpayer's tax home is the taxpayer's main place of business, regardless of where the taxpayer maintain the taxpayer's family home. The taxpayer cannot deduct expenses paid or incurred in connection with employment away from home if that period of employment exceeds 1 year.

In some cases, a taxpayer may want to include a spouse, dependent or someone else on a business trip. However, the taxpayer cannot deduct travel expenses for another unless:

- That person is the taxpayer’s employee;
- The travel is for a bona fide business purpose; and
- The expenses would otherwise be deductible by that person.

Instead of keeping records of the taxpayer’s actual incidental expenses, the taxpayer can use an optional method for deducting incidental expenses only if the taxpayer did not pay or incur meal expenses on a day the taxpayer was traveling away from the taxpayer’s tax home. The amount of the deduction is $5 a day. Incidental expenses include fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries. They do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls. The taxpayer cannot use this method on any day that the taxpayer uses the standard meal allowance.

The taxpayer cannot deduct expenses for attending a convention, seminar, or similar meeting held outside the North American area unless:

- The meeting is directly related to the taxpayer’s trade or business; and
- It is as reasonable for the meeting to be held outside the North American area as within it.

These rules apply to both employers and employees. Other rules apply to luxury water travel.

Deductible Meals – Line 24b

Enter the taxpayer’s deductible business meal expenses on Schedule C, line 24b. This includes expenses for meals while traveling away from home for business. The taxpayer’s deductible business meal expenses are a percentage of the taxpayer’s actual business meal expenses or standard meal allowance. Taxpayers are generally permitted to deduct 50% of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer’s premises primarily for employees. However, the 50% limitation on the deduction of an employer’s food and beverage expenses does not apply to any expenses if:

- The expenses are treated as compensation;
- The expenses, other than those treated as compensation, are for services performed by the taxpayer for another person under a reimbursement or other expense allowance arrangement;
- The expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees;
- The expenses are for goods, services and facilities made available by the taxpayer to the general public;
- The expenses are for goods or services sold by the taxpayer in a bona fide transaction for adequate compensation; or
- The expenses are includable in the gross income of a non-employee recipient.

Furthermore, the Consolidated Appropriations Act, 2021 provides for temporarily increased deductions for business meals. Pursuant to the Act, businesses are permitted a 100% tax deduction for business meals—up from the current 50%—if the food or beverages are provided by a restaurant. The increased business meal deduction is available for 2021 and 2022. The general rule (50%) for business meal deduction applies in 2023.

The taxpayer can deduct all or a percentage of the actual cost of a business meal (depending on the date the expense was incurred) if the following conditions are met.

- The meal expense was an ordinary and necessary expense in carrying on the taxpayer’s trade or

business;
- The expense was not lavish or extravagant under the circumstances;
- The taxpayer or the taxpayer's employee was present at the meal;
- The meal was provided to a current or potential business customer, client, consultant, or similar business contact; and
- In the case of food or beverages provided during or at an entertainment event, the food and beverages were purchased separately from the entertainment, or the cost of the food and beverages was stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

Prior tax law permitted a taxpayer to deduct expenses for entertainment, amusement or recreation provided that the expenses were directly related to the taxpayer's trade or business. The TCJA, §13304, amends that provision and disallows a deduction for expenses incurred by a taxpayer after December 31, 2017 and before January 1, 2026, despite their being directly related to the taxpayer's trade or business, with respect to:

- Activities normally considered to be entertainment, amusement or recreation;
- Club dues or fees for any club organized for the purpose of –
    - business,
    - pleasure,
    - recreation, or
    - any other social purpose; or
- A facility used in connection with any of those activities.

The taxpayer cannot avoid the entertainment disallowance rule by inflating the amount charged for food and beverages.

Standard Meal Allowance

Instead of deducting the actual cost of the taxpayer's meals while traveling away from home, the taxpayer can use the standard meal allowance for the taxpayer's daily meals and incidental expenses. Under this method, the taxpayer deducts a specified amount, depending on where the taxpayer travels, instead of keeping records of actual meal expenses. However, the taxpayer must still keep records to prove the time, place and business purpose of the travel.

The standard meal allowance is the federal M&IE rate. Federal per diem reimbursement rates consist of a maximum lodging allowance component and a meals and incidental expenses (M&IE) component. Most of the continental United States is covered by the standard per diem rate of $166 ($107 lodging, $59 M&IE). The taxpayer can find these rates for locations inside and outside the continental United States by visiting the General Services Administration's website.

Business meals are 100% deductible if the meals are food or beverages provided by a restaurant and paid or incurred after December 31, 2020, and before January 1, 2023. In most cases, for other business meals, the taxpayer can deduct only 50% of the taxpayer's business meal expenses, including meals incurred while away from home on business. However, for individuals subject to the Department of Transportation (DOT) hours of service limits, the percentage for other business meals is increased from 50% to 80% for business meals consumed during or incident to, any period of duty for which those limits are in effect. Individuals subject to the DOT hours of service limits include the following:

- Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations;

- Interstate truck operators who are under DOT regulations; and
- Certain merchant mariners who are under Coast Guard regulations.

However, the taxpayer can fully deduct meals and incidentals furnished or reimbursed to an employee if the taxpayer properly treats the expense as wages subject to withholding. The taxpayer can also fully deduct meals and incidentals provided to a nonemployee to the extent the expenses are includible in the gross income of that person and reported on Form 1099-NEC.

If the taxpayer qualifies as a family daycare provider, the taxpayer can use the standard meal and snack rates, instead of actual costs, to figure the deductible cost of meals and snacks provided to eligible children.

Additional information concerning:

- Standard meal and snack rates for family daycare providers may be found in IRS Publication 587, Business Use of Your Home; and
- Business deductions may be found in IRS Publication 463, Travel, Gift, and Car Expenses.

Utilities – Line 25

A sole proprietor may deduct utility expenses incurred in the trade or business on Schedule C, line 25. If the taxpayer works from an office in his or her home and used the home phone for business, the base rate (including taxes) for the first phone line into the taxpayer's residence is not deductible. Although the taxpayer cannot deduct the telephone base rate, he or she can deduct any additional telephone costs incurred in the business that exceed the base rate of the first phone line. For example, if the taxpayer had a second line, the taxpayer may deduct the business percentage of the charges for that line, including the base rate charges.

Wages – Line 26

The total of wages paid to employees—NOT including the amounts paid to the sole proprietor—during the year is entered on Schedule C, line 26. However, don't deduct salaries and wages deducted elsewhere on the taxpayer's return. If any of the following credits were payable, the amount entered on line 26 must be reduced by the credit received:

- Work Opportunity Credit, a non-refundable federal tax credit designed to promote workplace diversity that provides an employer credit of 40% of qualified first- and second-year wages. Available credit ranges from $2,400 to $9,600, depending on targeted group and wages paid until December 31, 2025. (IRS Form 5884, Work Opportunity Credit)
- Employee Retention Credit, a refundable federal tax credit designed to encourage employers to keep employees on their payroll during the economic slowdown caused by the coronavirus. Although the period during which the credit was available has expired, businesses have three years after the program ends to look back at wages paid after March 12, 2020 in order to determine eligibility. (IRS Form 5884-A, Employee Retention Credit).
- Empowerment Zone Employment Credit of up to 20% of an employer's qualified zone wages (up to $15,000) paid or incurred during the calendar year for services performed by an employee while the employee is a qualified zone employee, extended until December 31,2025. (IRS Form 8844, Empowerment Zone Employment Credit).
- Indian Employment Credit, a 20% tax credit on qualified income and benefits, is designed to create an incentive for employers to hire an enrolled member of an Indian tribe or the

enrolled member's spouse. (IRS Form 8845, Indian Employment Credit).

- Credit for Employer Differential Wage Payments, payments of 20% on up to $20,000 made to an employee while on active duty in the U.S. military for a period of more than 30 days. (IRS Form 8932, Credit for Employer Differential Wage Payments).
- Employer Credit for Paid Family and Medical Leave, a credit of up to 25% of wages paid to non-highly compensated employees for up to 12 weeks of family and medical leave per taxable year (IRS Form 8994, Employer Credit for Paid Family and Medical Leave).

Do not reduce the deduction for any portion of a credit that was passed through to the taxpayer from a pass-through entity.

Other Expenses – Line 27a

Other expenses are listed on Schedule C, Part V. The total of other expenses—ordinary and necessary business expenses not deducted elsewhere on Schedule C—is entered on line 48 and reported on line 27a.

List the following other expenses on Schedule C, Part V:

- Certain amortized costs, including –
    - the cost of pollution-control facilities,
    - amounts paid for research and experimentation,
    - amounts paid to acquire, protect, expand, register, or defend trademarks or trade names, and
    - goodwill and certain other intangibles;
- Any loss from this business that was not allowed last year because of the at-risk rules is treated as a deduction allocable to this business in the current year;
- Debts and partial debts from sales or services that were included in income and are definitely known to be worthless;
- Certain business start-up costs of up to $5,000;
- Up to $15,000 of costs paid or incurred in the current year to remove architectural or transportation barriers to individuals with disabilities and the elderly;
- De minimis amounts paid to acquire or produce certain tangible property if these amounts are deducted by the taxpayer for financial accounting purposes or in keeping the taxpayer's books and records;
- Costs of certain qualified film and television productions or qualified live theatrical productions; and
- Up to $10,000 ($5,000 if married filing separately) of qualifying reforestation costs paid or incurred in the current year.

However, when listing business expenses in Part V, don't include:

- The cost of business equipment or furniture;
- Replacements of or permanent improvements to property;
- Personal, living, and family expenses;
- Charitable contributions; or
- Fines or penalties paid to a government for violating any law.

Additional information on business expenses may be obtained at [IRS Publication 535, Business Expenses] and on amortization at [instructions for IRS Form 4562, Depreciation and Amortization].

Summary

The following summarizes the discussion of self-employed 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.
- 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.
- 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.
- 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.
- Depletion—a deduction (Schedule C, line 12) that allows an owner or operator to account for the reduction of the property's value or basis as a result of the extraction of the natural resource—is the using up of natural resources extracted from a mineral property by mining, drilling, or quarrying stone, or, in the case of a stand of timber, by cutting it.
- The adjusted basis of a taxpayer's property is the taxpayer's original cost or other basis, plus certain additions and improvements, and less certain deductions such as depletion allowed or allowable and casualty losses.
- Depreciation is an allowance (Schedule C, line 13) for the wear and tear, deterioration, or obsolescence of the property used in a business.
- 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.
- 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.
- 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.
- 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.
- Costs incurred for postage and office supplies are shown on Schedule C, line 18.

- 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.
- Leased business vehicle expenses entered on Schedule C, line 20a can be determined using the standard mileage rate or actual expenses.
- 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.
- 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.
- 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.
- Utility expenses incurred in taxpayer's trade or business are entered on Schedule C, line 25.
- 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.
- 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 2 Review

1. Harold is a sole proprietor of a small company. He sponsors an employee picnic each year at a local park that costs him $25,000. If he incurs $15,000 in food and $10,000 in beverage expenses for his 2025 employee picnic, how much of the expense may he deduct for income tax purposes?

   A. $0

   B. $10,000

   C. $12,500

   D. $25,000

2. James, a sole proprietor, incurred expenses of $50,000, part of which he attributes to his surfing hobby. If he attributes $10,000 to his hobby and although not indispensable for his business has ordinary and necessary expenses of the balance, how much can he deduct, if any, as legitimate business expenses?

   A. $0

   B. $10,000

C. $40,000

D. $50,000

3. Arthur, a sole proprietor, uses his personal vehicle for business purposes. He traveled 43,000 business miles from January 1, 2025 through December 31, 2025. In addition, he incurred $1,450 in parking fees and tolls and $15,000 in gas and oil. What amount may Arthur deduct on Schedule C, line 9 if he uses the optional standard mileage rates?

   A. $25,155

   B. $30,100

   C. $31,550

   D. $46,550

Chapter 3 – Business Use of a Home

Introduction

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

When you have completed this chapter, you should be able to:

- 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

In addition to these expenses incurred in the self-employed business, a taxpayer who uses a portion of his or her home in which to conduct the self-employed activity may also include certain expenses for business use of the home.

Although certain exceptions apply, qualifying for a home-office deduction for business use of a taxpayer's home generally requires that the taxpayer use part of his or her home:

- Exclusively and regularly as the principal place of business unless the space is used for the storage of inventory or product samples or as a daycare facility, in which case the requirement for exclusive use does not apply;
- Exclusively and regularly as a place where the taxpayer meets or deals with patients, clients or customers in the normal course of a trade or business;
- On a regular basis for certain storage use;
- For rental use; or
- As a daycare facility.

If the part of the taxpayer's home used is a separate structure, qualifying for a home-office deduction for its use requires that the separate structure be used exclusively and regularly in connection with the taxpayer's trade or business. However, the structure does not have to be the taxpayer's principal place of business or where he or she meets patients, clients, or customers.

Methods of Figuring the Home-Office Deduction

If a taxpayer qualifies for a home-office deduction by meeting the requirements, the next step is to figure the amount of tax deduction for which he or she qualifies. Two methods are available to calculate the home-office deduction:

- The actual expense method; and
- The simplified method.

Actual Expense Method

The actual expense method of figuring a home-office deduction uses the actual expenses incurred by the taxpayer as the basis for determining the deduction allowable for business use of the taxpayer's home. Bear in mind when using the actual expense method to figure the home-office deduction that a taxpayer cannot deduct expenses for the business use of a home incurred during any part of the year he or she did not use the home for business purposes. Thus, a taxpayer who begins using part of his or her home for business purposes beginning on July 1^{st} of the year and who qualifies for a home-office deduction cannot consider expenses for the period prior to July 1^{st}. Instead, the taxpayer may consider only those expenses for the period July 1 through December 31 in figuring the allowable deduction.

When using the actual expense method for figuring the home-office deduction for a client, a tax return preparer must determine:

- The nature of the expense, i.e., whether the expense is –
  - A direct expense,
  - An indirect expense, or
  - An unrelated expense; and
- The percentage of the home used for business purposes.

Nature of the Expense

When determining the nature of the taxpayer's expense, expenses are placed into one of the following three categories:

- Direct expenses;
- Indirect expenses; and
- Unrelated expenses.

Direct expenses are expenses applicable to and affecting only the business part of the taxpayer's home. These expenses are normally deductible in full, subject to any applicable deduction limit. (See **Deduction Limit** below.)

Indirect expenses are those expenses the taxpayer incurs for keeping up and running his or her entire home. Among those expenses would be homeowners insurance. Such indirect expenses are deductible under the home-office deduction ***only*** in an amount based on the percentage of the taxpayer's home used for business purposes. Similar to direct expenses, the deduction of indirect expenses is subject to the applicable deduction limit.

The third category of taxpayer expenses—expenses that are unrelated—are expenses applicable only to the parts of the taxpayer's home that are not used for business purposes. These unrelated expenses are not deductible.

Percentage of the Home Used for Business

Although direct expenses attributable to business purposes are deductible under the home-office deduction irrespective of the percentage of the home actually used by the taxpayer for business purposes, indirect expenses are not. Instead, indirect expenses are deductible under the permitted home-office deduction only in an amount equal to the total of such indirect expenses multiplied by the percentage of the home used for business.

Calculating Percentage of Home Used for Business

A taxpayer is permitted to use any reasonable method to determine the percentage of his or her home used for business purposes. Two methods commonly used for determining the applicable percentage of a home for purposes of the home-office deduction are:

1. Dividing the square footage of the home used for business purposes by the total square footage of the home; and

2. Dividing the number of rooms used for business by the total number of rooms in the taxpayer's home.

Determining the percentage of a taxpayer's home used for business purposes by dividing the number of rooms used for business by the total number of rooms in the house should be used only if the rooms in the house are all of approximately the same size.

Deductible Expenses for Home-Office Deduction

Expenses that are deductible under the home-office deduction fall into two categories and include the following:

- Expenses that are deductible by the taxpayer whether or not the taxpayer uses the home for business purposes, i.e. they are deductible by all homeowners; and
- Expenses that are deductible by the taxpayer only if the taxpayer uses the home for business purposes.

Expenses Deductible by All Homeowners

Expenses that are deductible by all homeowners, whether or not the home is used for business purposes, include the following:

- Real estate taxes, within prescribed limits;
- Deductible mortgage interest; and
- Casualty losses from a federally-declared disaster.

If the taxpayer qualifies for the home-office deduction, these amounts should be multiplied by the percentage of the home used for business purposes to figure the taxpayer's total deduction for business use of the home.

Expenses Deductible only by Taxpayers Using a Home for Business

In addition to those expenses that are deductible by all homeowners, many additional expenses are deductible by homeowners who use their homes for business purposes. These are expenses that would not normally be deductible by the homeowner except for the home's business use.

Principal among those expenses that are deductible by a homeowner who uses the home for business purposes, in an amount determined by the percentage of the home used for business, are the following:

- Depreciation, a deduction designed to reflect the wear and tear on the portion of the taxpayer's home used for business –
    - If the home was used for business in years before the current year, the taxpayer should continue using the same method of depreciation used in those prior years, or
    - If the home was placed in use for business purposes in the current year, the business part of the home should be depreciated as nonresidential business property under the modified accelerated cost recovery system (MACRS);
- Insurance premium for insurance covering the business part of the home only for the current tax year;
- Rent paid for the use of unowned property used in the taxpayer's trade or business calculated by multiplying the total rent payments for the period the home was used for business by the percentage of the home used for business purposes.;
- Repairs –
    - Deductible entirely if the repair costs are direct expenses, or

    - Deductible in part if the repair costs are indirect expenses in an amount equal only to the cost of repairs multiplied by the percentage of the home used as a home office;
- Security system maintenance and monitoring expenses –
    - Business part of costs of installation of the security system (based on percentage of home used for business) is depreciable, and
    - Business part of expenses to maintain and monitor the system is deductible if the security system protects all the doors and windows in the taxpayer's home; and
- Expenses for utilities and services, deductible in an amount equal to the expenses incurred for the utilities and services multiplied by the percentage of business use.

Although these expenses are deductible by a taxpayer using his or her home for business purposes, it is important to keep in mind that only the ***business percentage*** of these expenses is deductible.

Deduction Limit

The home-office deduction is not unlimited. Instead, if a taxpayer uses the actual expense method for claiming a home-office deduction, the deduction of otherwise nondeductible expenses—expenses such as insurance, utilities and depreciation allocable to the business—is limited to the taxpayer's gross income from the business use of the home minus the sum of the following:

1. The business portion of expenses the taxpayer could deduct even if he or she did not use the home for business purposes. Such expenses include eligible mortgage interest, real estate taxes (not exceeding prescribed limits) and net qualified disaster losses allowable as itemized deductions on Schedule A (Form 1040); and
2. The business expenses that relate to the business activity carried on in the home but not to the home itself. Such expenses include the costs of business telephone, supplies and equipment depreciation. (A self-employed taxpayer should not include the deductible one half of self-employment tax in the business expenses that must be subtracted from gross income.)

In applying the deduction 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.

Simplified Method

Instead of using the actual expense method of determining a taxpayer's home-office deduction, a simplified method—available for years beginning January 1, 2013—may be used. 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 square feet) multiplied by the prescribed rate. The current prescribed rate is $5, but the Internal Revenue Service and the Treasury Department may update the prescribed rate from time to time.

Election of the simplified method is irrevocable for the year made. The taxpayer's election of whether to use the actual expense method or simplified method is one that is made each year. The election to use the simplified method to figure the home-office deduction must be made on a ***timely filed***, original federal income tax return.

In addition to the expense deduction for business use of a home calculated using the simplified method, business expenses not related to the taxpayer's use of a home are also deductible.

Depreciation and Actual Expenses Related to Use of Home not Deductible

If a taxpayer elects to use the simplified method of determining the home-office deduction, neither depreciation nor any actual expenses other than those not related to use of the home, may be deducted. (Business expenses not related to the taxpayer's use of the home continue to be deductible.)

No Deduction of Actual Expense Carryover for Simplified Method Users

If a taxpayer used the actual expense method to figure the home-office deduction in a previous year and has an expense carryover because the deduction was limited in that year, no portion of the carried-over amount may be deducted in any year in which the taxpayer uses the simplified method. In such a case, the taxpayer will continue to carry over the disallowed amount to the next year in which he or she uses actual expenses to figure the home-office deduction.

Expenses Deductible Irrespective of Business Use

The expenses that would be deductible by a taxpayer whether or not claiming a home-office deduction are treated differently, depending on whether the actual expense method or simplified method is used. Unlike the expense treatment under the actual expense method of expenses that are deductible irrespective of business use of the taxpayer's home—expenses such as mortgage interest, real estate taxes and casualty losses—such expenses must be treated as personal expenses by a taxpayer using the simplified method of determining the home-office deduction.

Special Rules Applicable to Simplified Method

Special rules apply to a taxpayer using the simplified method to determine the home-office deduction under certain circumstances. Those special rules are applicable in the case of:

- **Shared use of a home** - If a taxpayer shares his or her home with someone else who also uses the home in a business that qualifies for the home-office deduction, each user must make his or her own election as to the method used for calculating the deduction;
- **Multiple qualified business uses** - If a taxpayer conducts multiple businesses that qualify for the home-office deduction, the taxpayer's election to use the simplified method applies to all of the taxpayer's qualified business uses of that home;
- **Multiple homes** - A taxpayer who uses more than one home for business purposes can use the simplified method of calculating the home-office deduction for only one of the homes; and
- **Part year use or area changes** - A taxpayer may have a qualified business use only for part of the taxable year or may change the square footage of the home office during the year. In either case, the deduction for the home office is based on the average monthly allowable square footage used. To calculate the average monthly allowable square footage, the tax return preparer must add the amount of allowable square feet used by the taxpayer each month and divide the sum by 12. The preparer cannot take more than 300 square feet into account for any one month. Furthermore, if the taxpayer's qualified business use was for less than 15 days in any month, the preparer must use zero for that month.

Gross Income Limitation

Somewhat similar to the deduction limit applicable to the actual expense method for determining the home-office deduction, a gross income limitation applies to the home-office deduction available under the simplified method. Under the gross income limitation applicable to the simplified method, a taxpayer's 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.

If the business deductions unrelated to the use of the taxpayer's home are greater than the gross income the taxpayer derived from the qualified business use, the home-office deduction for business use of the home is disallowed.

Recordkeeping Requirements

Although the law generally does not require that a self-employed taxpayer use any ***specific type*** of recordkeeping system, documents supporting the taxpayer's gross receipts, amounts paid for inventory and business expenses should be maintained for as long as they are material to the administration of tax law. If the self-employed taxpayer is involved in multiple businesses he or she should keep a complete and separate set of records and supporting documents for each business.

However, whether the taxpayer has a single business or multiple businesses, the records should include a summary of business transactions and show the following for the business:

- Gross receipts;
- Deductions; and
- Credits.

The supporting documents include sales slips, paid bills, invoices, receipts, deposit slips and canceled checks.

Gross Receipts

The documents supporting a self-employed taxpayer's gross receipts that should be kept for as long as they are material to the administration of tax law include:

- Cash register tapes;
- Bank deposit slips;
- Receipt books;
- Invoices;
- Credit card charge slips; and
- Forms 1099-NEC.

Inventory

Not all self-employed taxpayers maintain an inventory. However, if a self-employed taxpayer buys items for resale to customers, the supporting documents should show the amount paid and that the payment was for inventory. Such supporting documents include:

- Canceled checks;
- Cash register tape receipts;
- Credit card sales slips; and
- Invoices.

Expenses

Documents supporting a self-employed taxpayer's expenses—the cost incurred by the taxpayer, other than the cost of inventory, to carry on the business—should be kept as long as needed. In most cases, supporting documents should be kept for the later of 3 years following the date the taxpayer's original tax return was filed or 2 years following the date any tax payment was made. Such documents should show a) the amounts paid, and b) that the amounts paid were for business expenses.

Documents that should be kept to support a self-employed taxpayer's expenses include:

- Canceled checks;
- Cash register tapes;
- Account statements;
- Credit card sales slips;
- Invoices; and
- Petty cash slips for small cash payments.

Summary

- A taxpayer who qualifies for a home-office deduction may calculate that deduction using the actual expense method or the simplified 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.
- 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.
- 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.
- 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.
- 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.
- 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.
- 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 3 Review

1. What is Helen's deduction using the actual expense method if she opened her home office on July 1st, earned $6,000, has a 20% business percentage, incurred $3,000 to paint the office on July 2nd and paid a $1,200 annual homeowners insurance premium?

   A. $420

   B. $2,100

   C. $3,120

   D. $4,200

2. What is George's deduction for a 400 square foot office in his rented home, assuming he qualifies for a home office deduction, if he pays $1,200 for business telephone service, uses 20% of the home for business and elects the simplified method?

   A. $1,500

   B. $1,740

   C. $2,000

   D. $2,700

3. What is Harry's deduction for his 400 square foot office if he operates a summer business from home and elects the simplified method, assuming his office is used for 14 days in May, 30 days each month in June through August and 15 days in September?

   A. $375

   B. $500

C. $665

D. $835

Answers to Chapter Review Questions

Chapter 1

Question 1 Feedback

A. Your answer is incorrect. The amount shown on Schedule C, line 1 is unreduced by any refunds due to product returns or price reductions.

B. Your answer is incorrect. The amount that should be shown on line 1 of Schedule C should not be reduced by the amount of aggregate price reductions.

C. Your answer is incorrect. Your answer indicates you reduced the taxpayer's gross income by the amount of returns. Returns, however, are shown on Schedule C, line 2 and do not affect the gross revenue or sales that should be shown on line 1.

D. Your answer is correct. The amount entered on line 1 is the total revenue the taxpayer received from the sales of the company's products or services, unreduced by any refunds due to product returns or price reductions given to buyers to compensate for damaged goods, etc..

Question 2 Feedback

A. Your answer is correct. Subtracting the cost of goods sold ($50,000) from the gross receipts or sales ($500,000) less returns ($10,000) and allowances ($15,000) yields the gross profit amount to be entered on Schedule C, line 5. The taxpayer's other income, if any, is added to the gross profit to yield the taxpayer's gross income. Since Harry has no other business income, his gross income shown on line 7—$425,000—is the same as his gross profit shown on line 5.

B. Your answer is incorrect. In addition to subtracting the COGS, you must also account for any allowances and returns to determine the taxpayer's gross income.

C. Your answer is incorrect. You subtracted the returns and allowances from Harry's gross receipts, but you also need to account for his COGS.

D. Your answer is incorrect. It fails to account for Harry's allowances or COGS.

Question 3 Feedback

A. Your answer is incorrect. The $45,000 in returns and allowances would have been subtracted from her gross receipts to yield her $800,000 gross profit.

B. Your answer is incorrect. The answer given fails to account for Shirley's bad debt recovery or the prizes she was awarded.

C. Your answer is incorrect. The answer doesn't take Shirley's recovery of $15,000 in bad debts into consideration.

D. Your answer is correct. A Schedule C taxpayer must report any business income that doesn't come from normal business operations on Schedule C, line 6. In Shirley's case, she would report the $15,000 received in bad debts she recovered, $450 of interest earned on accounts receivable and $5,000 in prizes on line 6. The $45,000 in returns and allowances already would have been subtracted from her gross receipts (shown on line 1) to yield her $800,000 gross profit.

Chapter 2

Question 1 Feedback

A. Your answer is incorrect. Although the TCJA disallows a deduction for expenses incurred by a taxpayer after December 31, 2017 and before January 1, 2026, despite their being directly related to the taxpayer's trade or business, with respect to activities normally considered to be entertainment, amusement or recreation, the disallowance does not apply when the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

B. Your answer is incorrect. Expenses incurred for beverages are treated the same as food expenses for tax purposes.

C. Your answer is incorrect. Even though taxpayers are generally limited under the TCJA to a 50% deduction of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer's premises primarily for employees, the limitation does not apply when the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

D. Your answer is correct. Taxpayers are generally permitted to deduct 50% of the expenses for food and beverages paid or incurred in conducting their trade or business as well as the expenses for food and beverages provided by the taxpayer on the taxpayer's premises primarily for employees. However, the 50% limitation on the deduction of an employer's food and beverage expenses does not apply to any expenses if, among other exceptions, the expenses are for recreational, social or similar activities primarily for the benefit of employees other than highly compensated employees.

Question 2 Feedback

A. Your answer is incorrect. Although James, a sole proprietor, cannot deduct the expenses incurred in his hobby, he can deduct the portion attributable to his business.

B. Your answer is incorrect. Those are his hobby expenses; they are not deductible.

C. Your answer is correct. In order to be deductible, a business expense must be ordinary, i.e., one that is common and accepted in the taxpayer's field of business, and necessary, i.e., one that is helpful and appropriate for the taxpayer's business. Although the expense must be ordinary and necessary, it does not need to be indispensable to the business. However, if any expense is partly for business and partly personal, the personal part of the expense must be separated from the business part. The personal part is not deductible.

D. Your answer is incorrect. James cannot deduct the expenses of his hobby as business expenses.

Question 3 Feedback

A. Your answer is incorrect. This answer failed to consider the change in the optional standard mileage rate applicable for 2025 as well as the expenses for parking fees and tolls.

B. Your answer is incorrect. The expenditures for parking fees and tolls may also be deducted by a taxpayer taking the optional standard mileage rate.

C. Your answer is correct. A sole proprietor can deduct the actual expenses of operating a car or truck or take the standard mileage rate when used in the taxpayer's business. This is true even if the taxpayer used the taxpayer's vehicle for hire (such as a taxicab). To determine the amount to show on Schedule C, line 9, for a taxpayer taking a deduction for business travel using the optional standard mileage rate, multiply the number of business miles driven in 2025 by 70 cents, and add to this amount the taxpayer's parking fees and tolls. However, if electing to use the optional standard mileage rate, no deduction may be taken for gas and oil.

D. Your answer is incorrect. Arthur cannot take a deduction for gas and oil if he has elected to use the optional standard mileage rate.

Chapter 3

Question 1 Answer

A. Your answer is incorrect. Although a taxpayer using the actual expense method cannot deduct expenses for home use when the home was not being used for business, Helen's expense was incurred when the home was being used for business.

B. Your answer is incorrect. Helen's expenses are part direct costs and part indirect costs, some of which are fully deductible and others subject to her 20% business percentage.

C. Your answer is correct. Helen's $3,120 deduction is comprised of her indirect costs for homeowners insurance adjusted for her 20% business percentage and 6-month use of the office and her direct costs to paint the office.

D. Your answer is incorrect. Although some expenses are direct expenses incurred after Helen put the office in use, part of her expenses are indirect costs subject to adjustment for a partial year and the applicable business percentage.

Question 2 Answer

A. Your answer is incorrect. Although the home-office deduction is limited to no more than $1,500, George's business expenses not related to the business use of his home continue to be deductible.

B. Your answer is incorrect. Since George's costs for business telephone and internet apply solely to the business, they are not subject to the business percentage use of the house.

C. Your answer is incorrect. The simplified method limits George's home-office deduction to the prescribed rate times no more than 300 square feet, and his business telephone and internet service expenses are deductible.

D. Your answer is correct. George's business deduction is $2,700, comprised of a $1,500 home-office deduction and business expenses not related to his home of $1,200.

Question 3 Answer

A. Your answer is incorrect. Harry's use of his home office in September must be counted in the average because it is at least 15 days of use.

B. Your answer is correct. Harry's home-office deduction is $500, calculated by multiplying the office area by four months, dividing by 12 and multiplying the result by the $5 prescribed rate. (300 x 4 = 1,200; 1,200 ÷ 12 = 100; 100 x $5 = $500)

C. Your answer is incorrect. Although the answer selected shows that the proper number of months was used—four months, in this case—the maximum square footage used for any month is 300.

D. Your answer is incorrect. The maximum amount of square footage that may be used to determine the average is 300. In addition, any month in which the office is used for fewer than 15 days is considered unused for the entire month.

Glossary

Actual expense method (home office deduction)	A method of figuring a home-office deduction using the actual expenses incurred by the taxpayer as the basis for determining the deduction allowable for business use of the taxpayer's home.
Applicable federal rate (AFR)	Interest rates prescribed by the IRS for federal income tax purposes.
beginning inventory	The cost of merchandise on hand at the beginning of the year that is available to be sold to customers.
Business income	Any income received by a taxpayer that is connected to the taxpayer's business.
Cash discount	An amount a merchant taxpayer's suppliers permit the merchant to deduct from their purchase invoices for prompt payments.
Common-law control test (to determine employment status)	A taxpayer is considered an employee rather than an independent contractor 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.
Contract labor	Payments made to persons the taxpayer does not treat as employees (for example, independent contractors) for services performed for the taxpayer's trade or business.
Cost of Goods Sold (COGS)	The costs incurred to make or buy goods to sell.
Depletion	The using up of natural resources extracted from a mineral property by mining, drilling, or quarrying stone, or, in the case of a stand of timber, by cutting it.
Depletion deduction	A deduction allowing an owner or operator to account for the reduction of the property's value or basis as a result of the extraction of the natural resource.
Depreciation	The annual deduction allowed to enable a taxpayer to recover the cost or other basis of business or investment property having a useful life substantially beyond the tax year.
Direct expenses (home office deduction)	Expenses applicable to and affecting only the business part of the taxpayer's home.
Direct labor costs (for COGS calculation)	The wages the taxpayer pays to those employees who spend all their time working directly on the product being manufactured.
Drawing account	A separate account a Schedule C taxpayer keeps to record the business income that he or she withdrew to pay for personal and family expenses.
Finance reserve income ("other income" on Schedule C)	Income generated from reserves held by the taxpayer to finance goods purchased by a customer.

Gross receipts	The total revenue the taxpayer received from the sales of the company's products or services, unreduced by any refunds due to product returns or price reductions given to buyers to compensate for damaged goods, etc..
Hobby	An activity, for tax purposes, **not** engaged in for profit or income.
Home-office deduction	An income tax deduction for use of a taxpayer's home for business purposes.
Indirect labor costs (for COGS calculation)	Wages the taxpayer pays to employees who perform a general factory function that does not have any immediate or direct connection with making the saleable product, but that is a necessary part of the manufacturing process.
Indirect expenses (home office deduction)	Expenses the taxpayer incurs for keeping up and running his or her entire home.
Installment method	Recognition of income received in an installment sale over the duration of the payment period rather than in the year the transaction occurs.
Installment sale	A sale for which a taxpayer receives payment over more than a single year.
Legal and professional services	Fees charged by accountants and attorneys that are ordinary and necessary expenses directly related to operating the taxpayer's business.
Listed property	Property used in a business that has both personal and business uses
Luxury vehicle	A four-wheeled vehicle, regardless the cost of the vehicle, used mostly on public roads, and which has an unloaded gross weight of no more than 6,000 pounds. It includes vehicles not normally considered "luxury" vehicles on the basis of their price.
Maintenance	Routine activities and corrective or preventive repair done on business assets to prevent damage and prolong their life expectancy.
Office supplies	Traditional office items, like pens, staplers, paper clips, USB thumb drives, and printer ink cartridges that get used up by employees.
Overhead expenses (for COGS calculation)	Expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision.
Repairs	Restorative work designed to fix a business asset when it breaks, gets damaged, or stops working.
Schedule C	The IRS form on which a taxpayer reports the revenue from his or her business and the expenses incurred to run it.
Scrap sales ("other income" on Schedule C)	Income derived from the sale of excess unusable material left over after a product has been manufactured.

Self-employed taxpayer	A taxpayer who carries on a trade or business as a sole proprietor, is an independent contractor, is a member of a partnership or is in business for himself or herself in any other way.
Simplified method (home office deduction)	An alternative to the actual expense method of figuring the home-office deduction in which the deduction is equal to the square footage of the space used for business purposes, not exceeding 300 square feet, multiplied by the prescribed rate.
Sole proprietor	A person who owns an unincorporated business by himself or herself or 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.
Statutory employee	An independent contractor under the common-law control test treated as an employees (rather than independent contractors) for employment tax purposes.
Trade discount	The reduction in the retail price at which a manufacturer sells goods to a reseller rather than to a retail customer.

Index

Final Exam

Navigating Form 1040 Schedule C

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. Under the common law control test, a taxpayer is considered an employee rather than an independent contractor if the employer has the right to direct him or her in regard to all of the following concerning the job EXCEPT:
   A. What to do,
   B. The reason for doing it
   C. How to do it,
   D. When to do it
2. What are taxpayers called that are independent contractors under the common law test but who are treated as employees for employment tax purposes?
   A. Sole proprietors
   B. Statutory employees
   C. Commission salespersons
   D. Contract labor
3. Harry, a sole proprietor, generally uses the installment method for recognizing sales whenever possible. For which of the following sales is he permitted to use the installment method?
   A. Sales that involve multi-year payments
   B. Sales that result in a loss
   C. Dealer sales
   D. Sales of personal property
4. What occurs if an installment sale contract does not provide for the payment of interest?
   A. The buyer must declare the receipt of interest based on the APR
   B. Part of the stated principal amount may be recharacterized as interest
   C. The selling taxpayer will not be permitted to recognize income under the installment method
   D. The contract will be deemed invalid
5. On which of the following is the test rate of interest for an installment sale contract based?

A. The federal discount rate

B. The prime rate of interest

C. The applicable federal rate (AFR)

D. The LIBOR rate

6. Shirley's emporium, a sole proprietorship, regularly advertises as a way to gain new customers. For which of the following types of advertising is she unable to deduct advertising costs?

   A. Advertising directly related to her business activities

   B. Goodwill advertising to keep her business name before the public

   C. The cost of providing entertainment to the public as a means of advertising

   D. Advertising in a political convention program

7. For a business expense to be deductible, the expense must be

   A. Indispensable for the business

   B. Ordinary and necessary

   C. For a business operated as a profession

   D. Capitalized

8. Harry traveled 300 business miles by car in February, 2025 and incurred $30 in parking fees, $50 in tolls and $90 in gas and oil expenses. If he elected to use the alternative standard mileage rate, what is his deduction?

   A. $198

   B. $210

   C. $290

   D. $338.75

9. Which of the following cannot be depreciated?

   A. business or investment property having a useful life substantially beyond the tax year

   B. property owned by the taxpayer

   C. property having a determinable useful life

   D. land

10. Which of the following is NOT a characteristic of a "luxury vehicle" subject to depreciation?

   A. It is a four-wheeled vehicle

   B. It must cost more than $65,000

   C. It is used mostly on public roads

D. It has an unloaded gross weight of no more than 6,000 pounds

11. In connection with the actual expense method of figuring the deduction for business use of a home, a taxpayer's expenses applicable to and affecting only the business part of the taxpayer's home are referred to as which of the following?

    A. Direct expenses

    B. Qualified expenses

    C. Indirect expenses

    D. Unrelated expenses

12. Which of the following would be considered a ***direct expense*** when using the actual expense method of figuring the deduction for a taxpayer's business use of part of his or her home?

    A. Homeowner association dues

    B. Expenses of cleaning the carpets in the space used for business purposes

    C. Lawn maintenance expenses

    D. Expenses incurred for heating the home

13. For purposes of figuring the home-office deduction, the term _________ refers to an expense a taxpayer incurs for keeping up and running his or her entire home.

    A. Direct expense

    B. Unrelated expense

    C. Qualified expense

    D. Indirect expense

14. In applying the deduction limit to a taxpayer's home-office deduction under the actual expense method, the deduction for _______ should be taken last.

    A. Direct expenses

    B. Unrelated expenses

    C. Depreciation

    D. Security system installation costs

15. Ellen uses 10% of her home for business purposes and qualifies for a home-office deduction. If the space she used for business for the entire year was 400 square feet and she uses the simplified method, for what home-office deduction would she qualify?

    A. $1,500

    B. $2,000

    C. $2,500

    D. $3,000