# Chapter 12: Schedule C



Corrections were made to this workbook through January of 2004. No subsequent modifications were made.

## BUSINESS USE OF HOME

IRC §280A was enacted in 1976 to permit an office-in-home deduction. Various amendments and court decisions over the years have shifted this provision back and forth between one that is taxpayer friendly and one that is restrictive. In 1997, Congress amended the section to allow more taxpayers to qualify for the deduction. IRC §280A disallows expenses unless an exception applies. Therefore, the taxpayer must meet one of the exceptions in order to deduct any expenses in excess of the gross income from the business activity. The disallowance will not apply to mortgage interest, real estate taxes, or casualty losses. IRC §280A also defines the rules for the rental of vacation homes.

IRC §280A(c) describes one of the exceptions as **business use by the taxpayer.** The home office must be used **"exclusively on a regular basis"** as the principal place of business or as a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business.

If the taxpayer is an **employee,** the **exclusive use** must be for the **convenience of the employer.**

Space used on a **regular basis as a storage unit for the inventory or product samples** of the taxpayer's business of selling products at retail or wholesale also qualifies for an exception and may therefore be deductible.

**Example 1.** Betty operates a hair salon in the basement of her home. Since customers come to Betty's house in the normal course of her business, Betty qualifies for a deduction for that portion of her home.

**Example 2.** Chuck is an employee of a local insurance company. He has office space available at his employer's main office, but chooses to work out of his home to avoid driving into town every morning. Chuck does not qualify for an office-in-home deduction since working at home is for his convenience. If Chuck's employer required him to work out of his home for the employer's convenience, Chuck would qualify for the deduction.

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The issue of whether the office is the principal place of business was defined by the Supreme Court in the *Soliman*[1] case in 1993. An amendment to IRC §280A, effective in 1998, stated that a principal place of business includes a place of business used by the taxpayer for the administrative or management activities of any trade or business if there is no other fixed location where substantial administrative or management activities occur.

**Example 3.** Darryl is a self-employed plumber. He does not meet with customers in his home, but he has set aside a portion of his residence where he prepares invoices, pays his bills, and makes business telephone calls. He has no other office. Darryl likely qualifies for an office-in-home deduction.

## SPECIAL ALLOCATIONS FOR DAYCARE PROVIDERS

Taxpayers using their home on a **regular** basis for providing daycare can deduct the business expenses for that portion of the home, even though the same space is used for nonbusiness purposes. To qualify for the deductions the following requirements must be met:

1. The taxpayer must be in the trade or business of providing daycare for children, persons age 65 or older, or persons with physical or mental handicaps who are unable to care for themselves.
2. The taxpayer must have applied for, been granted, or be exempt from having a license, certification, registration, or approval as a daycare center or as a family or group daycare home under state law. The taxpayer does not meet this requirement if the application is rejected or other authorization was revoked.

If a portion of the home is used exclusively as a daycare facility, all allocable expenses are deductible, subject to a deduction limit. The deduction is limited to the gross income from the business use of the home minus the sum of:

1. The business part of expenses the taxpayer could deduct, even if the home were not used for business,[2] and
2. The business expenses that relate to the business activity in the home (e.g., business telephone, supplies, and depreciation on equipment), but not to the use of the home itself.

If the daycare portion of the home is used regularly but not exclusively for the daycare business, the deductions are allocated by the portion of the time they are used exclusively for daycare. A room that is **available for use** throughout each business day is **considered to be used** for daycare throughout each business day. The taxpayer does not need to record the specific hours the rooms are used for business. The area may be used occasionally for personal reasons. However, a room used only occasionally for business does not qualify for the deduction.

To determine what portion of the available time the home is actually used for business, compare the total time used for business to the total time that part of the home is used for all purposes.

**Example 4.** Joanna uses her basement to operate a daycare business for children. She calculates the business percentage of the basement as follows:

**1,700 (square footage of basement) ÷ 3,400 (square footage of entire home) = 50%**

She uses the basement for daycare 13 hours per day, 5 days per week, for 50 weeks each year. During the other 11 hours per day, the family may use the basement.

Joanna computes the percentage of time the basement is available for use as follows:

$$\frac{\text{Number of hours available for use } (13 \times 5 \times 50)}{\text{Total number of hours in the year } (24 \times 365)} = 37.1\%$$

Joanna can deduct 37.1% of any direct expense for the basement. However, because her indirect expenses are for the entire house, she can deduct only 18.6% of the indirect expenses as shown in the following calculation.

**50% (business percentage of home) × 37.1% (percentage of time used) = 18.55%**

Assuming Joanna has $50,000 of 2003 gross receipts from the daycare business and $25,000 of expenses not related to the business use of her home. Therefore, her 2003 tentative profit is $25,000. She paid the following expenses in 2003:

| | |
|---|---|
| Home rent | $8,400 |
| Utilities | 3,600 |
| Basement repairs | 500 |

Joanna will deduct $2,412 for business use of her home as shown on the completed Form 8829 which follows.

## For Example 4

Form **8829** | Department of the Treasury, Internal Revenue Service (99)

### Expenses for Business Use of Your Home

▶ File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

▶ See separate instructions.

OMB No. 1545-1266 | **2003** | Attachment Sequence No. **66**



Name(s) of proprietor(s): **Joanna** | Your social security number: **888 99 0000**

**Part I — Part of Your Home Used for Business**

| | | | | |
|---|---|---|---|---|
| 1 | Area used regularly and exclusively for business, regularly for day care, or for storage of inventory or product samples (see instructions) | | 1 | 1,700 |
| 2 | Total area of home | | 2 | 3,400 |
| 3 | Divide line 1 by line 2. Enter the result as a percentage | | 3 | 50 % |
| | • **For day-care facilities not used exclusively for business, also complete lines 4–6.** | | | |
| | • **All others, skip lines 4–6 and enter the amount from line 3 on line 7.** | | | |
| 4 | Multiply days used for day care during year by hours used per day | 4 hr. | | |
| 5 | Total hours available for use during the year (365 days × 24 hours) (see instructions) | 5 8,760 hr. | | |
| 6 | Divide line 4 by line 5. Enter the result as a decimal amount | 6 .3710 | | |
| 7 | Business percentage. For day-care facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ▶ | | 7 | 18.55 % |

**Part II — Figure Your Allowable Deduction**

| | | (a) Direct expenses | (b) Indirect expenses | | |
|---|---|---|---|---|---|
| 8 | Enter the amount from Schedule C, line 29, **plus** any net gain or (loss) derived from the business use of your home and shown on Schedule D or Form 4797. If more than one place of business, see instructions | | | 8 | 25,000 |
| | **See instructions for columns (a) and (b) before completing lines 9–20.** | | | | |
| 9 | Casualty losses (see instructions) | | | | |
| 10 | Deductible mortgage interest (see instructions) | | | | |
| 11 | Real estate taxes (see instructions) | | | | |
| 12 | Add lines 9, 10, and 11 | | | | |
| 13 | Multiply line 12, column (b) by line 7 | | 13 | | |
| 14 | Add line 12, column (a) and line 13 | | | 14 | 0 |
| 15 | Subtract line 14 from line 8. If zero or less, enter -0- | | | 15 | 25,000 |
| 16 | Excess mortgage interest (see instructions) | | | | |
| 17 | Insurance | | | | |
| 18 | Repairs and maintenance **($500 x .371)** | 186 | | | |
| 19 | Utilities | | 3,600 | | |
| 20 | Other expenses (see instructions) | | 8,400 | | |
| 21 | Add lines 16 through 20 | 186 | 12,000 | | |
| 22 | Multiply line 21, column (b) by line 7 | | 22 2,226 | | |
| 23 | Carryover of operating expenses from 2002 Form 8829, line 41 | | 23 | | |
| 24 | Add line 21 in column (a), line 22, and line 23 | | | 24 | 2,412 |
| 25 | Allowable operating expenses. Enter the **smaller** of line 15 or line 24 | | | 25 | 2,412 |
| 26 | Limit on excess casualty losses and depreciation. Subtract line 25 from line 15 | | | 26 | 22,588 |
| 27 | Excess casualty losses (see instructions) | | 27 | | |
| 28 | Depreciation of your home from Part III below | | 28 | | |
| 29 | Carryover of excess casualty losses and depreciation from 2002 Form 8829, line 42 | | 29 | | |
| 30 | Add lines 27 through 29 | | | 30 | 0 |
| 31 | Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30 | | | 31 | 0 |
| 32 | Add lines 14, 25, and 31 | | | 32 | 2,412 |
| 33 | Casualty loss portion, if any, from lines 14 and 31. Carry amount to **Form 4684**, Section B | | | 33 | |
| 34 | Allowable expenses for business use of your home. Subtract line 33 from line 32. Enter here and on Schedule C, line 30. If your home was used for more than one business, see instructions ▶ | | | 34 | 2,412 |

...eciation of Your Home

**Note.** IRS Pub. 587, *Business Use of Your Home, Including Use by Daycare Providers* is a valuable reference tool for practitioners and taxpayers.

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## BUSINESS VERSUS HOBBY ACTIVITY

Numerous court cases are initiated each year because taxpayers and the IRS disagree on whether an activity is a hobby or a business engaged in for a profit.

If the activity is a business, with a profit-making purpose, the taxpayer is entitled to normal business deductions. The taxpayer is able to deduct a loss from the activity on his tax return.

If the activity is classified as a hobby, the taxpayer is unable to deduct a net loss under the provisions of IRC §183. This section applies to **individuals and S corporations** and is commonly referred to as the "hobby loss rules." The taxpayer is entitled to deduct expenses only up to the amount of gross income derived from the activity.

IRC §183(c) defines a hobby (activity not engaged in for profit) as "any activity other than one with respect to which deductions are allowable for the taxable year under IRC §162 or under paragraph (1) or (2) of IRC §212." Therefore, it has been left to the courts to decide on a case-by-case basis whether an activity is treated as a business or a hobby.

### DETERMINATION OF STATUS

There are **nine factors** used by the courts to determine whether an activity is a business or a hobby. No one factor is consistently more important than any other, and there is no guarantee that the taxpayer or the IRS will prevail although the requirements of a majority of the factors are met. All facts and circumstances are taken into account when evaluating each case.

#### 1. Manner in Which Activity Is Conducted

The manner in which a taxpayer conducts the activity supports whether the activity is a business or hobby. The following are important to consider when distinguishing a business from a hobby:

- The taxpayer should prepare a business plan, including a break even analysis. This helps determine the amount of income necessary for the activity to be profitable by projecting the anticipated costs of the business.
- Detailed and accurate records should be kept, as well as a separate checking account for each activity.
- The taxpayer should advertise and promote the activity in a businesslike manner.
- The taxpayer should be willing to make changes to the operation if the activity is initially unsuccessful.
- The taxpayer should be able to demonstrate that circumstances beyond the control of the taxpayer prevented a profit from being realized.
- The taxpayer should not allow losses to grow without making an effort to change operations or consult experts.

#### 2. Expertise of the Taxpayer or Advisors

The taxpayer should consult with experts before beginning the activity and on an as-needed basis after starting. The taxpayer should also study and conduct research to increase personal expertise regarding the business.

#### 3. Time and Effort Expended in Carrying on the Activity

The amount of time and effort the taxpayer spends on the activity is important when distinguishing the activity as a business or hobby. Following are areas the IRS uses in its determination:

- The amount of personal time and effort spent on the activity, especially if it does not have recreational aspects
- Whether the taxpayer employs competent and qualified personnel, if there is limited time for owner participation
- Whether the taxpayer makes major decisions based upon personal enjoyment as opposed to business prospects

### 4. Expectation That Assets Used in Activity Will Appreciate

The IRS takes into account whether the assets will increase in value or could produce income if the assets were sold.

### 5. Taxpayer's Success in Other Activities

The taxpayer can show that she was successful in making a profit in similar activities in the past.

### 6. History of Income or Loss with Respect to the Activity

The taxpayer should be conscious of the typical start-up period required to make similar activities profitable. The taxpayer may keep track of business circumstances and personal setbacks beyond the taxpayer's control that may result in losses for a longer period than usual. Also, the taxpayer should not incur losses out of proportion to the expected gains from the activity.

### 7. Amount of Occasional Profits

The taxpayer should report any profits from the activity, no matter how small they are or how often they occur. If losses in one year are relatively small, the taxpayer may consider forgoing the loss deduction that year in order to strengthen the case for a profit motive permitting the deduction of losses in other years when they might be greater. The taxpayer should also consider business or economic cycles, which might make it unrealistic to expect profits on a regular basis.

> **Caution.** The taxpayer should not use changes in accounting methods to artificially create profits, since this may have a negative impact in later years.

### 8. Financial Status of the Taxpayer

The taxpayer should be prepared to invest substantial resources in the activity to demonstrate a serious intent to create a profitable activity. The taxpayer should not be willing to sustain continued losses because of the existence of other financial resources when a prudent businessperson would end the activity.

### 9. Elements of Personal Pleasure or Recreation

The taxpayer should be prepared to show that any personal pleasure or recreation derived from the activity is insignificant or merely incidental in comparison to the business motives. A taxpayer should not attempt to claim deductions from an activity where the possibility for profit is small in comparison to the substantial possibility for personal gratification.



## HOW FACTORS ARE USED

The IRS published an audit technique memorandum in June 2003 for the **direct sellers industry.** The IRS advises its examiners when examining taxpayers who are direct sellers that factors 1, 3, 6, and 8 are generally dominant; factors 2, 5, and 9 are less important; factor 4 rarely is applicable; and factor 7 applies in all situations and should always be considered.

Under IRC §183(d), if the taxpayer has **shown a net profit in three out of the last five taxable years** including the current year, it is **presumed the activity is engaged in for profit.** The burden of proof shifts from the taxpayer to the IRS, and the IRS will have to prove that the activity is a hobby. If the activity involves the breeding, training, showing, or racing of horses, the activity needs to show a profit only in two of the last seven years including the current year for the burden of proof to shift to the IRS.

The taxpayer may make an election to postpone any determination until the end of the fourth year (sixth year for breeding, training, showing, or racing of horses). The election precludes the IRS from disallowing losses from the activity under the hobby loss rules of IRC §183 until the end of the fifth year (seventh year for horse activities) of the activity. The election extends the statute of limitations solely for the activity for all the years in the five (seven) year period until two years after the due date of the return for the last year in the period. This election is made by filing Form 5213, *Election to Postpone Determination.* The election must be filed by the earlier of three years after the due date (without extensions) of the tax return for the first year of the activity, or sixty days after receipt of written notice from the IRS of the intent to disallow deductions under IRC §183. The consent to extend the statute of limitations cannot be revoked.

**Example 5.** Alex has always enjoyed watching and driving fast cars. In 1999, he decided to purchase a race car and enter it in races at the local speedway. He found that it was an expensive activity and very competitive. He incurred losses from this activity every year from 1999 through 2003 and deducted those losses on his Schedule C.

If any of these returns are examined by the IRS, Alex will have to prove the activity was entered into for profit. He will need to convince the IRS, based on the nine factors and the facts and circumstances of his activity, that he is entitled to deduct his losses. If he has shown a net profit in three of the years from 1999 through 2003, then the activity will be presumed as entered into for profit. In 2004, he will need to show a profit in three of the five years from 2000 through 2004 to shift the burden of proof to the IRS.

Alex can make an election to postpone any determination using Form 5213, which follows. If he did this, the statute of limitations for all of the tax years from 1999 forward until at least April 15, 2006 would be held open solely for the activity.

**Note.** Alex's tax preparer may advise him not to make this election and force the IRS to open an examination during the normal three-year statute of limitations for 1999 and 2000.

**For Example 5**

Form **5213** (Rev. July 2000) Department of the Treasury Internal Revenue Service

**Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit**

▶ **To be filed by individuals, estates, trusts, partnerships, and S corporations.**

OMB No. 1545-0195

Name(s) as shown on tax return: **Alex**

**Identifying number as shown on tax return**

Address (number and street, apt. no., rural route) (or P.O. box number if mail is not delivered to street address)

City, town or post office, state, and ZIP code

The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of:

- The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or
- The 4th tax year for any other activity,

after the tax year in which the taxpayer first engaged in the activity.

**1** Type of taxpayer engaged in the activity (check the box that applies):

☑ Individual ☐ Partnership ☐ S corporation ☐ Estate or trust

**2a** Description of activity for which you elect to postpone a determination

**Auto racing**

**2b** First tax year you engaged in activity described in 2a

**1999**

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules, and to the best of my knowledge and belief, it is true

Deductions that are disallowed under IRC §183 cannot be carried into any other tax year. This rule makes documentation of the profit motive extremely important. If possible, the activity should not show a loss for more than two consecutive years. If the taxpayer is able to prepay or postpone expenses, elect slower depreciation, or use any other legitimate device to help the activity show a profit, this may help the activity meet the profit presumption.

The hobby loss rule applies to any net loss (deductions in excess of gross income) incurred in connection with the particular activity. Therefore, this rule may not provide a complete disallowance of all deductions incurred in connection with the activity. First, the owner is allowed to offset any gross income from the activity with otherwise allowable deductions, such as depreciation and other ordinary and necessary expenses, to bring the net income down to zero. Additionally, there may be certain itemized deductions, such as property taxes, that are specifically allowed under other code sections. These deductions are not disallowed by the hobby loss rule.

**Note.** A C corporation that is profitable can be used to operate the nonprofitable business, because the provisions of IRC §183 do not apply to **C corporations.** An example is a profitable corporate manufacturer that owns a race car. However, IRS may question whether corporate expenses are ordinary and necessary under IRS §162. In addition, IRS could disallow a shareholder's personal expenses paid by the corporation under IRC §262 and raise the constructive dividend issue.

## UNIFORM CAPITALIZATION RULES

IRC §263A was enacted by Congress and effective for tax years after 1986. It is still a complicated and confusing section. IRC §263A defines certain allocable costs that may not be deducted and must be capitalized.

IRC §263A applies to property that is produced by the taxpayer (real or tangible), as well as certain property acquired for resale. Many taxpayers are exempted from IRC §263A by IRC §263A(b)(2)(B), which is a section that **excludes taxpayers whose average gross receipts for the three-year period ending with the prior year are less than $10 million.** The following property is excepted under IRC §263A(c) and (d):

- Personal use property
- Research and experimental expenditures under IRC §174
- Certain development and other costs of oil and gas wells or other mineral property
- Property produced pursuant to a long-term contract
- Timber and certain ornamental trees
- Certain farming businesses

Costs paid or incurred by an individual employer or employee-owner of a corporation who is a writer, photographer, or artist are also exempt from the rules in §263A.

Allocable costs are defined as the direct costs of the property, plus an appropriate share of those indirect costs that are allocable to the property. These costs are required to be included in inventory costs and capitalized as a part of ending inventory.

IRC §263A provides that both direct costs and an allocable portion of most indirect costs incurred during the tax year due to either production or resale activities must be capitalized. The effect is a timing issue and a deferral of the otherwise allowable deduction, as certain overhead expenses need to be included in the cost of the property manufactured, which becomes a part of the year-end inventory for the taxpayer. These capitalized costs are not lost but are later recovered when the inventory is sold or the property becomes subject to depreciation.

Whether the taxpayer is a manufacturer or producer, all direct costs of labor and material go into the cost of the finished product and become part of inventory if not sold by year-end. Resellers include not only direct costs of inventory purchases but also total costs for acquiring the inventory (freight, for example) and other necessary charges.

Certain indirect costs are required to be capitalized in part under IRC §263A. For a taxpayer who is not required to use IRC §263A, these costs are treated as "period" costs and are fully deductible as overhead:

**Note. De minimus exception.** A manufacturer using the simplified production method is not subject to UNICAP if the manufacturer incurs $200,000 or less of total indirect costs in a taxable year.[3]

| | |
|---|---|
| 1. Officers' compensation | 12. Purchasing costs |
| 2. Indirect labor costs | 13. Utilities |
| 3. Pension costs | 14. Insurance |
| 4. Indirect material costs | 15. Engineering/design costs |
| 5. Handling costs | 16. Repairs and maintenance |
| 6. Rent | 17. Quality control costs |
| 7. Taxes | 18. Spoilage |
| 8. Depletion | 19. Interest expense |
| 9. Depreciation expenses | 20. License/franchise costs |
| 10. Storage costs | 21. Bidding costs |
| 11. Handling costs | 22. Certain service costs |

These uniform capitalization rules apply not only to large corporate manufacturers but also to the self-employed home builder with just one house in inventory at year end. IRC §263A is not an option with taxpayers since the "unicap rules" are required to be used if applicable.

**Example 6.** Scott Enterprises had the following items of income and expense for 2003:

| | | |
|---|---|---|
| Gross sales | | $35,000,000 |
| Material, labor, and subcontractors | $30,000,000 | |
| Ending inventory | (6,000,000) | |
| Cost of sales | | (24,000,000) |
| Gross profit | | $11,000,000 |
| **Selling and administrative expense** | | |
| Salaries | $ 1,250,000 | |
| Rent | 350,000 | |
| Advertising | 250,000 | |
| Payroll taxes | 250,000 | |
| State income tax | 250,000 | |
| Depreciation | 400,000 | |
| Employee benefits | 265,000 | |
| Utilities | 200,000 | |
| Telephone | 235,000 | |
| Legal and accounting | 50,000 | |
| Repairs | 275,000 | |
| Insurance | 225,000 | |
| Total selling and administrative expense | | (4,000,000) |
| Net profit | | $ 7,000,000 |

Before complying with the uniform capitalization rules, the Scott Enterprises return is as follows:

## For Example 6

**SCHEDULE C (Form 1040)**

Department of the Treasury Internal Revenue Service (99)

# Profit or Loss From Business

**(Sole Proprietorship)**

▶ **Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.**

▶ **Attach to Form 1040 or 1041.** ▶ **See Instructions for Schedule C (Form 1040).**

OMB No. 1545-0074

2003

Attachment Sequence No. **09**

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

**A** Principal business or profession, including product or service (see page C-1 of the instructions) | **B Enter code from pages C-7, 8, & 9** ▶

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

**Scott Enterprises**

**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 2003? If "No," see page C-3 for limit on losses . ☐ **Yes** ☐ **No**

**H** If you started or acquired this business during 2003, check here ▶ ☐



**Part I** **Income**

| | | | |
|---|---|---|---|
| 1 | Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐ | 1 | 35,000,000 |
| 2 | Returns and allowances | 2 | |
| 3 | Subtract line 2 from line 1 | 3 | 35,000,000 |
| 4 | Cost of goods sold (from line 42 on page 2) | 4 | 24,000,000 |
| 5 | **Gross profit.** Subtract line 4 from line 3 | 5 | 11,000,000 |
| 6 | Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3) | 6 | |
| 7 | **Gross income.** Add lines 5 and 6 ▶ | 7 | 11,000,000 |

**Part II** **Expenses.** Enter expenses for business use of your home **only** on line 30.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 8 | Advertising | 8 | 250,000 | 19 | Pension and profit-sharing plans | 19 | |
| 9 | Car and truck expenses (see page C-3) | 9 | | 20 | Rent or lease (see page C-5): | | |
| | | | | a | Vehicles, machinery, and equipment | 20a | |
| 10 | Commissions and fees | 10 | | b | Other business property | 20b | 350,000 |
| 11 | Contract labor (see page C-4) | 11 | | 21 | Repairs and maintenance | 21 | 275,000 |
| | | | | 22 | Supplies (not included in Part III) | 22 | |
| 12 | Depletion | 12 | | 23 | Taxes and licenses | 23 | 500,000 |
| 13 | Depreciation and section 179 expense deduction (not included in Part III) (see page C-4) | 13 | 400,000 | 24 | Travel, meals and entertainment: | | |
| | | | | a | Travel | 24a | |
| 14 | Employee benefit programs (other than on line 19) | 14 | 265,000 | b | Meals and entertainment | | |
| 15 | Insurance (other than health) | 15 | 225,000 | c | Enter nondeductible amount included on line 24b (see page C-5) | | |
| 16 | Interest: | | | | | | |
| a | Mortgage (paid to banks, etc.) | 16a | | | | | |
| b | Other | 16b | | d | Subtract line 24c from line 24b | 24d | |
| 17 | Legal and professional services | 17 | 50,000 | 25 | Utilities | 25 | 435,000 |
| | | | | 26 | Wages (less employment credits) | 26 | 1,250,000 |
| 18 | Office expense | 18 | | 27 | Other expenses (from line 48 on page 2) | 27 | |

| | | | |
|---|---|---|---|
| 28 | **Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶ | 28 | 4,000,000 |
| 29 | Tentative profit (loss). Subtract line 28 from line 7 | 29 | 7,000,000 |
| 30 | Expenses for business use of your home. Attach **Form 8829** | 30 | |
| 31 | **Net profit or (loss).** Subtract line 30 from line 29.<br>• If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.<br>• If a loss, you **must** go to line 32. | 31 | 7,000,000 |

**32** If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you **must** attach **Form 6198.**

**32a** ☐ All investment is at risk.
**32b** ☐ Some investment is not at risk.

**For Paperwork Reduction Act Notice, see Form 1040 instructions.** Cat. No. 11334P **Schedule C (Form 1040) 2003**

## For Example 6

Schedule C (Form 1040) 2003 Page **2**

**Part III** **Cost of Goods Sold** (see page C-6)

33 Method(s) used to value closing inventory: a ☐ Cost b ☑ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ **Yes** ☑ **No**

| | | | |
|---|---|---|---|
| 35 | Inventory at beginning of year. If different from last year's closing inventory, attach explanation | 35 | 0 |
| 36 | Purchases less cost of items withdrawn for personal use | 36 | 30,000,000 |
| 37 | Cost of labor. Do not include any amounts paid to yourself | 37 | |
| 38 | Materials and supplies | 38 | |
| 39 | Other costs | 39 | |
| 40 | Add lines 35 through 39 | 40 | 30,000,000 |
| 41 | Inventory at end of year | 41 | 6,000,000 |
| 42 | **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4 | 42 | 24,000,000 |

**Part IV** **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ ______/______/______ .

44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:

a Business ______ b Commuting ______ c Other ______

45 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ **Yes** ☐ **No**

46 Was your vehicle available for personal use during off-duty hours? . . . ☐ **Yes** ☐ **No**

47a Do you have evidence to support your deduction? . . . ☐ **Yes** ☐ **No**

b If "Yes," is the evidence written? . . . ☐ **Yes** ☐ **No**

**Part V** **Other Expenses.** List below business expenses not included on lines 8–26 or line 30.

| | |
|---|---|
| | |
| | |
| | |
| | |
| | |
| | |
| | |
| | |
| | |

48 **Total other expenses.** Enter here and on page 1, line 27 . . . 48

**Schedule C (Form 1040) 2003**



12

## DETERMINING THE AMOUNT OF IRC §263A COSTS

### Step 1

Use a "reasonable allocation" method, such as taking the percentage of inventory to total direct costs. Total direct costs were $30,000,000 for 2003 including the ending inventory of $6,000,000.

This result indicates that 20% of the direct costs for the year are still in inventory ($6,000,000 ÷ $30,000,000) and that a true application of IRC §263A will require 20% of those allocable indirect costs to also be part of inventory.

### Step 2

Determine the allocable indirect costs subject to the uniform capitalization rules and apply the percentage (20%) against those costs. **All indirect costs except advertising and state income taxes have to be reduced by the 20%.** The following table summarizes these allocations.

| Selling and Administrative Expense | 100% | Expense Portion 80% | Capitalized Portion 20% |
|---|---|---|---|
| Salaries | $1,250,000 | $1,000,000 | $250,000 |
| Rent | 350,000 | 280,000 | 70,000 |
| Advertising | 250,000 | 250,000 | 0 |
| Payroll taxes | 250,000 | 200,000 | 50,000 |
| State income tax | 250,000 | 250,000 | 0 |
| Depreciation | 400,000 | 320,000 | 80,000 |
| Employee benefits | 265,000 | 212,000 | 53,000 |
| Utilities | 200,000 | 160,000 | 40,000 |
| Telephone | 235,000 | 188,000 | 47,000 |
| Legal and accounting | 50,000 | 40,000 | 10,000 |
| Repairs | 275,000 | 220,000 | 55,000 |
| Insurance | 225,000 | 180,000 | 45,000 |
| Total selling and administrative expense | $4,000,000 | $3,300,000 | $700,000 |

The IRC §263A costs are shown in the cost of goods sold section of the tax return. Since these costs are added as indirect costs, they become part of ending inventory. Therefore, the taxpayer's gross profit does not change.

Scott's gross profit of $11,000,000 remains unchanged. The $700,000 in indirect costs reduces his selling and administrative expenses from $4,000,000 to $3,300,000. This increases net taxable profit on the tax return from $7,000,000 to $7,700,000. Full indirect costs are entered in the applicable line on the tax return. The IRC §263A adjustment is reflected as an additional line item under other expenses, reducing overall costs by $700,000 and referencing the schedule prepared in Step 2.

## For Example 6

**SCHEDULE C (Form 1040)**
Department of the Treasury
Internal Revenue Service (99)

# Profit or Loss From Business
(Sole Proprietorship)
▶ Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
▶ Attach to Form 1040 or 1041. ▶ See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074
2003
Attachment Sequence No. 09

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see page C-1 of the instructions) | B Enter code from pages C-7, 8, & 9 ▶

C Business name. If no separate business name, leave blank. **Scott Enterprises** | D Employer ID number (EIN), if any

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 2003? If "No," see page C-3 for limit on losses ☑ Yes ☐ No
H If you started or acquired this business during 2003, check here ▶ ☐



**Part I Income**

| | | | |
|---|---|---|---|
| 1 | Gross receipts or sales. **Caution.** If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here ▶ ☐ | 1 | 35,000,000 |
| 2 | Returns and allowances | 2 | |
| 3 | Subtract line 2 from line 1 | 3 | 35,000,000 |
| 4 | Cost of goods sold (from line 42 on page 2) | 4 | 24,000,000 |
| 5 | **Gross profit.** Subtract line 4 from line 3 | 5 | 11,000,000 |
| 6 | Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3) | 6 | |
| 7 | **Gross income.** Add lines 5 and 6 ▶ | 7 | 11,000,000 |

**Part II Expenses.** Enter expenses for business use of your home **only** on line 30.

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 8 | Advertising | 8 | 250,000 | 19 | Pension and profit-sharing plans | 19 | |
| 9 | Car and truck expenses (see page C-3) | 9 | | 20 | Rent or lease (see page C-5): | | |
| | | | | a | Vehicles, machinery, and equipment | 20a | |
| 10 | Commissions and fees | 10 | | b | Other business property | 20b | 350,000 |
| 11 | Contract labor (see page C-4) | 11 | | 21 | Repairs and maintenance | 21 | 275,000 |
| | | | | 22 | Supplies (not included in Part III) | 22 | |
| 12 | Depletion | 12 | | 23 | Taxes and licenses | 23 | 500,000 |
| 13 | Depreciation and section 179 expense deduction (not included in Part III) (see page C-4) | 13 | 400,000 | 24 | Travel, meals and entertainment: | | |
| | | | | a | Travel | 24a | |
| 14 | Employee benefit programs (other than on line 19) | 14 | 265,000 | b | Meals and entertainment | | |
| 15 | Insurance (other than health) | 15 | 225,000 | c | Enter nondeductible amount included on line 24b (see page C-5) | | |
| 16 | Interest: | | | | | | |
| a | Mortgage (paid to banks, etc.) | 16a | | | | | |
| b | Other | 16b | | d | Subtract line 24c from line 24b | 24d | |
| 17 | Legal and professional services | 17 | 50,000 | 25 | Utilities | 25 | 435,000 |
| | | | | 26 | Wages (less employment credits) | 26 | 1,250,000 |
| 18 | Office expense | 18 | | 27 | Other expenses (from line 48 on page 2) | 27 | (700,000) |

| | | | |
|---|---|---|---|
| 28 | **Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ▶ | 28 | 3,300,000 |
| 29 | Tentative profit (loss). Subtract line 28 from line 7 | 29 | 7,700,000 |
| 30 | Expenses for business use of your home. Attach **Form 8829** | 30 | |
| 31 | **Net profit or (loss).** Subtract line 30 from line 29.<br>• If a profit, enter on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.<br>• If a loss, you **must** go to line 32. | 31 | 7,700,000 |

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and **also** on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you **must** attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

**For Paperwork Reduction Act Notice, see Form 1040 instructions.** Cat. No. 11334P **Schedule C (Form 1040) 2003**

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## For Example 6 — Prorated

Schedule C (Form 1040) 2003 Page **2**

**Part III** **Cost of Goods Sold** (see page C-6)

33 Method(s) used to value closing inventory: **a** ☐ Cost **b** ☐ Lower of cost or market **c** ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ **Yes** ☐ **No**

| | | | |
|---|---|---|---|
| 35 | Inventory at beginning of year. If different from last year's closing inventory, attach explanation | 35 | 0 |
| 36 | Purchases less cost of items withdrawn for personal use | 36 | 30,700,000 |
| 37 | Cost of labor. Do not include any amounts paid to yourself | 37 | |
| 38 | Materials and supplies | 38 | |
| 39 | Other costs | 39 | |
| 40 | Add lines 35 through 39 | 40 | 30,700,000 |
| 41 | Inventory at end of year **6,000,000 + 700,000** | 41 | 6,700,000 |
| 42 | **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4 | 42 | 24,000,000 |

**Part IV** **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on



| | | |
|---|---|---|
| Gross sales | | $35,000,000 |
| Material, labor and subcontractors | $30,000,000 | |
| IRC §263A indirect costs | 700,000 | |
| Ending inventory | (6,700,000) | |
| Cost of sales | | (24,000,000) |
| Gross profit | | $11,000,000 |
| **Selling and administrative expense** | | |
| Officer's salaries | $ 1,000,000 | |
| Office salaries | 250,000 | |
| Rent | 350,000 | |
| Advertising | 250,000 | |
| Payroll taxes | 250,000 | |
| State income tax | 250,000 | |
| Depreciation | 400,000 | |
| Employee benefits | 265,000 | |
| Utilities | 200,000 | |
| Telephone | 235,000 | |
| Legal and accounting | 50,000 | |
| Repairs | 275,000 | |
| Insurance | 225,000 | |
| Less: IRC §263A reduction | (700,000) | |
| Total selling and administrative expense | | (3,300,000) |
| Net profit | | $ 7,700,000 |

## MATERIAL PARTICIPATION PROVISIONS

The concept of material participation is important throughout the Internal Revenue Code. It not only helps determine whether Schedule C and F losses are deductible, but it plays a very important role in rental losses and in some of the estate tax provisions, such as IRC §§2032A and 6166.

Material participation is defined as the regular, continuous, and substantial involvement in the operation of an activity.[4] If a taxpayer owns an interest in the activity, any work he does is considered to be participation. Limited partners, subject to three exceptions, cannot materially participate in partnership activities. Unless the taxpayer materially participates in the activity, any losses incurred will be treated as passive losses and subject to the passive activity loss limitations. The determination of material participation is made on an annual basis.[5]

**To qualify as material participation,** the services provided by a taxpayer to a business **must pass six material participation tests or a facts-and-circumstances test.**[6]

The **six tests** are as follows:

1. The taxpayer participates more than 500 hours during the year.
2. The taxpayer's participation in the activity for the year represents substantially all of the participation of all individuals. This includes individuals who are not owners of interests in the business.
3. The taxpayer participates in the activity for more than 100 hours during the taxable year. The taxpayer's participation must not be less than the participation by any other individual.

**Example 7.** Debbie works full time as a secretary at the local university. In addition, she owns an interest in a quilt manufacturing business. The business is conducted entirely on Saturdays. Each Saturday, Debbie works eight hours for the business. Her other partners work the same amount of time. While Debbie does not work 500 hours per year in the business, she does work more than 100 hours and works as much as any other employee.

4. The activity is a significant participation activity for the taxable year. The taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours. An activity is a significant participation activity only if the activity is a trade or business in which the taxpayer significantly participates for more than 100 hours during the year and would be an activity in which the taxpayer did not materially participate if the significant participation rule did not apply.

**Example 8.** George is employed full time as an accountant. He also owns interests in a miniature golf course and a farm. Each business has full-time employees. During 2002, George worked 400 hours at the miniature golf course and 150 hours on the farm. Both the miniature golf course and the farm are significant participation activities. Since George's aggregate participation in the two activities is greater than 500 hours, he is considered as materially participating in both activities.

5. The taxpayer materially participates for any five taxable years (even if not consecutive) during the prior ten years.
6. The activity is a personal service activity and the taxpayer materially participated in the activity for any three taxable years (even if not consecutive) that precedes the taxable year.

Under the **facts and circumstances test,** material participation requires regular, continuous, and substantial participation. The taxpayer must participate throughout the year, but there can be breaks in the period of participation. For example, taking a vacation will not cause a break. If the taxpayer does no more than provide periodic consultation regarding general management decisions, he is not considered to be materially participating in the activity.

**Example 9.** Jessica owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically sends Jessica letters describing certain proposed actions and decisions with respect to the cattle-feeding operation. This includes actions such as what kind of feed to purchase, how much to purchase, when to purchase it, how often to feed the cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasizing that taking or not taking a particular action is solely at the discretion of Jessica. Jessica is asked to answer certain questions regarding each action and send her response to the general partner. The general partner receives a fee for his participation, which constitutes earned income. Jessica is not considered to be materially participating in the partnership.

A taxpayer is considered likely to be materially participating if:

- The activity is the principal business of the taxpayer,
- He can do everything required in the amount of time devoted to the activity even though he has a lower level of activity, and
- The taxpayer is at the activity site on a regular basis.

Performing management activities does not constitute material participation unless no other person receives earned income for performing management services[7] and no other individual's performance of management activities exceeds the services of the taxpayer.[8] The service is measured in terms of hours.

The taxpayer is not considered to be materially participating just because he has hired an agent to participate for them. Some exceptions to the material participation requirements exist for retired taxpayers and surviving spouses in the case of farming operations.

Work performed while an employee of the activity, but not an owner, does not count in meeting the material participation test.

**Example 10.** Joey is employed as the manager of a hardware store. In August he purchases the store. His work from January through July is not counted for the material participation test.

The amount of participation can be established using any reasonable means. For example, daily time reports, logs, or similar documents are not required if the amount of participation can be established in other reasonable ways. Reasonable means the identification of the service performed and the number of hours used to provide the service. This can be documented by appointment books, calendars, or narrative summaries.

## BUSINESS TRAVEL: CONTINUING EDUCATION

### INTRODUCTION

Many professionals such as health care professionals, doctors, lawyers, accountants, insurance agents, engineers, and real estate professionals are required to participate in continuing professional education (CPE). Many of these professionals must obtain 40 or more hours of CPE annually to comply with their licensing boards. Consequently, many organizations are in the business of providing continuing education programs. Some of these have taken creative approaches to entice professionals to use them as their CPE provider.

A popular approach for CPE course sponsors is to hold courses in highly desirable areas such as vacation resorts. This allows the professional to travel with his family, enjoy vacation time around the CPE offering, and deduct part of the trip as a business expense.

Cruise ships have become a popular place to hold CPE courses. Attendees can visit exotic locations, meet their CPE requirements, and receive a tax deduction. Programs such as these are often marketed as tax deductible by travel agents and vacation planning experts. The professional may believe the **whole** trip is tax deductible. However, it is the responsibility of the professional to understand the tax laws, to determine, document, and deduct only the **allowable** expenses.

Being cognizant of professionals wishing to deduct more of these types of training expenses, the IRS has issued guidelines on what expenses are allowed to be deducted for cruise trips. The guidelines are discussed in IRS Pub. 463, *Travel and Entertainment, Gift and Car Expenses* under the topic of Luxury Water Travel.

**Caution.** For noncruise regular travel, different rules exist for business-vacation trips within the United States and for business-vacation trips outside the United States.

## LUXURY WATER TRAVEL

Taxpayers who travel by ocean liner, cruise ship, or other forms of luxury water transportation for business purposes, are subject to both a daily and an annual limit on the amount they can deduct. **All ships that sail are considered cruise ships.** The daily limit is **twice** the highest federal per diem rate allowable at the time of the travel. Generally, the federal per diem is the amount paid to federal government employees for daily living expenses when they travel for business purposes away from home within the United States.

**Daily Limit on Luxury Water Travel.** The highest federal per diem rate allowed and the daily limit for luxury water travel in 2003 are shown in the following table:[9]

| 2003 Dates | Highest Federal Per Diem | Daily Limit on Luxury Water Travel |
|---|---|---|
| Jan. 1–Sep. 30 | $258 | $516 |
| Oct. 1–Dec. 31 | 259 | 518 |

**Example 11.** Caroline, a travel agent, went to London, England, on a business trip in June 2003. She traveled by ocean liner and her passage for the 6-day cruise was $3,500. Caroline's deduction for the cruise cannot exceed $3,096 (6 days × $516 daily limit).

Caroline will deduct $3,096 on line 24 of her Schedule C. She can also deduct any other expenses incurred while traveling away from her tax home to conduct business affairs on line 24 if they are ordinary and necessary expenses (see Transportation Cost Rule page 446).

**Caution.** The limit for conventions on cruise ships is $2,000 per year. If Caroline in **Example 11** was attending a convention on another cruise ship, her deduction would be limited to $2,000. See page 446 for detailed rules for convention cruise ships.



**Meals and Entertainment.** If luxury water travel includes separately stated amounts for meals or entertainment, these amounts are subject to the 50% limit on meals and entertainment before applying the daily limit.[10]

**Example 12.** Use the same facts as **Example 11** except, in Caroline's luxury water travel cost, $1,600 was separately stated as meals and entertainment. Caroline, who is self-employed, is not reimbursed for any of her travel expenses. She figures her deductible travel expenses as follows:

| | | |
|---|---|---|
| Meals and entertainment portion | $1,600 | |
| 50% limit | × 50% | |
| Allowable meals and entertainment | | $ 800 |
| Other travel expense portion | | 1,900 |
| **Allowable cost before daily limit** | | **$2,700** |
| Daily limit for June 2003 | $ 516 | |
| Days of travel | × 6 | |
| **Maximum luxury water travel deduction** | | **$3,096** |

Caroline's deduction for her cruise is limited to $2,700, although the limit on luxury water travel is higher.

**Not Separately Stated.** If the meal and entertainment charges are not separately stated or are not clearly identifiable, it is not necessary to allocate any portion of the total charge to meals or entertainment.

## CONVENTIONS

Taxpayers can deduct their travel expenses when they attend a convention if they can prove their attendance benefits their trade or business. If the convention is for investment, political, social, or other purposes unrelated to their trade or business, they cannot deduct the expenses. Travel expenses for the family are not deductible.

> **Example 13.** Roger, a small-town Kansas attorney, attends a convention concerning the League of Nations and the international law of butterfly propagation. Roger does not perform any international law work and does not obtain any referrals from attending the convention. His deduction for travel expense is denied because he cannot show any potential or actual business benefit that might result from attending the convention.

The taxpayer's appointment or election as a convention delegate does not, in itself, determine whether he can deduct travel expenses. He can deduct his travel expenses only if his attendance is connected to his own trade or business.

> **Example 14.** Alice is elected as a delegate to her service club's national convention. Her service club is not a qualified charitable organization. The convention is being held on a cruise ship and will make stops at eligible North American locations. Because her membership in the service club is not connected to her business, the cost of the trip is not deductible.

**Convention Agenda.** The convention agenda or program generally describes the **purpose** of the convention. Since taxpayers must show that their attendance at the convention **benefits their trade or business,** they may be able to support the business purpose of their attendance by comparing the agenda content with their business duties and responsibilities. Although the agenda does not have to specifically describe their business duties and responsibilities, it must show that the agenda content is related to their business position and that their attendance is for business purposes.

## CONVENTIONS HELD OUTSIDE THE NORTH AMERICAN AREA

**North American Area.** The following locations are included in the North American area:

| | | |
|---|---|---|
| American Samoa | Jamaica | United States |
| Baker Island | Jarvis Island | U.S. Virgin Islands |
| Barbados | Johnston Island | Wake Island |
| Bermuda | Kingman Reef | |
| Canada | Mexico | |
| Costa Rica | Marshall Islands | |
| Dominica | Micronesia | |
| Dominican Republic | Midway Islands | |
| Grenada | Northern Mariana Islands Saint Lucia | |
| Guam | Palau | |
| Guyana | Palmyra | |
| Honduras | Puerto Rico | |
| Howland Island | Trinidad and Tobago | |

**Deductions.** A deduction is **not allowed** for attending a convention, seminar, or similar meeting held outside the North American area **unless:**

- The meeting is directly related to the taxpayers trade or business and
- It is as **reasonable** to hold the meeting outside the North American area as it is inside.

If the event meets these requirements, the taxpayer must satisfy the rules for deducting expenses for business trips in general.[11]

**Reasonableness Test.** The following factors are taken into account when determining if it is reasonable to hold the meeting outside the North American area:

- The purpose of the meeting and the activities taking place at the meeting
- The purposes and activities of the sponsoring organizations or groups
- The homes of the active members of the sponsoring organizations and the places at which other meetings of the sponsoring organizations or groups have been or will be held
- Any other relevant factors

### Cruise Ships (Cruises within the United States)

**Annual Limit.** Taxpayers can deduct only $2,000 per year of expenses for attending conventions, seminars, or similar meetings held on cruise ships. The limit is $4,000 on a joint return if both taxpayers have valid business reasons for attending the convention.

These expenses can be deducted only if **all five** of the following requirements are met:

1. The convention, seminar, or meeting is directly related to the taxpayer's trade or business.
2. The cruise ship is a vessel registered in the United States.
3. **All of the cruise ship's ports of call are in the United States** or in possessions of the United States.
4. The taxpayer attaches a signed written statement to the tax return which includes information about:
   - The total number of days of the trip (not the days of transportation to and from the cruise ship port),
   - The number of hours each day devoted to scheduled business activities, and
   - A program of the scheduled business activities of the meeting.
5. The taxpayer must attach **a written statement, signed by an officer** of the organization or group sponsoring the meeting, that includes:
   - A schedule of the business activities of each day of the meeting and
   - The number of hours the taxpayer attended the scheduled business activities.

**Example 15.** An Internet website promotes an Alaskan cruise to business professionals. Promoters claim the cruise is tax deductible and that participants will be able to earn continuing education units totaling 36 hours. The cruise ship is operated by Bali Hi Boats, and registered in Tahiti. Departure is from Seattle, with ports of call including Alaska. Participants can choose from six different workshops for an additional cost:

- Rejuvenate Your Practice and Yourself: Essential Skills for Today's Mental Health Practitioner
- Coaching: Expand Your Practice
- Law and Ethics
- Couples Therapy (Home Study)
- Yoga for Therapists
- Overcome Your Constant State of Depression: Designed Especially for Lifelong Chicago Cub Fans

Participants can earn up to 31 credits for classroom sessions and 5 through home study.

**Analysis.** Although this cruise is marketed as tax deductible, including it as a business expense would be closely scrutinized by the IRS in an audit. The taxpayer would have to pass **all five requirements** previously mentioned:

- Most business owners couldn't pass the first test, "**directly related to business**" unless the business owner was a health care practitioner/therapist.
- The vessel must be registered in the United States. Requirement 2 is not met.
- All the ports of call must be U.S. destinations. Requirement 3 is met.
- The taxpayer would have to attach a written statement supporting information required in Requirement 4.
- The taxpayer must obtain, and attach to his tax return, the signed statement by an officer of the organization sponsoring the trip that includes information described in Requirement 5.

**Conclusion.** This trip is not deductible. However, if all requirements were met, the taxpayer would be limited to a $2,000 deduction, which is the annual limit on cruise ship conventions.

## TRANSPORTATION COST RULE

If the taxpayer is a managing executive, self-employed, related to his employer, or has more than 10% stock interest in the company, then the deduction for **transportation costs to and from the business destination may be limited.** A full deduction for transportation costs is allowed if at least one of the following exceptions is met:

- The taxpayer had no substantial control.

> **Note.** A self-employed individual generally has substantial control over arranging business trips.

- The trip outside the United States took a week or less, not counting the day the taxpayer returned.
- The trip abroad lasted more than a week (counting the days the trip began and ended), but less than 25% of the time was spent on vacation or other personal activities.[12]
- When planning the trip, a major emphasis was not placed on taking a vacation.

If the vacationing and other personal activities take up 25% or more of the taxpayer's time on a trip lasting more than one week and the taxpayer cannot prove that the vacation was a minor consideration in planning the trip, then the taxpayer must allocate travel expenses between the time spent on business and the time spent on personal affairs. The part allocated to business is deductible, the balance is not.

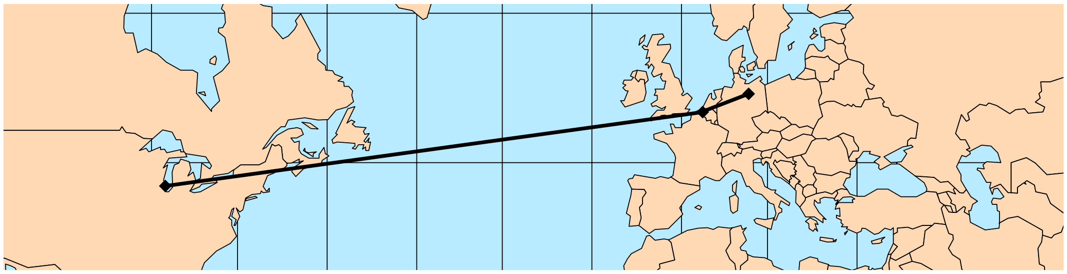
Combining business trips with vacation time creates a situation where the cost of the travel must be allocated between business and personal expense. The allocation differs depending upon whether the location of the vacation is closer to the place of departure or to the business destination.

To allocate the expenses, the taxpayer must count the number of days spent on the trip outside the United States, including the departure and return day. The taxpayer then divides the total days into the number of days spent on business activities. This ratio is used to allocate the expense for business.

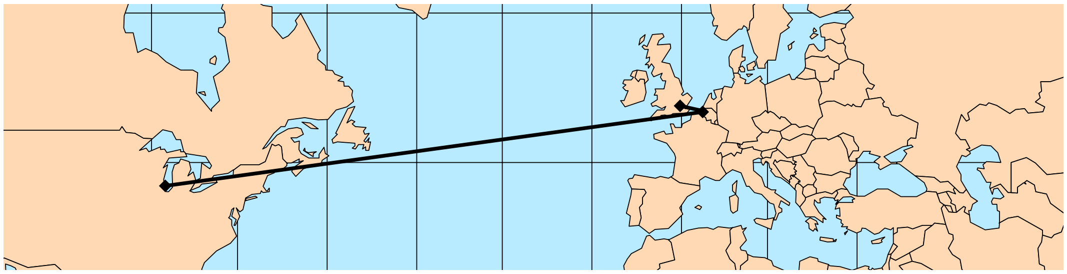
**Example 16.** Peggy is a self-employed attorney specializing in international environmental law. She traveled to Brussels from Chicago to attend and speak at a two-day conference about Global Preservation of Water. After the meeting, she went to Berlin for a five-day vacation, and then returned to Chicago from Berlin.

Peggy spent two days traveling from and to Chicago, two days at the conference, and five days on vacation. The length of her trip was nine days, including four days devoted to business. Peggy may deduct 4/9 of the round trip airfare from Chicago to Brussels. She may deduct lodging and 50% of the meal expense while in

Brussels. None of her expenses getting to or while in Berlin are deductible, including her airfare from Brussels to Berlin.



**Example 17.** Use the same facts as **Example 16** except, Peggy spends her vacation time in London. Since London is closer to her departure location than Brussels, her deductible travel is 4/9 of the round trip cost between Chicago and London. The round trip airfare between London and Brussels is also deductible.



## BARTERING

### INTRODUCTION

Bartering was once a popular means of trade. People traded something of value that they either grew, or made, for something of equal value. As money became a more convenient medium of change, the bartering system waned.

With the advent and growth of the Internet, bartering is again becoming popular. IRS Pub. 525, *Taxable and Non-taxable Income*, defines bartering as an **exchange** of property or services. Taxpayers must report as income the fair market value (FMV) of acquired property or services at the time it was received. If a taxpayer trades goods or personal services with another taxpayer, a taxable event occurs, although no money is exchanged.

12

For tax purposes, a Schedule C business owner who **barters** business services for goods and services is treated the same as if cash was exchanged for the business services. The barter transaction is **economically the same as receiving cash and paying cash.** The transaction is reported on Schedule C or Schedule C-EZ and **is subject to self-employment tax.**

If the taxpayer is **not in the business of providing the services** they bartered, the situation should be analyzed to determine if the barter income is taxable, where it should be reported on the Form 1040, and **whether it is subject to self-employment tax.** Usually, the income is reported as other income on line 21 of page 1, Form 1040.

**Note.** Sometimes a client will not want to report barter income as business income. If after explaining the law and requirements, the client still refuses to claim the income, the tax preparer should evaluate whether to retain the client. See Chapter 4, *Ethics*.

The IRS, as a matter of convenience, generally allows parties in a barter transaction to set the value of services and accepts that value, unless it is proved unrealistic. For example, circumventing the gift tax by valuing barter transactions low is one technique IRS examiners scrutinize. The market value of the more easily valued item is frequently used to determine the value of the more speculative one.[13]

**Example 18.** Emma is a self-employed trainer. She performs training services for a small corporation client in 2003. The corporation provides shares of its stock as payment for her services. It is Emma's responsibility to determine the FMV of the stock. The value she assigns may be less than the value of her normal fee for services because she believes the stock will appreciate in value. Emma must include the FMV of the shares in her income on 2003 Schedule C or Schedule C-EZ.

## FORMS 1099 — REPORTING BARTER TRANSACTIONS

### 1099-B — Barter Exchange

A **barter exchange** is any person or organization with members or clients that contract with each other (or with the barter exchange) to jointly trade or barter property or services. **The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.**

**Transactional/Aggregate Reporting.** Barter exchanges involving noncorporate members or clients must report each transaction on a separate Form 1099-B. Transactions involving corporate members or clients of a barter exchange may be reported on an aggregate basis.

**Member Information.** In the recipient area of Form 1099-B, information about the member or client who provided the property or services in the exchange is entered.

**Exceptions.** Barter exchanges are not required to file Form 1099-B for:

- Exchanges through a barter exchange having fewer than 100 transactions during the year,
- Exempt foreign persons as defined in Treas. Reg. §1.6045-1(g)(1)(i), and
- Exchanges involving property or services with an FMV of less than $1.00.

**Statements to Recipients.** If a barter exchange is required to file Form 1099-B, a statement must be provided to the recipient.

**Observation.** For additional information about the requirement to furnish a statement to the recipient, see Part H in the General Instructions for Forms 1099, 1098, 5498, and W-2G.

**Example 19.** Bart Arr is a self-employed accountant. Bart and Max Lott, a drywaller, are members of Barter Exchange, a barter club. Members contact each other directly and bargain for the value of services to be performed. Max drywalls Bart's basement in exchange for accounting services valued at $2,000.

Bart must report $2,000 as income on his Schedule C or Schedule C-EZ, which is the FMV of the drywall installation services. He is not allowed a corresponding deduction, since the drywall installation is a personal expense.

Max must include the $2,000 value of the accounting services Bart provided on his Schedule C income. Max may be able to deduct all or part of the $2,000 of the accounting expense on his Schedule C if the accounting services were business related.

**Note.** Bart will want to keep a record of the transaction. The cost will add to the basis of his home. If the drywalling were in his office, it would be capitalized and depreciated.

**Example 20.** Use the same facts as **Example 19,** except that Barter Exchange uses credit units as a means of exchange. The club adds credit units to Bart's account for goods or services he provides to members, which he can use to purchase goods or services offered by other members of the barter club. The club subtracts credit units from Bart's account when he receives goods or services from other members.

Bart must include as income the value of the credit units that are added to his account, although he may not actually receive goods or services from other members until a later tax year.

In 2003, Bart provided accounting services valued at $4,000 to other members of Barter Exchange. Bart must include $4,000 in his Schedule C income. Bart will receive a Form 1099-B from the Barter Exchange.

☐ CORRECTED (if checked)

| | | | | |
|---|---|---|---|---|
| PAYER'S name, street address, city, state, ZIP code, and telephone no.<br>**Barter Exchange**<br>**222 E. Main St.**<br>**Anytown, TX 62222**<br>**(219) 555-1212** | | **1a** Date of sale<br>**1b** CUSIP no.<br>**2** Stocks, bonds, etc.<br>$ | OMB No. 1545-0715<br>**2003**<br>Form **1099-B**<br>Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums | **Proceeds From Broker and Barter Exchange Transactions** |
| PAYER'S Federal identification number<br>**37-1111111** | RECIPIENT'S identification number<br>**444-44-4444** | **3** Bartering<br>$ **4000.00** | **4 Federal income tax withheld**<br>$ **0.00** | **Copy B**<br>**For Recipient** |
| RECIPIENT'S name<br>**Bart Arr** | | **5** Description<br>**Accounting services** | | This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported. |
| Street address (including apt. no.)<br>**2 Good Business Lane**<br>City, state, and ZIP code<br>**Someplace, GA 45555** | | **Regulated Futures Contracts**<br>**6** Profit or (loss) realized in 2003<br>$ | **7** Unrealized profit or (loss) on open contracts—12/31/2002<br>$ | |
| Account number (optional) | | **8** Unrealized profit or (loss) on open contracts—12/31/2003<br>$ | **9** Aggregate profit or (loss)<br>$ | |

Form **1099-B** (keep for your records) Department of the Treasury - Internal Revenue Service

**Form 1099-B from Barter Exchange.** If taxpayers exchange property or services through a barter exchange, they will receive Form 1099-B, *Proceeds from Broker and Barter Exchange Transaction*s, or a similar statement from the barter exchange by January 31, 2004. It will show the value of cash, property, services, credits, or scrip the taxpayers received from the exchanges for the year. The IRS also receives a copy of 1099-B.

**Backup Withholding.** The income received from bartering generally is not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected.

Under backup withholding, the barter exchange must withhold 30% of the income for income taxes if:

- The taxpayer fails to give the barter exchange a taxpayer identification number (generally a social security number or an employer identification number).
- The IRS notifies the barter exchange that the taxpayer gave an incorrect identification number.

## 1099-MISC — Traded Services

Individuals who are not involved in a barter exchange, but who trade services, do not file Form 1099-B. However, they may be required to file **Form 1099-MISC** if services are valued at $600 or more.[14]

**Example 21.** Jane owns a small apartment building. She usually charges $500 per month for rent for each apartment. In exchange for 6 months free rent in an apartment, an artist gives her a work of art. Jane must report the FMV of the artwork as rental income on Schedule E. The artist must report the fair rental value of the apartment as income on Schedule C or Schedule C-EZ.

**Note.** Because the artist uses the apartment as a personal residence, rather than as a studio, she does not issue a 1099-MISC to Jane. Because Jane is acquiring a product, rather that a service, she is not required to issue a 1099-MISC to the artist.

## RECORDKEEPING REQUIREMENTS

The last letter a tax practitioner wishes his client to receive at the end of an audit is a *Notice of Deficiency in Accounting Records*. The receipt of this letter almost ensures the client will be audited again within the next two to three years. Consequently, it is important that tax professionals discuss the type and need for good records with their clients. This is especially true for those who work with new businesses.

There are **three primary reasons** to keep financial records. They are:

1. To meet IRS requirements in the event of an audit,
2. To meet financial reporting requirements in order to borrow money, and
3. To meet management reporting requirements to successfully manage the business.

While reason three is obviously the most important, this section will deal almost exclusively with reason one.

Every person liable for any tax is required to keep records, render statements, and comply with regulations that IRS may prescribe.[15] They are required to keep permanent books of account or records, including inventory records, sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in income tax returns of those persons.[16]

**Observation.** Tax professionals may want to have copies of IRS Pub. 552, *Record Keeping for Individuals*, and Pub. 583, *Starting a Business and Keeping Records* available to clients who are starting a new business or have recordkeeping requirement questions.

### INTERNAL REVENUE MANUAL

Practitioners should become familiar with §4.10.3 of the *Internal Revenue Manual* (IRM).[17] IRS examiners are instructed that: "Auditing includes the accumulation of evidence for evaluating the accuracy of the taxpayer's tax return(s). Evidence takes many forms, including the taxpayer's testimony, the taxpayer's books and records, the examiner's own observations, and documents from third parties."[18]

The examiner has **six methods** of including evidence:[19]

1. Analytical tests
2. Documentation
3. Inquiry
4. Inspection
5. Observation
6. Testing

**Method 2** deals with examining the taxpayer's books and records to determine content and accuracy and to substantiate items claimed on the tax return.[20]

The examination of accounting records serves **two basic purposes:**

1. It allows the examiner to analyze the likelihood of material errors. It helps identify large, unusual, or questionable items.
2. It helps identify whether individual transactions are allowable, have not been omitted, are recorded for the correct dollar amount, and are in the correct time period.

An examiner will want an explanation of the accounting system. By gaining knowledge of the accounting system, he obtains information about many of the taxpayer's transactions. An examiner will become familiar with the normal flow of each type of transaction including the accounting records that are involved in the processing and the reporting of transactions. The IRM instructs the examiners to "acquire knowledge of how the business operates on a day-to-day basis with respect to customers, suppliers, management, sales, work performed, pricing, location, employees, assets used, production, and record keeping."[21]

Information the examiner seeks regarding the accounting system includes:

- *What the books of original entry are, whether they are automated, what types of subsidiary records (invoices, etc.) are maintained, what kinds of reports are prepared and how often.*[22]
- *How income is received, how expenses are paid, and who is responsible for receiving and recording income and expenses.*[23]
- *Who opens mail, deposits funds, writes checks, signs checks, makes book entries, prepares invoices, matches invoices, has access to cash registers, and receives and reconciles bank statements.*[24]

At the onset of an audit, the examiner must determine if the records furnished are reliable. If they are reliable, some of the audit procedures the examiner may use include:[25]

- Tracing specific items to receipts,
- Testing sample receipts to books and records,
- Applying taxpayer's mark-up to expenditures per records,
- Testing sample client accounts to receipts, and
- Analyzing adjusted journal entries and differences between books and the tax return.

If the examiner determines the records are unreliable, he will use indirect methods of auditing the return. The indirect methods include:[26]

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- Bank deposit analysis,
- Source and use of funds analysis,
- Net worth analysis,
- Percentage of markup analysis, and
- Unit and volume analysis.

**Note.** If inadequate records exist, the IRS may use an indirect method of determining income. Any tax deficiency proposed is presumptively correct, and the taxpayer has the burden of proof in refuting the presumption. However, the IRS has the burden of proving all factors in its case beyond a reasonable doubt whenever a reconstruction of income is used in a criminal prosecution.

## TAX SAVINGS

A good set of records will allow the taxpayer to determine if all income and expense items are recorded. Assuming the records are reconciled to bank, cash, and credit card accounts, there is little likelihood that expenses are omitted from the records and the tax return. The failure to deduct expenses is very costly to high-income taxpayers. A taxpayer in a 35% federal and a 3% state tax bracket who pays 15.3% social security and Medicare tax can pay an additional tax of $0.533 for every dollar of expense they fail to record. Even those taxpayers in the lowest brackets pay an additional $0.283 of tax on their omitted deductions.

## RECORD RETENTION

It is difficult to advise clients on how long they should retain records. Records must be kept as long as they are needed for the administration of any provision of the Internal Revenue Code. Generally this means records must be kept to support items shown on a return until the statute of limitations for that return expires.

The statute of limitations is the time period in which a taxpayer can amend returns to claim a credit or refund or the IRS can assess additional tax. The following table contains the limitation periods that apply to income tax returns. The years refer to the period beginning after the return is filed. Returns filed before the due dates are treated as being filed on the due date.

| If the taxpayer... | Then the period is... |
|---|---|
| 1. Owes additional tax and 2, 3, and 4 do not apply | 3 years |
| 2. Does not report income that he should and it is more than 25% of the gross income shown on the return | 6 years |
| 3. Files a fraudulent return | No limit |
| 4. Does not file a return | No limit |
| 5. Files a claim for credit or refund after filing the return | Later of 3 years or 2 years after tax was paid |
| 6. Files a claim for a loss from worthless securities | 7 years |
| 7. Has employment records | 4 years after the tax becomes due or is paid. |

Property records should be retained until the limitation period expires for the year in which the property is disposed.

For property received in a like-kind exchange, the records of the traded property should be retained until the limitation period ends for the property received. This would be after its disposition.

**Note.** Tax professionals should advise their clients never to destroy copies of tax returns. They may be needed for proving wages for social security or other reasons.

## ENDNOTES

1 Supreme Court of the United States, 91-998, January 12, 1993, 113 SCt 701, Reversing CA-4
2 Mortgage interest, real estate taxes, and casualty and theft losses
3 Treas. Reg. §1.263A-2(b)(3)(iv)
4 IRC §469(h)(1)
5 S. Rep. No. 313, 99th Cong., 2d Sess. 730 (1986)
6 Temp. Reg. §1.469-5T(a)
7 IRC §911(d)(2)(A)
8 Temp. Reg. §1.469-5T(b)(2)(ii)
9 The rates for travel after September 30, 2003, have yet to be released
10 IRS Pub. 463, Chapter 2
11 IRS Pub. 463 (2002)
12 IRC §274(c)(2)(B)
13 CCH NEWS-FEDERAL, Paragraph 13, Practitioners' Corner: Bartering Transactions Require Attention to Tax Details
14 IRS Pub. 525, *Taxable and Nontaxable Income*
15 IRC §6001
16 Treas. Reg. §1.6001-1(a)
17 *The Internal Revenue Manual* (IRM) can be printed from the IRS website at www.irs.gov.
18 IRM 4.10.3.1.2
19 IRM 1.10.1.4
20 IRM 1.10.3.1.4.B
21 IRM 410.63.4.3.2
22 IRM 4.10.3.4.5.1.5.A
23 IRM 4.10.3.4.5.1.5.B
24 IRM 4.10.3.4.5.1.5.C
25 IRM 4.10.3.4.6.1
26 IRM 4.10.4.6