

Chapter 4: Schedule C

Schedule C Filers C121

Part I: Income C129

Initial Schedule C Questions: Lines A–J..... C125

Part II: Expenses C132

Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

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This chapter discusses some challenging areas on the Schedule C, *Profit or Loss From Business*, such as lines that are frequently completed incorrectly and where allowable deductions are omitted. In addition to filing a Schedule C, taxpayers in a trade or business may also be required to file one or more of the following forms: Form 4797, *Sales of Business Property*; Schedule SE, *Self-Employment Tax*; Form 3800, *General Business Credit*; Form 4562, *Depreciation and Amortization*; Form 4684, *Casualties and Thefts*; Form 6198, *At-Risk Limitations*; Form 8582, *Passive Activity Loss Limitations*; Form 8594, *Asset Acquisition Statement*; Form 8824, *Like-Kind Exchanges*; Form 8829, *Expenses for Business Use of Your Home*, or Form PL8903, *Domestic Production Activities Deduction*.

A blank Schedule C is provided later in this chapter for reference.

SCHEDULE C FILERS

Schedule C is used to report income or loss from a trade or business operated as a sole proprietorship or as a statutory employee. An activity qualifies as a business if its primary purpose is to make a profit. The taxpayer must be operating the business with continuity and regularity. If there is only sporadic activity or the venture is a hobby, it is not a business. In this case, the income is reported on line 21 of Form 1040, *U.S. Individual Income Tax Return*.

STATUTORY EMPLOYEE

Schedule C is used to report wages and expenses earned as a **statutory employee**. These individuals are classified as **employees** for purposes of the Federal Insurance Contribution Act (FICA) and as **independent contractors** for purposes of determining their business deductions. If the taxpayer is in one of the following occupations, **the employer must withhold social security and Medicare contributions** from their taxable compensation.

1. Agent drivers or commissioned drivers who distribute meat, vegetable, or bakery products, or beverages other than milk (The category also includes individuals delivering laundry or dry cleaning.)
2. Full-time life insurance representatives
3. Individuals working at home performing work according to set specifications and using goods or materials supplied by the employer
4. Traveling sales representatives working full time soliciting orders of merchandise from wholesalers or retailers

An employee who belongs to one of the above groups can only be a statutory employee if **all** of the following apply.¹

1. The contract with the employer states that substantially all the services must be performed personally.
2. The employee has no substantial investment in facilities used in connection with performing the work. (The employee can personally own their car.)
3. The employee has a continuing relationship with the employer and the service performed is not a single transaction.


¹ IRS Pub. 15-A, *Employer's Supplemental Tax Guide*.

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There are substantial benefits to being a statutory employee. First, the employer is required to provide one-half of the social security and Medicare contribution (FICA). In addition, the employee is able to deduct all of their business expenses on Schedule C. If the individual is a common-law employee, they must report any unreimbursed expenses on Form 2106, *Employee Business Expenses*. The net expense from Form 2106 is then reported on Schedule A, *Itemized Deductions*, and is subject to the 2% of adjusted gross income (AGI) limitation.²

If box 13 of the Form W-2 is marked as statutory employee, the wage amount is reported on line 1c of Schedule C.

Example 1. Kent is an insurance salesman. He works for an insurance company that gives him a Form W-2 at the end of the year. The company withholds FICA tax from Kent and treats him as a statutory employee. Kent's Form W-2 and a portion of his Schedule C are shown next.

a Employee's social security number 111-22-3333		OMB No. 1545-0008		Safe, accurate, FAST! Use 		Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN) 12-3456789		1 Wages, tips, other compensation 95000.00		2 Federal income tax withheld			
c Employer's name, address, and ZIP code ABC Insurance Company 121 Main Street Anytown, IA 55555		3 Social security wages 95000.00		4 Social security tax withheld 3990.00			
		5 Medicare wages and tips 95000.00		6 Medicare tax withheld 1377.50			
		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. Kent Supersales		11 Nonqualified plans		12a See instructions for box 12			
1515 Reynolds Road Anytown, IA 55555		13 Statutory employee Retirement plan Third-party sick pay <input checked="" type="checkbox"/> <input type="checkbox"/> <input type="checkbox"/>		12b			
f Employee's address and ZIP code		14 Other		12c			
				12d			
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**

2011

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

Part I Income	
1a Merchant card and third party payments. For 2011, enter -0-	1a
1b Gross receipts or sales not entered on line 1a (see instructions)	1b
1c Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. Caution. See instr. before completing this line	1c 95,000

If the taxpayer has both statutory and nonstatutory income, separate Schedules C are filed. Because there is both self-employment and non-self-employment income, Schedule C-EZ, *Net Profit From Business*, cannot be filed and the amounts cannot be combined on a single Schedule C. The business expense attributable to either type of income is deducted on the appropriate Schedule C.

² Rev. Rul. 90-93, 1990-45 IRB 4.

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SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

► For information on Schedule C and its instructions, go to www.irs.gov/schedulec
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2011
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 2011? If "No," see instructions for limit on losses ☐ Yes ☐ No

H If you started or acquired this business during 2011, check here ☐

I Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☐ No

J If "Yes," did you or will you file all required Forms 1099? ☐ Yes ☐ No

Part I Income

1a Merchant card and third party payments. For 2011, enter -0-	1a		
b Gross receipts or sales not entered on line 1a (see instructions)	1b		
c Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. Caution. See instr. before completing this line	1c		
d Total gross receipts. Add lines 1a through 1c	1d		
2 Returns and allowances plus any other adjustments (see instructions)	2		
3 Subtract line 2 from line 1d	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		

Part II Expenses

Enter expenses for business use of your home only on line 30.

8 Advertising	8			18 Office expense (see instructions)	18		
9 Car and truck expenses (see instructions)	9			19 Pension and profit-sharing plans	19		
10 Commissions and fees	10			20 Rent or lease (see instructions):			
11 Contract labor (see instructions)	11			a Vehicles, machinery, and equipment	20a		
12 Depletion	12			b Other business property	20b		
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13			21 Repairs and maintenance	21		
14 Employee benefit programs (other than on line 19)	14			22 Supplies (not included in Part III)	22		
15 Insurance (other than health)	15			23 Taxes and licenses	23		
16 Interest:				24 Travel, meals, and entertainment:			
a Mortgage (paid to banks, etc.)	16a			a Travel	24a		
b Other	16b			b Deductible meals and entertainment (see instructions)	24b		
17 Legal and professional services	17			25 Utilities	25		
				26 Wages (less employment credits)	26		
				27a Other expenses (from line 48)	27a		
				b Reserved for future use	27b		
28 Total expenses before expenses for business use of home. Add lines 8 through 27a	28						
29 Tentative profit or (loss). Subtract line 28 from line 7	29						
30 Expenses for business use of your home. Attach Form 8829 . Do not report such expenses elsewhere	30						
31 Net profit or (loss). Subtract line 30 from line 29.							
<ul style="list-style-type: none"> If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. If you entered an amount on line 1c, see instr. Estates and trusts, enter on Form 1041, line 3. If a loss, you must go to line 32. 							
32 If you have a loss, check the box that describes your investment in this activity (see instructions).							
<ul style="list-style-type: none"> If you checked 32a, enter the loss on both Form 1040, line 12, (or Form 1040NR, line 13) and on Schedule SE, line 2. If you entered an amount on line 1c, see the instructions for line 31. Estates and trusts, enter on Form 1041, line 3. If you checked 32b, you must attach Form 6198. Your loss may be limited. 							
				32a <input type="checkbox"/> All investment is at risk.			
				32b <input type="checkbox"/> Some investment is not at risk.			

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2011

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Schedule C (Form 1040) 2011

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Part III Cost of Goods Sold (see instructions)

33	Method(s) used to value closing inventory: a <input type="checkbox"/> Cost b <input type="checkbox"/> Lower of cost or market c <input type="checkbox"/> Other (attach explanation)			
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation <input type="checkbox"/> Yes <input type="checkbox"/> No			
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">35</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	35		
35				
36	Purchases less cost of items withdrawn for personal use <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">36</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	36		
36				
37	Cost of labor. Do not include any amounts paid to yourself <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">37</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	37		
37				
38	Materials and supplies <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">38</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	38		
38				
39	Other costs <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">39</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	39		
39				
40	Add lines 35 through 39 <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">40</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	40		
40				
41	Inventory at end of year <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">41</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	41		
41				
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4 <table border="1" style="display: inline-table; vertical-align: bottom;"><tr><td style="width: 50px; text-align: center;">42</td><td style="width: 200px;"></td><td style="width: 50px;"></td></tr></table>	42		
42				

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 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 2011, enter the number of miles you used your vehicle for: a Business _____ b Commuting (see instructions) _____ c Other _____
45	Was your vehicle available for personal use during off-duty hours? <input type="checkbox"/> Yes <input type="checkbox"/> No
46	Do you (or your spouse) have another vehicle available for personal use? <input type="checkbox"/> Yes <input type="checkbox"/> No
47a	Do you have evidence to support your deduction? <input type="checkbox"/> Yes <input type="checkbox"/> No
b	If "Yes," is the evidence written? <input type="checkbox"/> Yes <input type="checkbox"/> 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 line 27a	48	

Schedule C (Form 1040) 2011

INITIAL SCHEDULE C QUESTIONS: LINES A–J

TYPE OF BUSINESS (LINE A)

Taxpayers that have more than one type of business are required to file a separate Schedule C for each business. The general business activity and the type of product or service are described on line A. If the general field of activity is wholesale or retail trade or services connected with production (mining, construction, or manufacturing), the type of customer should also be identified.

The instructions to Schedule C have a table of principal business and professional activity codes. The appropriate code should be entered in the box on line B. Caution should be taken when choosing the appropriate code. The taxpayer's Schedule C will be compared with other returns filed using the same code. If expenses are inconsistent with the other returns, the taxpayer has an increased chance of being selected for audit.

Example 2. Emma is a beautician with her own salon. On her 2011 income tax return, she reported \$60,000 of sales. She also reported \$40,000 for cost of goods sold. Therefore, her cost of sales was 67% of her sales. Shops of a similar size averaged only a 10% cost of sales. Consequently, Emma's return is more likely to be selected for audit.

It is often difficult to determine which code to use.

Example 3. Gale Force earns \$25,000 per year giving customers rides in his hot air balloon. When he files his Schedule C, which business code should he use?

713900	Other amusement and recreation services (including golf courses, skiing facilities, fitness centers, etc.)
481000	Air transportation
487000	Scenic and sightseeing transportation
999999	Unclassified establishments (unable to classify)

There is not necessarily a correct code to use in this example. However, the issue should be carefully considered.

METHOD OF ACCOUNTING (LINE F)³

The first time a taxpayer files a Schedule C, a method of accounting must be selected. Generally, the cash method, accrual method, or any other method permitted by the IRS can be selected. The method must be clearly reflected on line F. Once a method is chosen, it must be consistently used unless a change in method is approved by the IRS.

Unless the taxpayer is a qualifying taxpayer or a qualifying small business taxpayer, they must use the accrual method for sales and purchases of inventory. A **qualifying taxpayer** is one whose average annual gross receipts for the three prior years are \$1 million or less and whose business is not a tax shelter.⁴ A **qualifying small business taxpayer** is one whose average annual gross receipts for the three prior tax years are \$10 million or less. The business cannot be a tax shelter and the principal business activity cannot be an ineligible activity as defined in Rev. Proc. 2002-28.

Cash Method

Cash method taxpayers report all items of income when they are actually or constructively received during the year. Income is constructively received when it is available to the taxpayer, credited to their account, or set aside for their use.

³ See Schedule C instructions.

⁴ IRC §448(d)(3).

Expenses are deducted when they are paid during the year. When the expense is charged on a credit card, it is considered paid under the cash method.⁵ If an expenditure is for a capital asset with a useful life substantially beyond the end of the year, it must be depreciated.

Accrual Method

Under the accrual method, taxpayers report income when it is earned even if the income is not yet received. Accrual method taxpayers deduct expenses when incurred even if they are not paid during the tax year. However, an accrual-basis taxpayer is not allowed to deduct any business expenses owed to a related cash-basis taxpayer until the payment is made and reported as income by the cash-basis payee.

Example 4. Cam Era, an accrual-basis, calendar-year taxpayer, is a professional photographer. In addition, he is the sole shareholder of Cam's Photographic Supplies, Inc., a cash-basis taxpayer. Cam purchases all his photographic supplies from his corporation but only pays for them at the beginning of the next quarter. He purchased \$4,000 of supplies from the corporation in the fourth quarter of 2011. He paid for the supplies on January 5, 2012. Cam cannot take the deduction for the supplies purchased in the fourth quarter until 2012 even though he uses the accrual method of accounting for the photography business.

Change in Accounting Method

Taxpayers wishing to change accounting methods must obtain IRS approval. Approval is requested by filing Form 3115, *Application for Change in Accounting Method*. An adjustment must be made to prevent the income or expense from being duplicated or omitted.⁶

A taxpayer changing from the accrual- to the cash-basis method of accounting may be required to record the same transactions in two separate years. For example, if the taxpayer accrued sales prior to the year of change and received the payment after changing to the cash method, they must report the sale in both years. However, the taxpayer should make an IRC §481(a) adjustment in the second year to prevent the duplication of taxable income.

A taxpayer may choose to change to the cash method to account for inventory items in the same manner as material and supplies that are considered not incidental under Treas. Reg. §1.163-3. These are materials and supplies that are normally consumed during the year and are not inventoried.

A net negative §481(a) adjustment is taken into account entirely in the year of change. A net positive §481(a) adjustment is generally taken into account over a period of four years. For a net positive adjustment that is less than \$25,000, the adjustment can be taken into account in the year of change. The positive adjustments are reported on line 6 of the Schedule C. If the adjustment is negative, it is reported in Part V of the Schedule C.

Note. If the original method of accounting would produce a \$100 profit for the year and the new method of accounting would produce a \$300 profit, the IRC §481(a) positive adjustment is \$200.

MATERIAL PARTICIPATION (LINE G)

The question of whether the taxpayer materially participates in an activity is important because when a taxpayer does not materially participate, the activity is considered a passive activity. In a passive activity, any losses incurred are only deductible to the extent of passive activity gains.

Any activity performed by the taxpayer who owns the business at the time the work was performed is considered in determining material participation. The taxpayer's capacity in which the work was performed does not matter.

⁵ Rev. Rul. 78-39, 1978-1 CB 73.

⁶ IRC §481(a).

Work performed as an investor in an activity is not treated as material participation unless the taxpayer is involved in the day-to-day management or operations of the activity. Work done as an investor includes any of the following.

- Studying and reviewing financial statements or reports of the activity
- Preparing or compiling summaries or analyses of the finances or operations of the activity for the investor's own use
- Monitoring the finances or operations of the activity in a nonmanagerial capacity

Participation by the taxpayer's spouse during the tax year can be counted as participation by the taxpayer. This applies even if the spouse does not own an interest in the activity and regardless of whether the taxpayer and the spouse file a joint income tax return. However, this **does not apply** for purposes of determining whether the activity is a husband-wife qualified joint venture.

An individual is treated as materially participating in an activity if they meet any **one** of the following seven rules.⁷

1. The taxpayer participated in the activity for more than 500 hours during the year.
2. Taxpayer participation in the activity for the tax year was substantially all of the participation in the activity of all individuals. This includes individuals who do not own any interest in the activity.
3. The taxpayer participated in the activity for more than 100 hours during the tax year, and they participated at least as much as any other person.
4. The activity is a significant participation activity, and the taxpayer participated for more than 500 hours in all significant participation activities during the tax year. An activity is a "significant participation" activity if it involves the conduct of a trade or business. The taxpayer must participate in the activity for more than 100 hours, and the taxpayer must not have materially participated under any of the material participation tests other than rule 4.
5. The taxpayer materially participated in the activity for any five of the prior 10 years.
6. The activity is a personal service activity in which the taxpayer materially participated for any three prior tax years. A personal service activity is an activity that involves performing personal services in the fields of:
 - a. Health,
 - b. Law,
 - c. Engineering,
 - d. Architecture,
 - e. Accounting,
 - f. Actuarial science,
 - g. Performing arts,
 - h. Consulting, or
 - i. Any other trade or business in which capital is not a material income-producing factor.

⁷ Temp. Treas. Reg. §1.469-5T.

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7. Based on all of the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis for at least 100 hours during the tax year. The taxpayer's participation in managing the activity does not count in determining whether the taxpayer materially participates in the activity for the taxable year, unless:
- No person other than the taxpayer received compensation for performing management services in connection with the activity, or
 - No individual spent more hours during the tax year than the taxpayer in performing management services in connection with the activity. It does not matter if the person was compensated for the services.

Limit on Losses

If the "No" box on line G is checked, the taxpayer must use Form 8582, *Passive Activity Loss Limitations*, to calculate allowable losses.

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

G Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on losses ☐ Yes ☐ No

If you started or acquired this business during 2011, check here ☐

Gas and Oil Exception

Taxpayers filing Schedule C to report income and deductions from an oil or gas well should check the "Yes" box on line G if they own a working interest either totally or through an entity that does not limit their liability. This activity is not a passive activity regardless of the taxpayer's participation.

NEW BUSINESS (LINE H)

If this is the first return filed for a new business, the box on line H is checked.

FORM 1099 FILING REQUIREMENT (LINES I AND J)

The taxpayer checks a box on line I indicating whether they are required to file Form(s) 1099. A Form 1099-MISC is required if the business hires noncorporate independent contractors and pays them \$600 or more. Various Forms 1099 are required for payments of interest, rents, royalties, real estate transactions, annuities, and pensions. If the business sells items for resale to a business and the total annual sales to that business are \$5,000 or more, a Form 1099 may be required.

Line J of Schedule C asks if the required Forms 1099 were actually filed. Failure to file the required Forms 1099 subjects the taxpayer to penalties ranging from \$30 to \$250 per form depending on how late the forms are filed.⁸

An exception to the Form 1099 filing requirement applies if the taxpayer makes payments using a credit card. If this is the case, the payment settlement entity is required to issue a Form 1099-K. In that situation, a Form 1099-MISC is not necessary.

Note. For more information about various Forms 1099, see Chapter 1 in the 2011 *Federal Tax Fundamentals* workbook. Additionally, information regarding Form 1099 filing can be found on the IRS website at www.irs.gov/uac/A-Guide-to-Information>Returns.

⁸. IRC §6721.

PART 1: INCOME

FORM 1099-K

Beginning in 2011, the IRS requires payment settlement entities (PSE) to report payments made to merchants on Form 1099-K, *Merchant Card and Third Party Network Payments*. If the Schedule C taxpayer receives customer payments via credit cards or PayPal or some other third-party payor, they may receive a Form 1099-K from that payor.

Note. A de minimus exception applies to payments in settlement of third-party network transactions (e.g., PayPal and Google Wallet). For more information, see 2012 Volume B, Chapter 4: Information Reporting.

The IRS originally intended to require taxpayers to separately enter amounts reported on Forms 1099-K and added lines to various tax forms (including Schedule C) accordingly. However, on February 10, 2012, the IRS announced there would be no need to reconcile Form 1099-K payments in 2011 or in future years.

Note. The total income reported on Schedule C should be compared to any Forms 1099-K received. If the difference is significant, there may be an error in the bookkeeping.

Example 5. In 2011, Tony's Italian Restaurant submits total credit card sales to the PSE. The sales includes \$31,000 for food, \$1,860 for sales tax, and \$4,650 for tips, resulting in a total submission of \$37,510. The PSE deposits \$36,947 to Tony's bank account because they withheld \$563 for the settlement fee. The Form 1099-K Tony receives reports \$37,510. However, Tony is only required to report \$30,437 of sales. This is calculated by subtracting the \$563 settlement fee from the \$31,000 food sales. The \$1,860 of sales tax and \$4,650 of tips are offset when he pays the state and his employees.

As an alternate method, Tony could report sales of \$37,510 and report deductions of \$563 for the settlement fee, \$1,860 for sales tax, and \$4,650 for tips. This would result in \$30,437 of net income.

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no. MASTER CARD PROCESSING CENTER 110 STATE STREET ANYTOWN, MO 55555		FILER'S federal identification no. 12-3456789 <hr/> PAYEE'S taxpayer identification no. 98-7654321	OMB No. 1545-2205 <div style="font-size: 2em; font-weight: bold; text-align: center;">2011</div> Form 1099-K	Merchant Card and Third Party Network Payments
If checked, FILER is Payment Settlement Entity (PSE) <input checked="" type="checkbox"/> OR If checked, FILER is Electronic Payment Facilitator (EPF)/ Third Party Payer (TPP) <input type="checkbox"/>		1 Gross amount of merchant card/third party network payments \$ 37510.00	2 Merchant category code <div style="font-size: 1.5em; text-align: center;">1</div>	Copy B For Payee 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 taxable income results from this transaction and the IRS determines that it has not been reported.
PAYEE'S name TONY'S ITALIAN RESTAURANT Street address (including apt. no.) 21 CHARRO WAY City, state, and ZIP code ANYTOWN, MO 55555		3 5a January \$ 5c March \$ 5e May \$ 37510.00 5g July \$ 5i September \$ 5k November \$	4 5b February \$ 5d April \$ 5f June \$ 5h August \$ 5j October \$ 5l December \$	
PSE'S name and telephone number 555-555-5555				
Account number (see instructions)				

Form 1099-K
(Keep for your records)
IRS.gov/form1099k
Department of the Treasury - Internal Revenue Service

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COST OF GOODS SOLD (LINE 4)

If the taxpayer is a retailer, the cost of goods sold is reported on line 4 of Schedule C. The amount is transferred from line 42 in Part III. It consists of the inventory at the beginning of the year plus any inventory purchases minus the inventory at the end of the year.

If the taxpayer removes products from the inventory for personal use, their cost must be subtracted from the total purchases reported on line 36.

Example 6. Betty Lou sells Sarah Sue Products. She purchases \$30,000 of products in 2011. She gave products to friends and family for Christmas gifts. Her cost for these products was \$1,500. Betty Lou enters \$28,500 (\$30,000 – \$1,500) on line 36.

The cost of goods sold calculation for taxpayers who manufacture products is more complicated. All labor involved in the manufacturing process is reported on line 37. The amount on line 38 must include the cost of materials and supplies purchased. Other costs directly related to the manufacturing process are reported on line 39.

Example 7. Clay Potts manufactures and sells decorative vases at wholesale. In 2011, he sold \$200,000 of pots. The PSE withheld \$2,700 for settlement fees. In addition, Clay refunded \$1,000 to one customer because the entire shipment was damaged. Clumsy Transport paid \$500 to Clay as reimbursement for the damaged shipment.

Clay also sells ceramic items purchased from other manufacturers. In 2011, he incurred the following costs in his business.

Glass vases	\$7,000	
Metal urns	6,000	
Total purchases (line 36)	\$13,000	\$13,000
Employee wages	\$25,000	
Payroll taxes	1,912	
Total cost of labor (line 37)	\$26,912	26,912
Clay	\$10,000	
Paint	800	
Total material and supplies (line 38)	\$10,800	10,800
Packaging material	\$4,000	
Shipping fees to Clumsy Transport	900	
Total other costs (line 39)	\$4,900	4,900
Total manufacturing expense		\$55,612

The beginning and ending inventory for Potts Manufacturing is \$45,000 and \$50,000, respectively. These values are entered on lines 35 and 41. The total cost of goods sold for 2011 is \$50,612 (\$45,000 + \$55,612 – \$50,000).

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For Example 7

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

► For information on Schedule C and its instructions, go to www.irs.gov/schedulec
► Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2011

Attachment
Sequence No. **09**

Name of proprietor

CLAY POTTS

Social security number (SSN)

111-22-4444

A Principal business or profession, including product or service (see instructions)

CERAMIC POT MANUFACTURER

B Enter code from instructions

► **3 | 2 | 7 | 1 | 0 | 0**

C Business name. If no separate business name, leave blank.

POTTS MANUFACTURING

D Employer ID number (EIN), (see instr.)

E Business address (including suite or room no.) ► **15 ARTIST WAY**

City, town or post office, state, and ZIP code **BRANSON, MO 44444**

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

G Did you "materially participate" in the operation of this business during 2011? If "No," see instructions for limit on losses ☒ Yes ☐ No

H If you started or acquired this business during 2011, check here ☐

I Did you make any payments in 2011 that would require you to file Form(s) 1099? (see instructions) ☐ Yes ☒ No

J If "Yes," did you or will you file all required Forms 1099? ☐ Yes ☐ No

Part I Income

1a Merchant card and third party payments. For 2011, enter -0-	1a		
b Gross receipts or sales not entered on line 1a (see instructions)	1b	200,000	
c Income reported to you on Form W-2 if the "Statutory Employee" box on that form was checked. Caution. See instr. before completing this line	1c		
d Total gross receipts. Add lines 1a through 1c	1d	200,000	
2 Returns and allowances plus any other adjustments (see instructions)	2	1,000	
3 Subtract line 2 from line 1d	3	199,000	
4 Cost of goods sold (from line 42)	4	50,612	
5 Gross profit. Subtract line 4 from line 3	5	148,388	
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	500	
7 Gross income. Add lines 5 and 6	7	148,888	

Enter expenses for business use of your home only on line 8

Schedule C (Form 1040) 2011

Page **2**

Part III Cost of Goods Sold (see instructions)

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? ☐ Yes ☒ No
If "Yes," attach explanation

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	45,000	
36 Purchases less cost of items withdrawn for personal use	36	13,000	
37 Cost of labor. Do not include any amounts paid to yourself	37	26,912	
38 Materials and supplies	38	10,800	
39 Other costs	39	4,900	
40 Add lines 35 through 39	40	100,612	
41 Inventory at end of year	41	50,000	
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on line 4	42	50,612	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9

4

OTHER INCOME (LINE 6)

Line 6 of Schedule C is used to report finance income, scrap sales, bad debts recovered, prizes and awards related to the business, and other kinds of miscellaneous income.

If the business-use percentage of any listed property dropped to 50% or less during the taxable year, the recapture of excess depreciation is also reported on this line. This includes the §179 expense deduction. Any inclusion amount is also reported on this line. The inclusion amount is the amount of income required to be reported if the fair market value (FMV) of a leased vehicle exceeds a certain threshold.

Note. For more information, see the worksheet in Chapter 5 of IRS Pub. 946, *How to Depreciate Property*.

PART II: EXPENSES

All the expenses incurred in conducting the trade or business other than those related to the cost of goods sold are reported in Part II of Schedule C. To be deductible, the expense must be directly attributable to the trade or business. Expenses only remotely connected with the trade or business are not deductible, such as state taxes based on net income even though the taxpayer's income is derived from the conduct of a trade or business.⁹

ADVERTISING (LINE 8)

Advertising and promotional expenses are reported on line 8. These are expenditures made with the intent of increasing income. It is not necessary that the expense actually generated additional revenue. The purpose of some advertising is to make people aware of the business. Other types are direct solicitations for business. A determination should be made as to whether the advertising is currently deductible or if it must be amortized.

Website Development Costs

Whether website development costs should be amortized or expensed is a gray area for the IRS. It has yet to take a stance on such costs. The IRS may try to categorize the costs into three areas: planning, construction, and content. This determines if the costs are amortized or deducted currently. Many taxpayers attempt to deduct all of the development costs under advertising and software. Ultimately, the IRS makes a decision based on the facts and circumstances of the taxpayer.

If the website will have a life of more than one year, then capitalization is appropriate. However, if the contents of the site change on a regular basis, then the costs may be a current advertising expense. Consideration of this question can serve as a guide when deciding how to handle the planning, construction, and content costs.

One of the first costs in developing a website is the acquisition of a domain name. Although a domain name can be registered for as little as \$2, there is no de minimis rule under IRC §263. If it is a multi-year fee, it should be capitalized and amortized.

There is little doubt that the costs of continually updating the website are currently deductible. The life of the update does not provide a significant benefit for more than one year.

⁹ Temp. Treas. Reg. §1.62-1T(d).

Promotion

Advertising costs are generally deductible as a current expense under IRC §162. Regulations provide that “advertising and other selling expenses” are among the items included in deductible business expenses.¹⁰ The regulations also provide that institutional and goodwill advertising expenses that are designed to keep the taxpayer’s name before the public are generally deductible as ordinary and necessary business expenses. However, the expenses must be related to the patronage the taxpayer might reasonably expect in the future.¹¹

Solicitations

Small businesses are constantly solicited for donations from various groups or causes. Examples include the following.

- The local Boy Scout troop requests donations to support their future camping trip.
- Firemen solicit donations for their “Toys for Needy Children” program.
- The Knights of Columbus sell candy for a special project.
- Girl Scouts have an annual cookie sale drive.
- The high school athletic booster club solicits a donation for placing the taxpayer’s name in the basketball program.

It is often difficult to decide if these are business expenses or charitable contributions. There is no obvious answer for any of these solicitations. Whether the amount paid constitutes a business deduction must be based on the facts and circumstances of the expenditure. The taxpayer must have an expectation of increased business by having their name publicized in order for the payment to constitute an advertising expense.

If there is no business purpose for the donation, sole proprietors must deduct the contribution on Schedule A instead of Schedule C. In this case, the recipient organization must be a §501(c)(3) organization.

Signage

When a taxpayer pays to have a sign attached to their business, they usually expect the sign to have a useful life of more than one year. In this case, the cost is capitalized. The capitalized costs include the design, material, and erection expense.

Example 8. Paula’s Family Diner paid an artist \$3,000 to design an outdoor sign to be erected next to the street. She paid a sign manufacturer \$10,000 to build the sign and a sign company \$6,000 to erect the sign on a concrete base. Paula must depreciate the \$19,000 cost.

Example 9. Paula also paid a sign painter \$400 to make signs promoting each day’s specials. This is deducted as an advertising expense.

Example 10. Paula paid ABC Billboards \$4,000 per month to advertise her restaurant on an electronic billboard. The message changes periodically and Paula has no ownership in the billboard. This is a currently deductible advertising expense.

Example 11. Use the same facts as **Example 10**, except that Paula paid ABC Billboards \$16,000 in November 2012 for four month’s rent of the billboard. She is a cash-basis taxpayer. Even though the usage falls in two different tax years, Paula may deduct the entire \$16,000 in 2012 because the lease period is for less than one year.¹²

¹⁰ Treas. Reg. §1.162-1(a).

¹¹ Treas. Reg. §1.162-20(a)(20).

¹² *Zaninovich v. Comm’r*, 616 F.2d 429 (9th Cir. 1980).

CAR AND TRUCK EXPENSES (LINE 9)

The actual expense of operating a car or truck within a business is deductible unless the standard mileage rate is used. If the business uses five or more vehicles simultaneously, such as fleet operations, actual expenses must be used. Actual expenses include all out-of-pocket expenses plus depreciation. Beginning in 2011, taxpayers can elect to use the standard mileage rate if they used a vehicle for hire (such as a taxi). Actual expenses for a leased vehicle cannot be used if the standard mileage rate was previously used.

Note. There are special rules and limitations regarding the depreciation deduction.

The standard mileage rate can only be used if:

1. The taxpayer used the standard mileage rate the first year the business owned the vehicle, or
2. The taxpayer leases the vehicle and uses the standard mileage rate the entire time the vehicle is leased.

Note. The standard mileage rate for 2012 is 55.5 cents per mile. These rates are subject to change.

When using the standard mileage rate, parking fees, interest, and tolls can be added to the total deduction.

Reporting

When claiming the auto or truck deduction, Part IV of Schedule C, Part III of Schedule C-EZ, **or** Part V of Form 4562, *Depreciation and Amortization*, must be completed and attached to the tax return.

COMMISSIONS AND FEES (LINE 10)

Commissions and fees can have multiple tax consequences. A commission paid to a salesperson for the business is deductible on line 10 of Schedule C. However, a commission paid for the purchase of a capital asset must be included with the cost of the asset and depreciated. If a commission is paid for the sale of a capital asset, the commission reduces the gain on the sale and is reported on Form 4797, *Sales of Business Property*.

CONTRACT LABOR (LINE 11)

Contract labor only includes payments to individuals that the business does not treat as employees. These individuals are often called “independent contractors.” Depending on the work performed, this expense could require capitalization. For example, the money paid to a carpenter for a building addition must be added to the cost of the building and depreciated.

If an independent contractor is paid \$600 or more during the year, a Form 1099-MISC, *Miscellaneous Income*, must be filed. The penalties for failure to file Forms 1099-MISC range from \$30 to \$250 per form depending on how late the forms are filed.¹³

In an examination of a tax return, the IRS scrutinizes contract labor expenses. This is an area commonly abused by taxpayers. Many businesses classify workers as independent contractors in order to avoid incurring payroll taxes and workers’ compensation. If an employer is unsure whether a worker is an employee or independent contractor, Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*, should be reviewed. The SS-8 is divided into five parts.

1. General information
2. Behavioral control
3. Financial control
4. Relationship of the worker and firm
5. Service providers or salespersons

¹³ IRC §6721.

2012 Workbook

Form SS-8 is used only for determination purposes. If the form is submitted, the IRS issues a determination letter. The form is not required to be filed, but it provides the taxpayer with the criteria that the IRS uses to make a determination. No one factor on the form determines the status of the worker. Determination is made after examining all the answers provided on the form.

A worker can file Form SS-8 if they believe they should be treated as an employee rather than an independent contractor.

Form SS-8 (Rev. August 2011) Department of the Treasury Internal Revenue Service	Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding	OMB. No. 1545-0004 For IRS Use Only: Case Number: _____ Earliest Receipt Date: _____	
Name of firm (or person) for whom the worker performed services		Worker's name	
Firm's mailing address (include street address, apt. or suite no., city, state, and ZIP code)		Worker's mailing address (include street address, apt. or suite no., city, state, and ZIP code)	
Trade name	Firm's email address	Worker's daytime telephone number	Worker's email address
Firm's fax number	Firm's website	Worker's alternate telephone number	Worker's fax number
Firm's telephone number (include area code)	Firm's employer identification number	Worker's social security number	Worker's employer identification number (if any)
Note. If the worker is paid for these services by a firm other than the one listed on this form, enter the name, address, and employer identification number of the payer. ► _____			
Disclosure of Information			
<p>The information provided on Form SS-8 may be disclosed to the firm, worker, or payer named above to assist the IRS in the determination process. For example, if you are a worker, we may disclose the information you provide on Form SS-8 to the firm or payer named above. The information can only be disclosed to assist with the determination process. If you provide incomplete information, we may not be able to process your request. See <i>Privacy Act and Paperwork Reduction Act Notice</i> on page 6 for more information. If you do not want this information disclosed to other parties, do not file Form SS-8.</p>			
<p>Parts I–V. All filers of Form SS-8 must complete all questions in Parts I–IV. Part V must be completed if the worker provides a service directly to customers or is a salesperson. If you cannot answer a question, enter “Unknown” or “Does not apply.” If you need more space for a question, attach another sheet with the part and question number clearly identified. Write your firm's name (or workers' name) and employer identification number (or social security number) at the top of each additional sheet attached to this form.</p>			
Part I General Information			
<p>1 This form is being completed by: <input type="checkbox"/> Firm <input type="checkbox"/> Worker; for services performed _____ to _____. (beginning date) (ending date)</p> <p>2 Explain your reason(s) for filing this form (for example, you received a bill from the IRS, you believe you erroneously received a Form 1099 or Form W-2, you are unable to get worker's compensation benefits, or you were audited or are being audited by the IRS). _____ _____ _____</p> <p>3 Total number of workers who performed or are performing the same or similar services: _____</p> <p>4 How did the worker obtain the job? <input type="checkbox"/> Application <input type="checkbox"/> Bid <input type="checkbox"/> Employment Agency <input type="checkbox"/> Other (specify) _____</p> <p>5 Attach copies of all supporting documentation (for example, contracts, invoices, memos, Forms W-2 or Forms 1099-MISC issued or received, IRS closing agreements or IRS rulings). In addition, please inform us of any current or past litigation concerning the worker's status. If no income reporting forms (Form 1099-MISC or W-2) were furnished to the worker, enter the amount of income earned for the year(s) at issue \$ _____. If both Form W-2 and Form 1099-MISC were issued or received, explain why. _____ _____ _____</p> <p>6 Describe the firm's business. _____ _____ _____</p>			
<hr/>			

For Privacy Act and Paperwork Reduction Act Notice, see page 6.

Cat. No. 16106T

Form **SS-8** (Rev. 8-2011)

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2012 Workbook

Part I General Information (continued)

- 7 If the worker received pay from more than one entity because of an event such as the sale, merger, acquisition, or reorganization of the firm for whom the services are performed, provide the following: Name of the firm's previous owner: _____
Previous owner's taxpayer identification number: _____ Change was a: ☐ Sale ☐ Merger ☐ Acquisition ☐ Reorganization
☐ Other (specify) _____
Description of above change: _____
Date of change (MM/DD/YY): _____
- 8 Describe the work done by the worker and provide the worker's job title. _____
- 9 Explain why you believe the worker is an employee or an independent contractor. _____
- 10 Did the worker perform services for the firm in any capacity before providing the services that are the subject of this determination request?
☐ Yes ☐ No ☐ N/A
If "Yes," what were the dates of the prior service? _____
If "Yes," explain the differences, if any, between the current and prior service. _____
- 11 If the work is done under a written agreement between the firm and the worker, attach a copy (preferably signed by both parties). Describe the terms and conditions of the work arrangement. _____

Part II Behavioral Control (Provide names and titles of specific individuals, if applicable.)

- 1 What specific training and/or instruction is the worker given by the firm? _____
- 2 How does the worker receive work assignments? _____
- 3 Who determines the methods by which the assignments are performed? _____
- 4 Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution? _____
- 5 What types of reports are required from the worker? Attach examples. _____
- 6 Describe the worker's daily routine such as his or her schedule or hours. _____
- 7 At what location(s) does the worker perform services (for example, firm's premises, own shop or office, home, customer's location)? Indicate the appropriate percentage of time the worker spends in each location, if more than one. _____
- 8 Describe any meetings the worker is required to attend and any penalties for not attending (for example, sales meetings, monthly meetings, staff meetings). _____
- 9 Is the worker required to provide the services personally? ☐ Yes ☐ No
- 10 If substitutes or helpers are needed, who hires them? _____
- 11 If the worker hires the substitutes or helpers, is approval required? ☐ Yes ☐ No
If "Yes," by whom? _____
- 12 Who pays the substitutes or helpers? _____
- 13 Is the worker reimbursed if the worker pays the substitutes or helpers? ☐ Yes ☐ No
If "Yes," by whom? _____

Form **SS-8** (Rev. 8-2011)

Part III Financial Control (Provide names and titles of specific individuals, if applicable.)

- 1 List the supplies, equipment, materials, and property provided by each party:
The firm: _____
The worker: _____
Other party: _____
- 2 Does the worker lease equipment, space, or a facility? ☐ Yes ☐ No
If "Yes," what are the terms of the lease? (Attach a copy or explanatory statement.) _____
- 3 What expenses are incurred by the worker in the performance of services for the firm? _____
- 4 Specify which, if any, expenses are reimbursed by:
The firm: _____
Other party: _____
- 5 Type of pay the worker receives: ☐ Salary ☐ Commission ☐ Hourly Wage ☐ Piece Work
☐ Lump Sum ☐ Other (specify) _____
If type of pay is commission, and the firm guarantees a minimum amount of pay, specify amount. \$ _____
- 6 Is the worker allowed a drawing account for advances? ☐ Yes ☐ No
If "Yes," how often? _____
Specify any restrictions. _____
- 7 Whom does the customer pay? ☐ Firm ☐ Worker
If worker, does the worker pay the total amount to the firm? ☐ Yes ☐ No If "No," explain. _____
- 8 Does the firm carry workers' compensation insurance on the worker? ☐ Yes ☐ No
- 9 What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary (for example, loss or damage of equipment, material)? _____
- 10 Does the worker establish the level of payment for the services provided or the products sold? ☐ Yes ☐ No
If "No," who does? _____

Part IV Relationship of the Worker and Firm

- 1 Please check the benefits available to the worker: ☐ Paid vacations ☐ Sick pay ☐ Paid holidays
☐ Personal days ☐ Pensions ☐ Insurance benefits ☐ Bonuses
☐ Other (specify) _____
- 2 Can the relationship be terminated by either party without incurring liability or penalty? ☐ Yes ☐ No
If "No," explain your answer. _____
- 3 Did the worker perform similar services for others during the time period entered in Part I, line 1? ☐ Yes ☐ No
If "Yes," is the worker required to get approval from the firm? ☐ Yes ☐ No
- 4 Describe any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period. Attach any available documentation. _____
- 5 Is the worker a member of a union? ☐ Yes ☐ No
- 6 What type of advertising, if any, does the worker do (for example, a business listing in a directory or business cards)? Provide copies, if applicable. _____
- 7 If the worker assembles or processes a product at home, who provides the materials and instructions or pattern? _____
- 8 What does the worker do with the finished product (for example, return it to the firm, provide it to another party, or sell it)? _____
- 9 How does the firm represent the worker to its customers (for example, employee, partner, representative, or contractor), and under whose business name does the worker perform these services? _____
- 10 If the worker no longer performs services for the firm, how did the relationship end (for example, worker quit or was fired, job completed, contract ended, firm or worker went out of business)? _____

2012 Workbook

Part V For Service Providers or Salespersons. Complete this part if the worker provided a service directly to customers or is a salesperson.

- 1 What are the worker's responsibilities in soliciting new customers? _____
- 2 Who provides the worker with leads to prospective customers? _____
- 3 Describe any reporting requirements pertaining to the leads. _____
- 4 What terms and conditions of sale, if any, are required by the firm? _____
- 5 Are orders submitted to and subject to approval by the firm? ☐ Yes ☐ No
- 6 Who determines the worker's territory? _____
- 7 Did the worker pay for the privilege of serving customers on the route or in the territory? ☐ Yes ☐ No
If "Yes," whom did the worker pay? _____
If "Yes," how much did the worker pay? \$ _____
- 8 Where does the worker sell the product (for example, in a home, retail establishment)? _____
- 9 List the product and/or services distributed by the worker (for example, meat, vegetables, fruit, bakery products, beverages, or laundry or dry cleaning services). If more than one type of product and/or service is distributed, specify the principal one. _____
- 10 Does the worker sell life insurance full time? ☐ Yes ☐ No
- 11 Does the worker sell other types of insurance for the firm? ☐ Yes ☐ No
If "Yes," enter the percentage of the worker's total working time spent in selling other types of insurance _____ %
- 12 If the worker solicits orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments, enter the percentage of the worker's time spent in the solicitation _____ %
- 13 Is the merchandise purchased by the customers for resale or use in their business operations? ☐ Yes ☐ No
Describe the merchandise and state whether it is equipment installed on the customers' premises. _____

**Sign
Here**

Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and to the best of my knowledge and belief, the facts presented are true, correct, and complete.



Type or print name below signature.

Title ►

Date ►

Form **SS-8** (Rev. 8-2011)

Misclassification Penalties

If the IRS determines an employer has misclassified an employee as an independent contractor, it can assert substantial penalties. These include all of the following.¹⁴

- 1.5% of each misclassified employee's wages because income taxes were not withheld
- 20% of each misclassified employee's FICA taxes that were not withheld
- The amounts of the employer's FICA and FUTA taxes
- Any other applicable penalties and interest such as late payment penalties

¹⁴ IRC §3509.

Example 12. Perry has a very successful lawn mowing service. He has 20 workers that mow for him. In 2010, he treated the workers as independent contractors and paid them a total of \$400,000. In 2011, he paid the workers \$380,000. At the time of an IRS audit in 2012, he had paid them \$200,000. No employee earned over the FICA wage base. If the IRS determines the workers are employees, Perry will owe all of the following penalties.

- \$14,700 for income taxes not withheld ($1.5\% \times (\$400,000 + \$380,000 + \$200,000)$)
- \$6,554 for FICA taxes not withheld in 2011 and 2012 ($5.65\% \times (\$380,000 + \$200,000) \times 20\%$)
- \$6,120 for FICA taxes not withheld in 2010 ($7.65\% \times \$400,000 \times 20\%$)
- \$74,970 ($7.65\% \times \$980,000$) for the employer's share of FICA tax
- FUTA tax
- Any other applicable penalties and interest

Perry owes the IRS at least \$102,344 ($\$14,700 + \$6,554 + \$6,120 + \$74,970$).

Penalty Relief. On September 21, 2011, the IRS announced a **new** voluntary worker classification settlement program (VCSP) providing payroll tax relief to employers who voluntarily reclassify their employees. This program offers the employer a low-cost way of reclassifying their employees.

To be eligible for the program, the employer must satisfy all of the following requirements.

- Have consistently treated the workers in the past as nonemployees
- Have filed all required Forms 1099-MISC for the workers for the previous three years
- Not currently under audit by the IRS
- Not currently under audit by the Department of Labor or a state agency concerning the classification of these workers

Employers that were subject to an IRS, Department of Labor, or state agency audit may still qualify for this amnesty program if all requirements of the audit were satisfied.

An employer can apply for the program by filing Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*, at least 60 days before they want to begin treating the workers as employees.

When an employer is accepted into the program, they pay an amount effectively equal to just over 1% of the wages paid to the reclassified workers over the past year. No interest or penalties are due and the employer will not be audited for payroll taxes related to these workers for the prior years. Employers under the program are subject to a special 6-year statute of limitations, rather than the usual three years that generally applies to payroll taxes.¹⁵

Example 13. Use the facts from **Example 12**, except Perry is not under audit. He can apply for the VCSP. Perry completes and files Form 8952 and requests the beginning date to be January 1, 2013. His payment is based on his 2011 payroll because 2012 is not yet ended. He bases his VCSP payment on the 2011 payroll of \$380,000. Following the instructions on the form, Perry calculates the payment using 10.28% of \$380,000, or \$39,064. Under the VCSP, he pays the IRS 10% of this amount, or \$3,906. Perry's potential savings by voluntarily reclassifying his employees is at least \$98,438 ($\$102,344 - \$3,906$). However, he must continue to classify the workers as employees to stay in compliance with the VCSP.

Perry's Form 8952 follows.

¹⁵ IRS News Rel. IR-2011-95 (Sep. 21, 2011).

2012 Workbook

For Example 13

Form 8952 (Rev. September 2011) Department of the Treasury Internal Revenue Service	Application for Voluntary Classification Settlement Program (VCSP) ▶ See separate instructions.	OMB No. 1545-2215
Caution. Taxpayer must make certain representations in order to be eligible to participate in the VCSP. These representations can be found in Part V, below.		
Part I Taxpayer Information		
1 Employer Identification Number (EIN) 11-1234567		2 Taxpayer Name PERRY'S LAWN SERVICE
3 Number and street (If a P.O. box, see instructions) 101 WRIGHT ROAD		Room/Suite
4 City, town, state, and ZIP code NEW MADISON, TN 44444		
5 Telephone Number 999-555-1212		6 Taxpayer's website address (optional)
7 Fax Number (optional)		8 Email address (optional)
9 Type of Entity. Check the applicable box <input checked="" type="checkbox"/> Sole proprietorship <input type="checkbox"/> Cooperative organization described in section 1381 of the Internal Revenue Code <input type="checkbox"/> Joint venture <input type="checkbox"/> Tax exempt organization <input type="checkbox"/> Partnership <input type="checkbox"/> State or local government (for worker class or position not covered under a section 218 agreement) <input type="checkbox"/> C corporation <input type="checkbox"/> Other (specify here) _____ <input type="checkbox"/> S corporation		
10 Are you a member of an affiliated group filing consolidated returns for income tax purposes? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No If "Yes," complete the common parent information on lines 11-14. If "No," skip to Part II.		
11 Name of common parent of the affiliated group		12 Employer Identification Number (EIN) of common parent
13 Number and Street (or P.O. box no. if mail is not delivered to a street address) of common parent		
14 City, town, state, and ZIP code of common parent		
Part II Contact Person		
Attach a properly completed Form 2848, Power of Attorney and Declaration of Representative, if applicable.		
a Name and title of contact person _____		
b Contact person address: Number and street (or P.O. box no. if mail is not delivered to a street address) _____		
c Contact person address: City, town, or P.O. box, state, and ZIP code _____		
d Contact person telephone number _____		
e Contact person fax number (optional) _____		
f Contact person email address (optional) _____		
Part III General Information About Workers to be Reclassified		
15 Enter the number of workers from all classes to be reclassified 20		16 Description of the class or classes of workers to be reclassified. If more space is needed, attach separate sheets (see instructions). DAY LABORERS
17 Enter the beginning date of the tax period (year or quarter) for which you want to begin treating the class or classes of workers as employees. This date should be at least 60 days from the date you file Form 8952 (see instructions). 01 / 01 / 2013		
For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.		
Cat. No. 37772H		Form 8952 (Rev. 9-2011)

2012 Workbook

For Example 13

Form 8952 (Rev. 9-2011)

Page **2**

Taxpayer's Employer Identification Number (EIN)

11-1234567

Taxpayer's Name

PERRY'S LAWN SERVICE

Part IV Payment Calculation using Section 3509(a) rates (see instructions)

	Column A	Column B	Column C
	Compensation paid to all classes of workers at or below the social security wage base (see instructions)	Compensation paid to all classes of workers above the social security wage base (see instructions)	Totals
18 Compensation paid to all classes of workers to be reclassified for the most recently completed tax year	380,000	0	380,000
19 Multiply line 18, Column A by the percentage (10.68% for compensation paid in 2010 or 10.28% for compensation paid in 2011) (see instructions)	39,064		
20 Multiply line 18, Column B by the percentage (3.24% for 2010 and for 2011)		0	
21 Total of line 19, Column A and line 20, Column B			39,064
22 Multiply the amount on line 21, Column C by 10%. This will be your VCSP payment			3,906

Part V Taxpayer's Representations

(Note: Since the representations include the penalty of perjury statement, the representations under Part V must be signed by the Taxpayer, not the Taxpayer's representative.)

A Treatment of Workers

- 1** Taxpayer wants to voluntarily reclassify certain workers as employees for federal income tax withholding, Federal Insurance Contributions Act, and Federal Unemployment Tax Act taxes (collectively, federal employment taxes) for future tax periods.
- 2** Taxpayer is presently treating the workers as nonemployees.
- 3** Taxpayer has satisfied any Form 1099 requirements for each of the workers for the 3 preceding calendar years ending before the date of this application.
- 4** Taxpayer has consistently treated the workers as nonemployees.
- 5** There is no dispute between Taxpayer and the Internal Revenue Service as to whether the workers are nonemployees or employees for federal employment tax purposes.

B Examination

- 1** Taxpayer is not under examination by the Internal Revenue Service.
- 2** Taxpayer is not under examination by the Department of Labor or any state agency for the proper classification of the workers.
- 3a** Taxpayer has not been examined previously by the Internal Revenue Service or the Department of Labor concerning the classification of the workers; or,
- b** Taxpayer has been examined previously by the Internal Revenue Service or the Department of Labor concerning the classification of workers and Taxpayer has complied with the results of the prior examination.

C Extension of Period of Limitations

The Taxpayer understands that by participating in the VCSP, Taxpayer agrees to extend the period of limitations on assessment of employment taxes for 3 years for the first, second, and third calendar years beginning after the date Taxpayer elects to begin treating the workers as employees under the VCSP closing agreement. Taxpayer has the right to refuse to extend the period of limitations on assessment or to limit the extension to particular issues or to a particular period of time. However, if Taxpayer refuses to extend the period of limitations on assessment or provides only a limited extension, the IRS will not execute the VCSP closing agreement.

Sign Here	Under penalties of perjury, I declare that I have examined this submission, including any accompanying documents, and to the best of my knowledge and belief, all of the facts contained herein are true, correct, and complete.				
	Your signature ▶				Date
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶		Firm's EIN ▶		
	Firm's address ▶		Phone no.		

Form **8952** (Rev. 9-2011)

4

DEPLETION (LINE 12)

The depletion deduction may be claimed on Schedule C if the depletable property is used in a trade or business. Depletion is claimed on natural resources such as timber, gas and oil wells, coal mines, and gravel pits. To be eligible for the deduction, the taxpayer must have an economic interest in the property.

DEPRECIATION (LINE 13)

The depreciation deduction is entered on line 13 of Schedule C. The depreciation deduction is calculated on Form 4562.

Note. A detailed explanation of depreciation is included in Chapter 4 of the University of Illinois 2011 *Federal Tax Fundamentals* workbook.

EMPLOYEE BENEFIT PROGRAMS (LINE 14)

Line 14 of Schedule C is used for employee benefit programs that are not an incidental part of a pension or profit-sharing plan. Employee benefit programs include accident and health plans, group-term life insurance, and dependent care assistance programs. The employer cannot include benefit payments made on their own behalf as a self-employed person for group-term life insurance.

If the employer receives any credit for small employer health insurance premiums, they must reduce their health insurance deduction. The credit is calculated using Form 8941, *Credit for Small Employer Health Insurance Premiums*. The credit then becomes a part of the general business credit, which is reported on line 53 of Form 1040.

If the employer offers a medical reimbursement plan, they may be able to take a deduction on Schedule C for the medical expense and health and accident insurance premiums for their spouse, children, and themselves if their spouse is an employee of the business offering the plan. However, the employer must strictly follow the rules.

A medical reimbursement plan falls under IRC §105. Amounts paid to an employee to reimburse them for medical expenses incurred by them, their spouse, or dependents are not included in the employee's gross income if these expenses would be allowed as a medical deduction under IRC §213.¹⁶ A §105 plan may not discriminate and must cover:

- 70% or more of all eligible employees, or 80% or more of all employees who are eligible to benefit under the plan;¹⁷ or
- Those employees qualifying under a classification set up by the employer and determined by the IRS not to discriminate in favor of highly compensated individuals.¹⁸

Certain employees can be excluded from the medical reimbursement plan.¹⁹ These include all the following.

- Employees who have not completed three years of service
- Employees who have not attained age 25
- Part-time and seasonal employees
- Employees covered by a collective bargaining agreement (However, accident and health benefits must have been subject to good faith bargaining between employee representatives and the employer.)
- Employees who are nonresident aliens and who receive no earned income from the employer

¹⁶ IRC §105(b).

¹⁷ IRC §105(h)(3)(A)(i).

¹⁸ IRC §105(h)(3)(A)(ii).

¹⁹ IRC §105(h)(3)(B).

Self-Employed Health Insurance Deduction

Self-employed taxpayers can deduct the entire cost of health insurance coverage that was paid during the tax year up to the amount of net earned income from self-employment.²⁰ However, the deduction is taken on Form 1040, line 29 (2011), not on Schedule C. The deduction can be claimed for the cost incurred for accident and health insurance for the taxpayer and the taxpayer's spouse, dependents, and any child of the taxpayer who has not attained age 27 by the end of the tax year.

Self-employed taxpayers that can claim the self-employed health insurance deduction include the following.

- Self-employed taxpayers reporting income on Schedules C or F
- General partners in a partnership
- Actively participating members in an LLC that elected partnership tax treatment
- Employees of an S corporation that own 2% or more of the corporation's stock

Note. CCA 20122037, issued on May 1, 2012, states that all Medicare premiums paid for the taxpayer, spouse, and children up to age 27 can be deducted.

This deduction directly reduces adjusted gross income rather than being treated as an itemized deduction. However, with an exception for the 2010 tax year,²¹ this deduction cannot be used to reduce net earned income for purposes of calculating the applicable SE tax for the year. Moreover, this deduction is not available for any month in which the self-employed person is eligible to participate in a subsidized health plan of their employer or spouse's employer.²²

Spousal Employees

It is possible for some self-employed taxpayers to benefit from the §105 rules by having a self-funded medical reimbursement plan. Self-employed taxpayers are specifically excluded from the definition of "employee" under these types of plans. However, if the spouse is a bona fide employee, a self-employed taxpayer can still benefit from this type of plan. Because a §105 plan can cover the employee, their spouse, and their children under age 27, the self-employed person can deduct medical and health insurance costs on Schedule C without having to itemize the deductions. The §105 plan has a second benefit. Because this is a Schedule C deduction, it also reduces SE tax. A third benefit is that the deduction on Schedule C reduces the amount of state income tax liability.

To qualify for the deduction, the taxpayer should adhere to the following.

1. Have a signed written employment agreement with the spouse. The agreement should state:
 - a. The duties of the spouse,
 - b. The number of hours of work to be performed, and
 - c. A reasonable rate of pay for the work to be performed.
2. Have a written medical reimbursement plan. The plan should state:
 - a. Which employees are covered by the plan, and
 - b. That the plan cannot exclude any employee not mentioned in the exclusions listed earlier.

²⁰ IRC §162(l)(2)(A).

²¹ IRC §162(l)(4), as amended by the Small Business Jobs Act of 2010, PL 111-240 (Sep. 27, 2010).

²² IRC §162(l)(2)(B).

3. The spouse should keep a list of the duties performed and the time spent on each job. This should be the same or more hours than what is listed in the employment agreement.
4. Cash wages should be paid and a W-2 form issued.
5. A list of all medical expenses paid by the employee for themselves and qualifying family members should be submitted to the plan administrator for verification of deductibility.
6. Reimbursement of the qualified expenses should be made to the employee.
7. A separate bank account should be maintained for the spousal employee to prove that the wages and reimbursements are arms-length transactions.

Recent court cases on this issue include the following.

- In *Shellito v. Comm'r*,²³ the IRS and the Tax Court originally denied the medical reimbursement deduction. The decision was based on the fact that Mrs. Shellito had performed the same duties on the family farm since 1982, but only received wages and Forms W-2 since 2001. Although Mrs. Shellito had an employment agreement with Mr. Shellito, the farm operator, the agreement did not specify her hours or compensation. Mrs. Shellito kept a daily log of the hours worked but did not list the duties performed. The IRS's argument was that Mrs. Shellito was not a bona fide employee because she performed the same duties prior to the time covered by the employment agreement. The Circuit Court found enough evidence to indicate that she was a bona fide employee and remanded the case back to the Tax Court.
- In *Knowles v. Comm'r*,²⁴ Mr. Knowles entered into an employment agreement with his wife. The agreement required him to pay her \$200 per month for her services as an office manager and for furnishing accounting services. Mr. Knowles also furnished a medical reimbursement plan. Although the IRS argued Mrs. Knowles was not a bona fide employee, the court found enough evidence to indicate that she did work 20 or more hours per week, even though she had a full-time job at a university. Mr. Knowles did not write paychecks to Mrs. Knowles, but he did furnish a Form W-2 and paid the required payroll taxes. Mrs. Knowles argued that it did not make sense to write a paycheck and then redeposit it back into the same account because the Knowles only had one bank account. The court could not find evidence that the reimbursed medical expenses were for Mrs. Knowles and disallowed the deduction.

Analyzing the litigation between the IRS and taxpayers shows that the taxpayers normally win if they have good records to support the facts of their case. However, when they do not follow all of the rules, the courts agree with the IRS and disallow the medical reimbursement deductions.

INSURANCE (LINE 15)

Premiums paid for business insurance, such as property damage, professional liability, and general liability are deductible. Premiums paid for life insurance on a self-employed owner are not deductible even if they are required by a lender in order to secure a business loan.²⁵

INTEREST (LINE 16)

The tax treatment of interest expense differs depending on its type. For example, home mortgage and investment interest are treated differently. "Interest allocation" rules require the taxpayer to allocate their interest deduction and report it on the correct line.

²³ *Shellito v. Comm'r*, U.S. Court of Appeals, 10th Circuit, 2011-2 USTC (Aug. 24, 2011).

²⁴ *Knowles v. Comm'r*, TC Summ. Op. 2008-40 (Apr. 21, 2008).

²⁵ IRC §264(a)(1).

Tracing Rules

Generally, the interest expense deduction is determined by how the taxpayer used the loan proceeds on which interest was incurred.²⁶ Debt is allocated by tracing the disbursements of the debt proceeds to the specific expenditures.

Example 14. Ima Debtor uses \$20,000 of her investment portfolio to secure a loan to purchase inventory for her Schedule C business. The interest is business interest even though the security is investment property.

Debt is allocated to an expenditure for the period beginning on the date the proceeds are used and ending on the earlier of the date the debt is repaid or the date the debt is reallocated.²⁷ If the debt is deposited in the borrower's account, the interest is treated as investment interest until the borrowed money is spent, then it is reallocated based on the nature of the expenditure.²⁸

Example 15. Clarice, a calendar-year taxpayer, borrows \$100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, Clarice uses \$20,000 of the debt proceeds held in the account for the payment of business expenses. On September 1, she uses an additional \$40,000 of the debt proceeds held in the account to purchase computer equipment for her business.

From January 1 through March 31, interest on the entire \$100,000 debt is allocated as investment interest for the account. From April 1 through August 31, interest on \$20,000 of the debt is allocated to her Schedule C, and interest on \$80,000 of the debt is allocated as investment interest for the account. From September 1 through December 31, interest on \$60,000 of the debt is allocated to her Schedule C, and interest on \$40,000 is allocated as investment interest for the account.

An ordering rule provides that debt proceeds deposited in an account are treated as expended before:²⁹

- Any unborrowed amounts held in the account at the time the debt proceeds are deposited, and
- Any amounts (borrowed or unborrowed) that are deposited in the account after the debt proceeds are deposited.

Example 16. On January 10, Edwardo opens a checking account, depositing \$500 of proceeds of Debt A and \$1,000 of unborrowed funds. The following chart summarizes the transactions that occur during the year pertaining to the account.

Date	Amount	Transaction
1/10	\$1,500	Proceeds of Debt A and \$1,000 unborrowed funds deposited
1/11	500	Proceeds of Debt B deposited
2/17	(800)	Personal expense
2/26	(700)	Business expense
6/21	1,000	Proceeds of Debt C deposited
11/24	(800)	Business expense
12/20	(600)	Personal expenditure

²⁶ Temp. Treas. Regs. §§1.163-8T(a)(3) and 1.163-8T(c).

²⁷ Temp. Treas. Reg. §1.163-8T(c)(2)(i).

²⁸ Temp. Treas. Reg. §1.163-8T(c)(4)(i).

²⁹ Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

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Interest is allocated to each expenditure as follows.

- The \$800 personal expenditure is treated as made from the \$500 proceeds of Debt A and \$300 of the proceeds of Debt B.
- The \$700 business expenditure is treated as made from the remaining \$200 proceeds of Debt B and \$500 of unborrowed funds.
- The \$800 business expenditure is treated as made entirely from the proceeds of Debt C.
- The \$600 personal expenditure is treated as made from the remaining \$200 proceeds of Debt C and \$400 of unborrowed funds.
- The debt is treated as an investment expenditure for periods during which debt proceeds are held in the account.

	Balance			
	Unborrowed	Debt A	Debt B	Debt C
1/10	\$1,000	\$500		
1/11			\$500	
2/17		(500)	(300)	
2/26	(500)		(200)	
6/21				\$1,000
11/24				(800)
12/20	(400)			(200)

Once the debt is allocated in accordance with the ordering rules, the taxpayer can then determine how much interest is deductible. For example, the interest attributable to business expenditures is generally deductible, but interest attributable to personal expenditures is not deductible.

A taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such a manner as if made from the proceeds to the extent of the deposit. This is true even if the debt proceeds would be treated as shown in **Example 16** to make one or more other expenditures.³⁰

Example 17. Darnel has an account with a balance of \$5,000. The \$5,000 of funds on deposit are from Darnel's savings at the bank. On January 1, 2012, Darnel borrows \$3,000 from the bank and deposits the \$3,000 loan proceeds into his account, which results in an \$8,000 account balance. Darnel makes the following expenditures from his account.

Date	Amount	Purpose
Jan. 3, 2012	\$3,000	Personal expenditure
Jan. 13, 2012	5,000	Business expenditure

Under the ordering rules³¹ the \$3,000 that Darnel used for his January 3 personal expenditure would be treated as coming from the \$3,000 debt proceeds and the \$5,000 business expenditure would be traceable to his own \$5,000 of savings. Because the ordering rules allocate Darnel's use of debt proceeds to his personal expenditure, none of the interest is deductible.

³⁰ Temp. Treas. Reg. §1.163-8T(c)(4)(iii)(B).

³¹ Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

However, because Darnel made the business expenditure within 15 days of the deposit, he can treat the \$5,000 business expenditure as having been made using the \$3,000 of debt proceeds and \$2,000 of savings. This allows Darnel to deduct the interest on the \$3,000 of debt because the business expenditure was made within 15 days of the deposit of debt proceeds into his account.

Example 18. Use the same facts as in **Example 17**, except Darnel's business expenditure was not made until January 18. Darnel must apply the ordering rules which allocate his debt proceeds to his January 3 personal expenditure and his savings to the business expenditure. Darnel cannot deduct any interest.

The regulations allow an optional method of determining the date of reallocation.³² Solely for the purpose of determining the date on which debt allocated to an account is reallocated, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in the account as occurring on the later of the first day of the month or the date on which the debt proceeds are deposited in the account. This applies only if all expenditures from the account during the same calendar month are treated similarly.

LEGAL AND PROFESSIONAL SERVICES (LINE 17)

Legal and professional expenses include fees charged by accountants and attorneys that are ordinary and necessary expenses related directly to operating the business. Fees for tax advice and for preparation of the tax forms **related to the business** are included in this category. Fees incurred for resolving asserted tax deficiencies related to the business can also be included.³³ A taxpayer is not relieved from their responsibility to make a proper allocation and apportionment of fees on the grounds that the statement of services rendered does not identify the services performed beyond a generalized designation such as "professional," does not provide any type of allocation, or does not properly allocate the fees involved.

Legal and accounting fees in connection with a divorce or separation agreement are not normally deductible. However, if the taxpayer has a business and a portion of the settlement is based on determining a value for the business, then that portion of the fee is deductible on line 17. If possible, the taxpayer should request that the accountant or attorney divide the bill between the deductible and nondeductible fees.

OFFICE EXPENSES (LINE 18)

Office supplies and postage are reported on line 18.

Note. Expenses for rent, utilities, repairs, and other expenses related to an office are reported on the appropriate lines. Taxpayers using an office in their residence should complete Form 8829, *Expenses for Business Use of Your Home*, and report the amount on line 30. Home office expenses are discussed in 2012 Volume C, Chapter 7: Home Office.

³² Temp. Treas. Reg. §1.163-8T(c)(4)(iv).

³³ Treas. Reg. §1.1861-8(e)(5).

PENSION AND PROFIT-SHARING PLANS (LINE 19)

The deduction for contributions to a pension, profit-sharing, or annuity plan for the benefit of employees is reported on line 19. If the plan includes the taxpayer, the taxpayer's deduction is entered on Form 1040, line 28.

In most cases, the taxpayer must file one of the following forms.

- **Form 5500-EZ, *Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan*.** This is filed for 1-participant plans that meet certain requirements. A 1-participant plan is a plan that only covers the business owner and/or their spouse.
- **Form 5500-SF, *Short Form Annual Return/Report of Small Employee Benefit Plan*.** This form is required for a small plan. A small plan is defined as one having less than 100 employees and meeting certain requirements.
- **Form 5500, *Annual Return/Report of Employee Benefit Plan*.** This form is filed for plans that do not meet the Forms 5500-EZ or 5500-SF requirements.

In order to avoid filing Form 5500, many small employers have established SIMPLE retirement plans. A Savings Investment Match Plan for Employers (SIMPLE) plan can be established by employers having no more than 100 employees who earned at least \$5,000 during the preceding calendar year. For purposes of the 100-employee limitation, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE plan. More information about SIMPLE plans is provided in the next section.

Employer-Based Retirement Plan Arrangements

Although an eligible taxpayer can establish a traditional or Roth IRA independent of any employer, several qualified retirement plans are available only through the taxpayer's employer. This section discusses several of these employer-based plans. These plans are authorized by specific sections of the Code and include the following.

- SEP IRAs (under IRC §408(k))
- SIMPLE IRAs (as provided for by IRC §408(p))
- §§401(k), 403(b), 457 and 501(c)(18) plans

SEP and SIMPLE IRAs. To provide an additional way to save for retirement, employers can establish IRA accounts for an employee. Two such employer-based arrangements are:

- The simplified employee pension IRA (SEP IRA), and
- The SIMPLE IRA.

Some of the basic rules for each of these two plans follow.

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	SEP IRA	SIMPLE IRA
Description	Plan may provide for a low-cost retirement plan for small business owners and their employees. A SEP IRA is established for each employee including business owners.	An IRA-based retirement savings plan the employer establishes for employees. A SIMPLE IRA account is set up for each employee.
Contributions by Employee	None. All contributions are made by the employer.	Salary reduction arrangement up to a maximum of \$11,500 for 2012 (\$14,000 if over age 50 by December 31, 2012).
Contributions by Employer	<p>Contribution rate must be the same for all participants.</p> <p>The maximum deduction is the lesser of:</p> <ul style="list-style-type: none"> • The amount contributed, or • 25% of employee compensation up to \$50,000 maximum deductible contribution per participant (2012). <p>Self-employed individuals contributing to their own SEP must use special calculations to determine tax deductible amount.</p>	Employer must match employee contributions up to 3% of compensation for the year. Employer can reduce matching contributions to 1% temporarily. Employer can choose to make nonelective contributions of 2% of compensation for each eligible employee.
Employer Qualifications	Any employer can establish a plan.	No more than 100 employees receiving \$5,000 or more in compensation in the preceding year.
Employee Qualifications	Employees at least age 21 who have worked for the employer for at least three of the last five years with at least \$550 in compensation for 2012. These are the most restrictive requirements allowed. Employer can adopt less restrictive requirements if desired.	Employees with at least \$5,000 compensation during any two prior years and reasonable expectation of \$5,000 compensation in the current year must be allowed to participate.
Vesting	100% vested at all times.	100% vested at all times.
Plan Combinations	Employer can offer other plans simultaneously.	Employer cannot sponsor any other retirement plan if a SIMPLE plan is provided.
Contribution Tax Treatment	The employer contributions are tax deductible to the employer.	<p>Employee contributions are pre-tax via salary reduction arrangement.</p> <p>Employer contributions are tax deductible to the employer.</p>

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	SEP IRA	SIMPLE IRA
Tax Reporting	Employer contributions are not reported on employee Form W-2.	Contributions are not included on employee Form W-2. Salary reduction arrangement contribution amounts are included in wages subject to social security and Medicare taxes. Box 12, code S is used.
Establishment Deadline	The tax filing deadline of the employer's business, plus any extensions.	Plan for the current year must be established by October 1 if no SIMPLE plan was previously maintained. Must be set up effective January 1 if a SIMPLE plan was previously maintained. A new business established after October 1 can establish a SIMPLE plan after the October 1 deadline.
Funding Deadline	Employer contributions must be made by the employer's tax filing deadline, plus any extensions.	Tax filing deadline of the employer, plus extensions.

A SIMPLE plan can also be established as part of a §401(k) plan instead of a plan that uses IRA accounts.

Note. The rules on SEP IRAs and SIMPLE IRAs are complex. An exhaustive review of the applicable rules and regulations in connection with these plan arrangements is beyond the scope of this chapter. Further details on both plans can be found in IRS Pub. 560, *Retirement Plans for Small Business*. Additional details on the SIMPLE IRA plan can also be found in IRS Pub. 590, *Individual Retirement Arrangements*.

§401(k) Plans. A §401(k) plan is a defined contribution retirement plan which accommodates pre-tax contributions by employees. This provides the employee with the ability to defer tax on their contributed amounts until those funds are withdrawn. With §401(k) arrangements, the employer may choose to make matching contributions to the employee's account. Employer contributions into the employee's §401(k) account are not includable in the employee's income until withdrawn. For 2012, employees under the age of 50 can contribute a maximum of the lesser of 100% of compensation or \$17,000 annually to a §401(k) plan. A plan may also provide the ability for "catch up" contributions of up to \$5,500 in 2012 for employees age 50 or older. The \$17,000 and \$5,500 maximum amounts are subject to annual cost-of-living increases.

Section 401(k) plans generally must meet certain **nondiscrimination** requirements each year.³⁴ This ensures that contributions for rank-and-file employees are proportional to the contributions made on behalf of owners and managers.

³⁴ Treas. Reg. §1.401(k)-1(b).

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Example 19. Jenny works for Diversified Enterprises, Inc. She participates in a §401(k) plan at work. Her gross salary is \$52,000. She contributes \$1,000 per month into the §401(k) plan. Her Form W-2 appears as follows.

		a Employee's social security number 111-11-1111		OMB No. 1545-0008 This information is being furnished to the Internal Revenue Service. If you are required to file a tax return, a negligence penalty or other sanction may be imposed on you if this income is taxable and you fail to report it.	
b Employer identification number (EIN) 11-111111		1 Wages, tips, other compensation 40000.00		2 Federal income tax withheld 3000.00	
c Employer's name, address, and ZIP code DIVERSIFIED ENTERPRISES INC. 207 HIGH STREET ANYTOWN, IA 33333		3 Social security wages 52000.00		4 Social security tax withheld 2184.00	
		5 Medicare wages and tips 52000.00		6 Medicare tax withheld 754.00	
		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. JENNY EMPLOYEE 21 JUMP STREET SOMEWHERE, IA 33356		11 Nonqualified plans		12a See instructions for box 12 D 12000.00	
		13 Statutory employee Retirement plan Third-party sick pay <input type="checkbox"/> <input checked="" type="checkbox"/> <input type="checkbox"/>		12b	
		14 Other		12c	
				12d	
f Employee's address and ZIP code					
15 State Employer's state ID number IA 555555555	16 State wages, tips, etc. 40000.00	17 State income tax 2000.00	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2 Wage and Tax Statement**
Copy C—For EMPLOYEE'S RECORDS (See Notice to Employee on the back of Copy B.)

2012

Department of the Treasury—Internal Revenue Service

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Note. Employers with at least two and no more than 500 employees can establish a combined defined benefit/ §401(k) plan for plan years commencing after December 31, 2009.³⁵

§403(b) Plans. A §403(b) plan provides eligible employees with pre-tax retirement savings. Participation in a §403(b) plan is generally limited to employees of §501(c)(3) tax-exempt organizations and public school systems. The same §401(k) annual contribution limit of \$17,000 and “catch up” contribution limit of \$5,500 also apply to a §403(b) account. A taxpayer who has both a §401(k) and §403(b) account can contribute to a combination of both accounts only up to the overall total annual \$17,000 and \$5,500 limits.

Note. Tax rules permit §401(k) and §403(b) account holders to choose a **Roth contribution** arrangement if the particular plan provides this option. Roth contributions are after-tax contributions, which are later received as tax-exempt retirement income. As with traditional contributions, Roth contributions grow tax-free while invested in the plan. Any Roth contributions made during the year count toward the annual limits.

§457 Plans. Employees of state or municipal government agencies may use a deferred compensation arrangement under IRC §457 to defer up to 100% of their compensation, up to a maximum limit of \$17,000 per year for employees under age 50. An additional \$5,500 catch-up contribution can be made by employees age 50 or older. This amount can be deferred **in addition** to any other amounts contributed to other types of retirement plans.

³⁵ Pension Protection Act of 2006, PL 109-280.

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Example 20. Bob is 43 years old. He is a State of Illinois employee who teaches at a local community college. The college is a §501(c)(3) tax-exempt organization. Bob also works weekends as an employee at Associated Metal Fabricating. Bob's state employment provides him with the ability to maintain a §403(b) and a §457 account. His weekend employer provides him with a §401(k) plan. Bob can shelter a total of \$17,000 per year using a combination of his §401(k) and §403(b) accounts. Bob's §457 account provides him with the ability to shelter an **additional \$17,000** each year.

Plan Comparison. The following table compares and contrasts the §§401(k), 403(b), and 457 qualified retirement plan arrangements and indicates the applicable code for each type of plan that will appear on the employee's Form W-2, *Wage and Tax Statement*, in box 12. Because all three of these plans are qualified plans, the employee must be at least age 21 before participating and must have been employed for any waiting period, not to exceed one year, that is imposed by the employer.

Plan	Employee Eligibility	2012 Maximum Contribution	Key Advantages	W-2 Box 12 Code
§401(k)	Employment with an employer that offers the arrangement	<ul style="list-style-type: none"> • \$17,000 per year • \$5,500 additional catch-up contributions • Limits coordinate with §403(b) accounts 	<ul style="list-style-type: none"> • Widely available • Possible employer matching of some or all contributions • Tax deferral of current earnings and tax-free growth • Possible Roth option 	D
§403(b)	Employees of §501(c)(3) organizations and public schools	<ul style="list-style-type: none"> • \$17,000 per year • \$5,500 additional catch-up contributions • Limits coordinate with §401(k) accounts 	<ul style="list-style-type: none"> • Tax deferral of current earnings and tax-free growth • Possible Roth option 	E
§457	Employees of state and municipal governments	<ul style="list-style-type: none"> • \$17,000 per year • \$5,500 additional catch-up contributions • Limits are in addition to those applicable to a §§401(k) or 403(b) account 	Can be used to shelter additional amounts for retirement along with a §401(k) or 403(b) account	G

RENT OR LEASE PAYMENTS (LINE 20)

Rent or lease payments are divided between two lines on Schedule C. Rent or lease payments for personal property such as vehicles, equipment, or machinery are reported on line 20a. The payments for real property such as buildings are reported on line 20b.

Lease or Purchase

When acquiring property, business taxpayers can either lease property or purchase the property. These businesses might wish to use off-balance-sheet financing or strive to derive certain tax benefits from the transaction such as accelerated depreciation or lease expense. Sometimes, businesses enter into transactions that are called leases because this is the only readily available method of financing for the asset being acquired. In these situations, the taxpayer may not be concerned with the result of the financing; their only purpose is to be able to use the asset. Regardless of the circumstances, a proper determination must be made as to whether the transaction is a true operating lease or a conditional sales contract (purchase of the property).

IRC §162(a) provides that:

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

In deciding whether a taxpayer is entitled to a deduction for any payments as rentals, it is necessary to determine if the wording of the transfer agreement will **transfer title or equity** in the property.

Conditional Sales Contract. Although no single test or specific combination of tests always applies, the IRS may consider an agreement to be a conditional sales contract rather than a lease if any of the following is true.³⁶

- The agreement applies part of each payment toward an **equity interest** that the taxpayer will receive.
- The taxpayer **receives title** to the property after making a stated amount of required payments.
- The amount the taxpayer must pay to use the property for a **short time** is a large part of the amount they would pay to obtain title to the property.
- The taxpayer pays much **more** than the **current fair rental value** of the property.
- The taxpayer has an option to buy the property at a **nominal price** compared to the **value** of the property when the option is exercised.
- The taxpayer has an option to buy the property at a **nominal price** compared to the **total payments** under the agreement.
- The agreement designates part of the payments as **interest**, or a portion of the payments is easy to recognize as interest.

Example 21. Kathlyn leases a desktop computer from a national retailer for \$150 per month for 24 months. Her total payments are \$3,600. If she were to purchase the computer instead of leasing it, the retail price would be \$3,300. At the end of the lease term, she has the option to buy the computer for \$1.

This lease is actually a purchase agreement. Kathlyn's agreement meets at least one of the conditions to be considered a purchase contract — the option price is nominal compared to the total payments under the agreement. It is not necessary to analyze any of the other factors.

³⁶ *Income and Expenses*. Dec. 20, 2010. [www.irs.gov/faqs/faq/0,,id=199657,00.html] Accessed on Nov. 8, 2011.

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In a 2010 case, the **Tax Court** referenced five specific conditions that might cause a lease to be considered a conditional sales contract.³⁷

1. The lease term comprises the equipment's entire **useful life**.
2. The lease is an **open-end lease**. When the taxpayer assumes the risk of fluctuations in the residual value of the property at the end of the lease term, the lease is an open-end lease.
3. The **title automatically passes** to the taxpayer upon conclusion of the lease or when the sum of the rental payments equals the cost of the equipment.
4. The taxpayer has the **option to purchase** the equipment at a nominal or **below-market price**.
5. The lessor has the option to **compel** the taxpayer to purchase the equipment.

Vehicle Lease

If a vehicle is leased for a period of 30 days or more, the taxpayer may have to reduce the deduction on Schedule C by a lease inclusion amount. The inclusion amount is a percentage or part of the FMV of the leased vehicle multiplied by the percentage of business and investment use of the vehicle for the tax year. It is prorated for the number of days of the lease term in the tax year.

The inclusion amount applies to each tax year that the vehicle is leased if the FMV when the lease began was more than the amounts shown in the following tables.³⁸

Cars (Except for Trucks and Vans)

Year Lease Began	Fair Market Value
2008–2012	\$18,500
2007	15,500
2005–2006	15,200
2004	17,500
2003	18,000
1999–2002	15,500

Trucks and Vans

Year Lease Began	Fair Market Value
2010–2012	19,000
2009	18,500
2008	19,000
2007	16,400
2005–2006	16,700
2004	18,000
2003	18,500

Note. The calculation of the inclusion amount can be found in Chapter 4 of IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

³⁷ *Boyce v. Comm'r*, TC Summ. Op. 2010-100 (Jul. 26, 2010).

³⁸ IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

REPAIRS AND MAINTENANCE (LINE 21)

The instructions for line 21 of Schedule C state that a taxpayer can deduct the cost of incidental repairs and maintenance that do not add to the property's value or appreciably prolong its life. The taxpayer cannot deduct the cost of their own labor to complete repairs. Amounts spent to restore or replace property must be capitalized.

The rules concerning which expense is a repair and, therefore, currently deductible, compared to expenditures that must be capitalized and depreciated have never been crystal clear. In general, any expense associated with a business is currently deductible as a repair if the cost involves incidental repairs. These repairs neither materially add to the value of the property nor appreciably prolong its life. They instead keep it in an ordinarily efficient operating condition.³⁹ Thus, amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses.

Note. Questions often arise concerning the proper handling of expenses associated with tires and tools. For tires, the IRS provides a safe-harbor method of accounting for the cost of original and replacement tires.⁴⁰ In general, the cost of small tools is currently deductible if income is not materially distorted and it would not be practical to require the taxpayer to maintain records for depreciating the tools.

Any cost that produces a benefit lasting for more than one year (such as expenses for improvements that increase the property's value) is generally not currently deductible but must be depreciated or amortized over the period of benefit or use.

Observation. A review of the cases and rulings on the issue, as well as the applicable regulations, reveal that the IRS takes the following positions.

- Deductible repairs are expenditures that keep the property in an ordinarily efficient operating condition.
- Capital expenditures add to the value of the property, substantially prolong the useful life of the property, or adapt the property to a new or different use.

The cases, rulings, and regulations indicate that the amount of the expenditure is immaterial to the issue of whether the expenditure is currently deductible or must be capitalized.

Note. The IRS recently issued guidance in TD 9564 on repairs versus capitalization. For additional information, see 2012 Volume B, Chapter 3: Small Business Issues.

SUPPLIES (LINE 22)

In most cases, the taxpayer can deduct the cost of materials and supplies on line 22 of Schedule C only to the extent they are actually consumed or used in the business during the tax year (unless they were deducted in a prior tax year). However, if there are incidental materials and supplies on hand for which no inventories or records of use are kept, then the cost of any materials and supplies actually purchased during the tax year can be deducted. The method used to deduct materials and supplies must clearly reflect the income of the business.

A taxpayer can also deduct the cost of books, professional instruments, equipment, and so forth if they normally use them within a year. However, if the usefulness of such items extends substantially beyond the year, the taxpayer must generally recover their costs through depreciation.

³⁹ Treas. Reg. §1.162-4.

⁴⁰ Rev. Proc. 2002-27, 2002-11 CB 802. Rev. Proc. 2002-27 was modified and/or amplified numerous times, most recently in Rev. Proc. 2005-9, 2005-1 CB 303.

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The deduction on line 22 cannot include any materials or supplies that were reported on Part 3, line 38 of Schedule C.

Example 22. Dr. Halle Tosis purchases new dental instruments for her practice. A set costs \$25 and she purchases 12 sets for both of her examination rooms. Her total cost is \$600. While an instrument may have a life of more than one year, most are replaced each year. Dr. Tosis can deduct this cost as a supply expense.

TAXES AND LICENSES (LINE 23)

The following taxes can be deducted on line 23 of Schedule C.

- State and local sales tax imposed on the **business** as a seller of goods or services (If the business collects this tax from the buyer, the business must also include the amount collected in gross receipts or sales on line 1.)
- Real estate and personal property taxes on business assets
- Licenses and regulatory fees for the trade or business paid each year to state and local governments (However, some licenses, such as liquor licenses, must be amortized.)
- The employers' social security and Medicare taxes on employees' wages (This amount should be reduced by any amount shown on line 4 of Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.*)

The following taxes are not deductible.

- State and local sales taxes imposed on **buyers** that the seller is required to collect and pay to state and 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 allows the taxpayer to retain any part of the sales tax collected, they must include that amount as income on line 6.)
- Other taxes and license fees not related to the business

Any sales tax the business pays due to the purchase of a capital asset must be added to the cost of the capital asset and depreciated.

TRAVEL, MEALS, AND ENTERTAINMENT (LINE 24)

Travel expenses are reported on line 24a of Schedule C and deductible meals and entertainment are reported on line 24b. These expenses are discussed thoroughly in 2012 Volume C, Chapter 6: Travel, Meals and Entertainment.

UTILITIES (LINE 25)

No deduction is allowed for the base rate of the home phone. If there is a separate business line, the base rate is deductible.

The expense of cell phone service is deductible if it is used for the business. It is no longer necessary to have a log of the business use of the cell phone. If the cell phone plan is for multiple phones, such as those of family members, only the cost of the phone used for business is deductible.

WAGES (LINE 26)

Salaries and wages are reported on line 26 of Schedule C. Any wages and salaries that are reported elsewhere on the return should not be listed on line 26. The deduction must be reduced for any amounts claimed on any of the following.

- Form 5884, *Work Opportunity Credit*, line 2
- Form 8844, *Empowerment Zone and Renewal Community Employment Credit*, line 2
- Form 8845, *Indian Employment Credit*, line 4
- Form 8932, *Credit for Employer Differential Wage Payments*, line 2

If a taxable fringe benefit is provided to an employee, such as personal use of a car, the amount applicable to depreciation and other expenses claimed elsewhere should not be deducted as wages.

If wages are deducted on line 26, the employer should file a Form W-2 for each employee.

OTHER EXPENSES (LINE 27)

Any trade or business expenses not listed elsewhere on Schedule C should be detailed and deducted on line 27. When the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an “other expense” category) the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words “bad debt” must be written or typed on the line of Schedule C that shows the amount of the bad debt.⁴¹ If space limitations on Schedule C do not allow for an adequate description, the description must be continued on an attachment.⁴²

⁴¹ Rev. Proc. 2011-13, 2011-3 IRB 318.

⁴² Ibid.

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