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# 2021 Workbook

**Please note.** Corrections were made to this workbook through January of 2022. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

## About the Author

**Kelly Golish, CPA**, is a Senior Tax Materials Specialist at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Other chapter contributors and reviewers are listed at the front of this volume.

## BUSINESS OR HOBBY

### ENGAGED IN FOR PROFIT

Schedule C, *Profit or Loss From Business*, 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.<sup>1</sup> 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 8 on Form 1040, *U.S. Individual Income Tax Return*, from Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

Before making the decision to file items of income and expense on Schedule C, a taxpayer must determine whether their activity is a business (that is, an activity engaged in for profit), or a **hobby**. A sporadic activity, hobby, or amusement diversion does not qualify as a business.<sup>2</sup> Historically, the hobby versus trade or business issue was mainly concerned with the proper treatment of losses. With the introduction of the qualified business income deduction (QBID)<sup>3</sup>, the Paycheck Protection Program (PPP),<sup>4</sup> and economic injury disaster loans (EIDL)<sup>5</sup>, there is increased focus on the profitability of a trade or business. Therefore, a tax professional must ask probing questions to determine whether an activity is a hobby or a trade or business.

Whether an activity is engaged in for profit is a facts and circumstances determination. **Neither the Code nor regulations provide an absolute definition.** However, the Code and regulations serve as a guide in formulating the facts necessary to determine whether an activity is not engaged in for profit. Taxpayers bear the burden of proving that they engage in the activity with an actual objective of realizing a profit.<sup>6</sup>

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<sup>1</sup> See *Comm'r v. Robert P. Groetzinger*, 480 U.S. 23 (1987).

<sup>2</sup> *Ibid.*

<sup>3</sup> *Tax Cuts and Jobs Act*, PL 115-97, §11011.

<sup>4</sup> *CARES Act*, PL 116-136, §1102, Div. A.

<sup>5</sup> For information about EIDLs, see *Economic Injury Disaster Loans*. U.S. Small Business Administration. [[www.sba.gov/funding-programs/loans/coronavirus-relief-options/covid-19-economic-injury-disaster-loans](http://www.sba.gov/funding-programs/loans/coronavirus-relief-options/covid-19-economic-injury-disaster-loans)] Accessed on Feb. 25, 2021.

<sup>6</sup> *Keanini v. Comm'r*, 94 TC 41 (1990).

Several Code sections have an impact on the deductibility of expenses. **Under IRC §212, expenses related to the production of income or investment income are generally deductible against nonbusiness income.** Under IRC §162, business expenses can be deducted only if the activity qualifies as a **trade or business.** IRC §162(a) allows deductions for all ordinary and necessary expenses paid or incurred during the year in carrying on a trade or business. Even though the intent is to make a profit, the IRS can deem the activity is a hobby under IRC §183.<sup>7</sup>

## THE 9-FACTOR TEST<sup>8</sup>

Treas. Reg. §1.183-2(b) provides the relevant guidance in determining whether an activity is engaged in for profit. All the facts and circumstances are taken into account, but there are nine particular factors that should normally be considered. In making the for-profit determination, no one factor is determinative. Other factors not listed in the regulations can also be taken into account. The number of factors in favor of the taxpayer is also not determinative. The nine factors that should be considered include the following.

1. Is the activity conducted in a businesslike manner, and are complete and accurate books and records maintained?
2. Are there personal motives in carrying on the activity?
3. Does the time and effort put into the activity indicate a profit motive?
4. Is the taxpayer dependent on income from the activity?
5. Are losses due to circumstances beyond the taxpayer's control (or are normal in the startup phase of the type of business)?
6. Is the taxpayer knowledgeable or do they have advisors necessary to carry on the activity as a successful business?
7. What is the taxpayer's history of success in making a profit with similar activities in the past?
8. Is the activity profitable some years and how much is the profit?
9. Does the taxpayer expect to make a future profit from the appreciation of the assets used in the activity?



### Practitioner Planning Tip

The IRS and the courts rely heavily on the 9-factor test in their determination of the facts and circumstances regarding the profit motive of a taxpayer's activity. Practitioners are encouraged to consider these items annually with their clients, regardless of how long the client's activity has existed, because a taxpayer's situation may change from year to year. Last year's activity engaged in with a profit motive may become this year's hobby and vice versa.

<sup>7</sup> IRC §183(c).

<sup>8</sup> Treas. Reg. §1.183-2(b); *How do you distinguish between a business and a hobby?* Jan. 19, 2021. IRS. [[www.irs.gov/faqs/small-business-self-employed-other-business/income-expenses/income-expenses](http://www.irs.gov/faqs/small-business-self-employed-other-business/income-expenses/income-expenses)] Accessed on Jul. 14, 2021.

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**Example 1.** Jim has operated his home repair business since 1972. Each year he provides his tax professional with meticulous records and always realizes a profit. He has commented that he cannot complete all the work people want him to do. Mary, his tax professional, considers Jim to be a shining example of how a self-employed taxpayer should operate.

In 2021, however, Jim reports very little income and his results reflect a loss for the year. Jim explains to Mary he has lost interest in his repair business due to poor health and has been turning work away. He tells Mary he thinks he may have only done one or two jobs this past year and does not know if he will continue working in his business at all in 2022. Mary considers the nine factors and determines that Jim's activity was not engaged in for profit during 2021. She informs him that any losses from his activity will not be deductible against his other income.

**Example 2.** Use the same facts as in **Example 1**. In February 2023, Mary meets with Jim to prepare his 2022 filings. She discovers a reinvigorated Jim who states he is feeling great, and his 2022 income reflects his new lease on life. He states that he once again has more work than he can handle and wants to wrap up his tax meeting as quickly as possible so he can get back to serving his customers. As with 2021, Mary considers the nine factors and concludes that for 2022, Jim's repair activity is engaged in for profit.

**Note.** It is not necessary to have a positive result to more of the nine factors than negative results. Having more positive results to the factors may help support the for-profit argument, but the IRS may also argue against a for-profit motive by merely failing one factor.

A taxpayer may use the §183 safe harbor to shift the burden to the **IRS to prove** a profit motive does **not** exist. Under the safe harbor, if the taxpayer realizes a net profit from the activity in **three out of five** of the consecutive tax years that end with the tax year, the taxpayer is presumed to have a profit motive. Taxpayers engaged in breeding, training, showing, or racing horses are presumed to have a profit motive if they show a profit in **two out of seven** consecutive tax years.<sup>9</sup>

## HOBBY REPORTING

If a determination is made that an activity is **not** engaged in for profit (i.e. a hobby), gross income from the activity is generally reported on Form 1040, Schedule 1, line 8 (other income).<sup>10</sup> Prior to the Tax Cuts and Jobs Act (TCJA),<sup>11</sup> deductible expenses were claimed on Schedule A, *Itemized Deductions*.<sup>12</sup> During the TCJA period (2018–2025), miscellaneous itemized deductions are not allowed.<sup>13</sup> As a result, for hobby activities, only cost of goods sold (COGS) and expenses that would otherwise be deductible (i.e., mortgage interest, real estate taxes, and contributions) are allowed.

**Example 3.** Use the same facts as in **Example 1**. When Mary determined that Jim's repair business was not engaged in for profit during 2021, she reported his gross income on Form 1040, Schedule 1, line 8 (other income). Jim's other business expenses were not allowed against his hobby activity income due to the elimination of Schedule A miscellaneous itemized deductions.

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<sup>9</sup> IRC §183(d).

<sup>10</sup> Instructions for Form 1040.

<sup>11</sup> *Tax Cuts and Jobs Act*, PL 115-97.

<sup>12</sup> See IRS Pub. 535, *Business Expenses*.

<sup>13</sup> *Tax Cuts and Jobs Act*, PL 115-97, §11045.

## Gross Income Defined

Gross income for an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from the activity.<sup>14</sup> This generally includes capital gains and rents received for the use of property held in connection with the activity.<sup>15</sup> The taxpayer can determine gross income from an activity by subtracting the COGS from the gross receipts, if this practice is consistently followed and conforms to generally accepted accounting methods.<sup>16</sup> COGS includes the purchase price of the items sold and the cost of all raw materials or parts purchased for creating a finished product. Freight-in, express-in, and cartage-in on raw materials and supplies used in production are also included. Other direct expenses may be included, but only those that are necessary to create the product.<sup>17</sup>

### Practitioner Planning Tip

COGS may be considered as a deduction against gross hobby income if it is reasonably and consistently allocated against the income of the activity. It can be argued that taxpayers who do not maintain inventory and therefore do not have “traditional” COGS may deduct a reasonably and consistently allocated cost of sales against hobby income as an expense but limited to no more than the gross hobby income.<sup>18</sup>

**Example 4.** Use the same facts as in **Example 1**. When Mary determined Jim’s activity was not engaged in for profit during 2021, she reported his gross income on his Form 1040, Schedule 1, line 8 (other income). She determined that Jim’s costs for the materials used in his jobs, which he always accounted for in the same way, represented COGS and could be deducted from his gross income reported. She entered the reasonably and consistently allocated COGS as an additional line item on Schedule 1, line 8 (other income) as a negative number (but limited the deduction to no more than the gross income reported).

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<sup>14</sup> Treas. Reg. §1.183-1(e).

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> IRS Pub. 334, *Tax Guide for Small Business*.

<sup>18</sup> Treas. Reg. §1.183-1(e).

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## Expenses<sup>19</sup>

Treasury regulations stipulate three ordered categories of deductions for expenses related to not-for-profit activities. However, two of the categories fall into the classification of miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limit. For tax years 2018 through 2025 under the TCJA, no deductions are allowed for this class of deductions.<sup>20</sup>

The only expenses (other than COGS) allowed for hobby activities are those that would otherwise be deductible, such as mortgage interest, real estate taxes, and contributions. These ordinary and necessary expenses are included in their respective sections of Schedule A. Generally, a taxpayer can only deduct hobby expenses to the extent of hobby income. Taxpayers can claim a loss from hobby activities but cannot use the loss to offset other income.<sup>21</sup>

**Note.** For more information on trades or businesses versus hobby, see pages B232–263 of the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

## COGS

As mentioned previously, Treas. Reg. §1.183-1(e) allows a deduction for COGS if the taxpayer consistently uses the practice and conforms to generally accepted methods of accounting. COGS is calculated by adding purchases, costs of labor, and materials/supplies made during the year to beginning inventory and subtracting ending inventory (detailed analysis of how to calculate COGS is covered later in this chapter).

**Example 5.** Bridget is employed as a bartender. Starting in 2021, she begins crafting jewelry and selling her items online. After discussing the 9-factor test with her tax preparer, they agree that she is not in the business of jewelry making during 2021.

During 2021, Bridget earns \$5,000 from her jewelry sales. She spends \$2,500 on materials and \$1,000 on shipping to her customers. Bridget had no inventory at the beginning of the year and \$850 at the end of the year. Her COGS is \$1,650 ( $\$0 + \$2,500 - \$850$ ). Shipping costs are not considered a direct manufacturing expense and are not included in the COGS calculation.<sup>22</sup> Bridget reports her hobby income of \$3,350 ( $\$5,000 - \$1,650$ ) on Form 1040, Schedule 1, line 8 (other income).

**Note.** Sales of capital assets are reported on Form 8949, *Sales and Other Dispositions of Capital Assets*. Inventory for sale to customers in the ordinary course of business is not a capital asset.<sup>23</sup> However, some practitioners may determine that for an activity not engaged in for profit, the products for sale are classified as capital assets because there is no business. Under this approach, sales of products and the related cost of the goods are reported on Form 8949. Net gains are then reported as either short-term or long-term depending on the holding period. **Net losses from sales of merchandise used in a hobby activity are not deductible.**<sup>24</sup>

<sup>19</sup> Treas. Reg. §1.183-1(b).

<sup>20</sup> IRC §67(g).

<sup>21</sup> *Five Things to Remember about Hobby Income and Expenses*. Nov. 21, 2017. IRS. [[www.irs.gov/newsroom/five-things-to-remember-about-hobby-income-and-expenses](http://www.irs.gov/newsroom/five-things-to-remember-about-hobby-income-and-expenses)] Accessed on Feb. 26, 2021.

<sup>22</sup> IRS Pub. 334, *Tax Guide for Small Business*.

<sup>23</sup> IRC §1221.

<sup>24</sup> IRC §183.

## SCHEDULE C FILERS

A variety of individuals and entities are eligible to file their activities on Schedule C. These include statutory employees, sole proprietors, single-member limited liability company (SMLLC), sole proprietors who die during the year, qualified joint ventures (QJV), and spouses who exclusively own an unincorporated business as community property in a community property state.

### STATUTORY EMPLOYEE

Schedule C is used to report wages and expenses earned as a statutory employee. The term statutory employee is not defined in the Code. However, IRC §3121(d)(3) lists workers for occupational groups who, under certain circumstances, are considered employees for Federal Insurance Contribution Act (FICA) tax, and in some instances Federal Unemployment Tax Act (FUTA) tax, but not for federal income tax withholding. These groups of workers are described as “statutory employees” because they are specifically listed in the Code. Statutory employees are classified as **employees** for purposes of 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.<sup>25</sup>

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** the following apply.<sup>26</sup>

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 service performed is not a single transaction.


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

<sup>25</sup> See Treas. Reg. §31.3121(d)-1.

<sup>26</sup> IRS Pub. 15-A, *Employer's Supplemental Tax Guide*.

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**Example 6.** Kent is an insurance salesman. He works for an insurance company that provides 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 <b>111-22-3333</b>		OMB No. 1545-0008		Safe, accurate, FAST! Use		 Visit the IRS website at <a href="http://www.irs.gov/efile">www.irs.gov/efile</a>	
b Employer identification number (EIN) <b>12-3456789</b>			1 Wages, tips, other compensation <b>95000.00</b>		2 Federal income tax withheld		
c Employer's name, address, and ZIP code <b>ABC Insurance Company 121 Main Street Anytown, IA 55555</b>			3 Social security wages <b>95000.00</b>		4 Social security tax withheld <b>5890.00</b>		
			5 Medicare wages and tips <b>95000.00</b>		6 Medicare tax withheld <b>1377.50</b>		
			7 Social security tips		8 Allocated tips		
d Control number			9		10 Dependent care benefits		
e Employee's first name and initial <b>Kent</b>		Last name <b>Supersales</b>		Suff.		11 Nonqualified plans	
1515 Reynolds Road Anytown, IA 55555			13 Statutory employee <input checked="" type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12a See instructions for box 12		
			14 Other		12b		
					12c		
					12d		
f Employee's address and ZIP code			15 State		Employer's state ID number		16 State wages, tips, etc.
			17 State income tax		18 Local wages, tips, etc.		19 Local income tax
							20 Locality name

Form **W-2** Wage and Tax Statement **2021** 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**

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . . . <input checked="" type="checkbox"/>	1	<b>95,000</b>
2	Returns and allowances . . . . .	2	

If a taxpayer has both statutory and nonstatutory income, they must file separate Schedules C. Because there is both self-employment (SE) and non-SE income, the taxpayer cannot combine the amounts on a single Schedule C. The business expense attributable to either type of income is deducted on the appropriate Schedule C.<sup>27</sup>

<sup>27</sup> Instructions for Schedule C.



## SOLE PROPRIETOR<sup>28</sup>

A sole proprietor owns an unincorporated business by themselves. There is no distinction between the owner and the business. As such, the owner is entitled to all the profits and is also liable for all the debts, losses, and liabilities.

An owner does not need to undertake any formal action to form a sole proprietorship. Engaging in a business activity for a profit is sufficient to establish oneself as a sole proprietor. However, a sole proprietor needs to acquire all necessary business licenses and permits for the industry, state, and locality.

A sole proprietorship is not taxed separately from the sole proprietor as an individual. The income from the sole proprietorship is the income of the taxpayer.

A single member of a domestic limited liability company (LLC) is not a sole proprietor if they elect to treat the SMLLC as a corporation.

## SMLLC<sup>29</sup>

An LLC is created by state statute and is treated as either a corporation, partnership, or a disregarded entity for income tax purposes. An LLC with only one member is treated as a **disregarded entity** that is separate from its owner. However, an SMLLC can elect to be treated as a corporation by filing Form 8832, *Entity Classification Election*.

The activities of a disregarded entity are reflected on the owner's federal tax return. For individual owners, the activities are reported on Schedule C, Schedule E, *Supplemental Income and Loss*, or Schedule F, *Profit or Loss From Farming*.

An individual owner of an SMLLC is subject to SE tax in the same manner as a sole proprietor.

**Note.** For more discussion on SMLLCs, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Transferring Sole a Proprietorship an LLC.

## DECEDENTS

When a sole proprietor dies, the business dies with them. Any business assets become part of the owner's estate. If the estate operates the business, the income and expenses are reported using Schedule C (Form 1040). The net profit or loss from Schedule C is reported on line 3 of Form 1041, *U.S. Income Tax Return for Estates and Trusts*.<sup>30</sup>

**Note.** If an estate operates a business after the owner's death, the estate administrator is required to secure a new employer identification number (EIN) for the business, report wages or income under the new EIN, and pay any taxes that are due.<sup>31</sup>

**Note.** For more information on the laws governing the administrative responsibilities and tax liability for a deceased business owner, particularly a sole proprietor, and the deceased business owner's estate, see the Death of a Business Owner section in the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

<sup>28</sup> *Sole Proprietorships*. Jun. 11, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/sole-proprietorships](http://www.irs.gov/businesses/small-businesses-self-employed/sole-proprietorships)] Accessed on Jul. 12, 2021; *Sole Proprietorship*. Small Business Association. [[www.sba.gov/starting-business/choose-your-business-structure/sole-proprietorship%20](http://www.sba.gov/starting-business/choose-your-business-structure/sole-proprietorship%20)] Accessed on Jul. 12, 2021.

<sup>29</sup> *Single Member Limited Liability Companies*. Jan. 13, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies](http://www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies)] Accessed on Jul. 12, 2021.

<sup>30</sup> Instructions for Form 1041.

<sup>31</sup> IRS Pub. 1635, *Understanding Your EIN*.

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## QJV<sup>32</sup>

Spouses can elect to treat an unincorporated business as a QJV instead of a partnership if they each materially participate in the business, are the only owners of the business, have not created a separate entity such as an LLC, and file a joint return for the tax year. The taxpayers make the election by dividing all items of business income, gain, loss, deduction, and credit between the spouses based on their ownership interests in the business. Each spouse files a separate Schedule C and may need to file a separate Schedule SE, *Self-Employment Tax*, to pay SE tax.

**Note.** For more information on QJVs, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E and the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Transferring a Sole Proprietorship to an LLC.

## SPOUSES LIVING IN COMMUNITY PROPERTY STATES<sup>33</sup>

Spouses who exclusively own an unincorporated business as community property in a community property state can treat the business as a sole proprietorship. As such, the spouses report the income and deductions in the following manner.

- If only one spouse participates in the business, the spouse who carried on the business reports all the income as SE earnings.
- If both spouses participate, the spouses allocate the income and deductions based on their distributive shares.
- Spouses who carry on a business together and share in the profits and losses may be partners even if they do not have a formal partnership agreement and should report business activity on Form 1065, *U.S. Return of Partnership Income*.<sup>34</sup>
- Spouses who elect to treat their business as a QJV must file according to the QJV rules mentioned previously.

**Note.** Community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.<sup>35</sup>

Under Rev. Proc. 2002-69<sup>36</sup> a business that is only considered a partnership because it is owned by spouses in a community property state can be treated as either a partnership or a sole proprietorship.

**Note.** An LLC owned by a husband and wife in a **non-community property state** should file as a partnership.<sup>37</sup>

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<sup>32</sup> Instructions for Schedule C.

<sup>33</sup> Ibid.

<sup>34</sup> IRS Pub. 541, *Partnerships*.

<sup>35</sup> Instructions for Schedule C.

<sup>36</sup> Rev. Proc. 2002-69, 2002-45 IRB 831.

<sup>37</sup> *Single Member Limited Liability Companies*. Jan. 13, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/single-member-limited-liability-companies] Accessed on Jul. 12, 2021.

## SURVIVORS OF DECEASED INSURANCE AGENTS RECEIVING RESIDUALS

Life insurance renewal commissions paid to a survivor are considered income in respect of a decedent (IRD).<sup>38</sup> IRD is taxed to the beneficiary in the same manner as it would have been taxed to the decedent.<sup>39</sup> The conclusion from this statement is that the commissions would be considered ordinary taxable income. The issue is whether the payments are subject to SE tax. IRS Pub. 533, *Self-Employment Tax*, specifically states:

*However, renewal commissions paid to the survivor of an insurance agent is not SE income.*

Therefore, commissions received by an estate would be reported as ordinary income. If the income were paid directly to a surviving beneficiary, it would be reported on the beneficiary's Form 1040, Schedule 1, line 8 (other income) and not on Schedule C. This is because the income was not received in the course of the active conduct of a trade or business. In neither case is the income subject to SE tax.

### Practitioner Planning Tip

If the issuer of Form 1099-NEC, *Nonemployee Compensation*, reports commissions paid to a survivor in this manner and refuses to correct the 1099, it is suggested the taxpayer report the income on Schedule C and then enter an expense amount equal to the income with a note that the income was reported in error but is being properly reported on Form 1040, Schedule 1, line 8.

## COVID-19 ISSUES

Many of the governmental assistance programs that provide support to businesses and individuals suffering from the COVID-19 pandemic are available for Schedule C filers. These include the employee retention credit (ERC), sick and family leave tax credits, PPP, and EIDL.

### ERC<sup>40</sup>

The Consolidated Appropriations Act of 2021<sup>41</sup> (CAA) modified the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)<sup>42</sup> that provides for an ERC. The ERC is a refundable tax credit available to qualified employers that is equal to 70% of qualified wages (including allocable qualified health plan expenses) that eligible employers pay to their employees after December 31, 2020, through December 31, 2021. Qualified wages for this period are limited to \$10,000 per employee **per calendar quarter** in 2021. Therefore, the maximum ERC available is \$7,000 per employee per calendar quarter, for a total of \$28,000 for 2021.

**Note.** For more information on the ERC, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments and Volume B, Chapter 6: Small Business Issues.

<sup>38</sup> See *Findlay v. Comm'r*, 332 F.2d 620 (2nd Cir. 1964).

<sup>39</sup> IRC §691(a)(3).

<sup>40</sup> IRS Notice 2021-20, 2021-11 IRB 922; *COVID-19-Related Employee Retention Credits: General Information FAQs*. Apr. 26, 2021. IRS. [www.irs.gov/newsroom/covid-19-related-employee-retention-credits-general-information-faqs] Accessed on Jun. 29, 2021.

<sup>41</sup> *Consolidated Appropriations Act of 2021*, PL 116-260.

<sup>42</sup> *CARES Act*, PL 116-136.

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## SICK AND FAMILY LEAVE TAX CREDITS<sup>43</sup>

Under the Families First Coronavirus Response Act (FFCRA),<sup>44</sup> eligible self-employed individuals can claim sick and family leave tax credits. The FFCRA, passed in March 2020, allows eligible self-employed individuals to claim refundable tax credits to offset their federal income tax if they cannot work or telework because of their own health or to care for a family member due to COVID-19.

**Note.** For more information on the FFCRA, sick, and family leave credits, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

Eligible self-employed individuals must operate a trade or business that qualifies as SE income and be eligible to receive qualified sick or family leave wages under the Emergency Paid Sick Leave Act or Emergency Family and Medical Leave Expansion Act (both Acts are part of FFCRA) as if the taxpayer was an employee.

Credits for leave taken between January 1, 2021 and September 30, 2021<sup>45</sup> are claimed on the taxpayer's 2021 Form 1040. A self-employed individual determines their sick and family leave equivalent tax credit by completing Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*.

**Example 7.** Joe is a self-employed voiceover artist with a home studio. In January 2021, he contracted COVID-19 and was off work for three weeks. Shortly after he recovered, his daughter contracted COVID-19 and Joe took two weeks off to care for her while she was home from daycare.

Joe qualifies for sick and family leave tax credits. He reports the credit on his Form 7202, which creates a refundable tax credit on his Form 1040.

## EIDL AND PPP

In addition to the relief measures mentioned previously, the acts passed by Congress contained financial advances or loan programs designed to provide financial relief to taxpayers including Schedule C filers. Two of the relief measures contained in the legislation, EIDL<sup>46</sup> advances (and loans) and PPP loans<sup>47</sup> (both first and second round<sup>48</sup> programs), are now closed to new borrowing. However, discussion points remain which may impact sole proprietors filing Schedule C.

1. When an EIDL (advance or loan) or PPP loan is forgiven, the forgiven amount is not included in the gross receipts of the business.<sup>49</sup>
2. Expenses paid with forgiven EIDL or PPP proceeds may still be deducted.<sup>50</sup>

**Note.** If expenses paid with forgiven PPP proceeds were not deducted on a 2020 return, the taxpayer may amend their 2020 filing or elect to include the omitted deductions when filing their 2021 return (safe harbor provision).<sup>51</sup>

<sup>43</sup> *New IRS form available for self-employed individuals to claim COVID-19 sick and family leave tax credits under FFCRA.* Feb. 9, 2021. IRS. [www.irs.gov/newsroom/new-irs-form-available-for-self-employed-individuals-to-claim-covid-19-sick-and-family-leave-tax-credits-under-ffera] Accessed on Jun. 29, 2021; *Special Issues for Employees.* Mar. 15, 2021. IRS. [www.irs.gov/newsroom/special-issues-for-employees#specific-provisions-related-self-employed-individuals] Accessed on Jun. 29, 2021.

<sup>44</sup> *Families First Coronavirus Response Act*, PL 116-127, §7002.

<sup>45</sup> The American Rescue Plan Act extended the period for qualified sick and family leave wages through September 2021. See *American Rescue Plan Act*, PL 117-2, §§9641, 9642, and 9643.

<sup>46</sup> *Economic Injury Disaster Loans.* Benefits.gov. [www.benefits.gov/benefit/1504] Accessed on Jun. 22, 2021.

<sup>47</sup> *CARES Act*, PL 116-136, §1102; *First Draw PPP Loan.* SBA. [www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/first-draw-ppp-loan] Accessed on Jul. 21, 2021.

<sup>48</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §311; *Paycheck Protection Program Second Draw Loans.* U.S. Treasury. [home.treasury.gov/system/files/136/Top-line-Overview-of-Second-Draw-PPP.pdf] Accessed on Jul. 22, 2021.

<sup>49</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §276, Div. N.

<sup>50</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §276, Div. N, amending *CARES Act*, PL 116-136, §1106(i).

<sup>51</sup> Rev. Proc. 2021-20, 2020-50 IRB 1552.



## Practitioner Planning Tip

Determining when to include expenses paid with forgiven PPP loan proceeds (on a 2020 return or on a 2021 return as provided in the safe harbor provisions of the Rev. Proc.), provides a tax planning opportunity for practitioners and their clients.

**Note.** For more discussion regarding coordination among various COVID-19 relief measures established for small businesses, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Small Business Issues.

## GIG ECONOMY<sup>52</sup>

Individuals engaged in the gig economy report their activity on Schedule C. The **gig economy** includes activities where people earn income by providing on-demand work, services, or goods. Some examples of gig economy work include the following.

- Drive a car for booked rides or deliveries
- Rent out all or part of their property
- Run errands or complete tasks
- Sell goods online
- Rent personal equipment
- Provide creative or professional services
- Provide other temporary, on-demand, or freelance work

Often, taxpayers find the work through a **digital platform**. Digital platforms are businesses that match workers' services or goods with customers via apps or websites. This includes businesses that provide access to the following nonexclusive services.

- Ridesharing services
- Delivery services
- Crafts and handmade item marketplaces
- On-demand labor and repair services
- Property and space rentals

<sup>52</sup> *Gig Economy Tax Center*. Oct. 15, 2020. IRS. [[www.irs.gov/businesses/gig-economy-tax-center](http://www.irs.gov/businesses/gig-economy-tax-center)] Accessed on Jun. 26, 2021 and *Manage Taxes for Your Gig Work*. Jun. 17, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/manage-taxes-for-your-gig-work](http://www.irs.gov/businesses/small-businesses-self-employed/manage-taxes-for-your-gig-work)] Accessed on Jun. 26, 2021.

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Income earned from the gig economy is taxable. This includes income that is any of the following.

- From part-time, temporary, or side work
- Not reported on an information return form (e.g., Forms 1099-K, *Payment Card and Third Party Network Transactions*, 1099-MISC, *Miscellaneous Income, W-2*, or other income statement)
- Paid in any form, including cash, property, goods, or virtual currency

Taxpayers engaged in the gig economy must understand whether they are considered an employee or an independent contractor. Employers should withhold tax from paychecks associated with gig work performed as an employee. Independent contractors report their activity on Schedule C (assuming their activity is undertaken with a profit motive as discussed previously), are responsible for SE taxes, and may need to pay estimated taxes.

## Practitioner Planning Tip

An individual who performs gig work on the side and also is an employee of another employer may avoid making estimated taxes by increasing their withholding through the other employer.

**Example 8.** Kara is a middle school science teacher in District 1. In 2020, she began working as an independent delivery driver for Grocerz2URDoor, a grocery delivery service, to supplement her income during the pandemic. Kara increased her withholding through District 1 to compensate for her gig economy income to avoid paying quarterly estimates.

Gig economy workers must collect and retain their records for proper reporting. Taxpayers must report all income on their tax returns, even if they do not receive a Form 1099 from the business that pays them. Retaining records of all money received from gig work and sales supports the income reported on Schedule C. Additionally, taxpayers can reduce their taxes by deducting certain expenses associated with carrying on a trade or business supported by receipts.

**Example 9.** Use the same facts as **Example 8.** Grocerz2URDoor failed to send Kara a Form 1099 for 2020. Luckily, Kara kept records of all her income during the year. She also tracked her mileage for deliveries to the customers. She is allowed to deduct the associated expenses on her Schedule C.

## Practitioner Planning Tip

Practitioners should advise gig economy workers who use their automobile to track all their mileage rather than relying on the digital platform to do it for them.

## BUSINESS INFORMATION<sup>53</sup>

Basic information for the business is entered on the top of Schedule C. Taxpayers who own more than one business must complete a separate Schedule C for each business.

### BUSINESS OR PROFESSIONAL ACTIVITY (LINE A)

On line A, the taxpayer describes the business or professional activity that provides the principal source of income reported on line 1. If the general field or activity is wholesale or retail trade, or services connected with production services (e.g., mining, construction, or manufacturing), the type of customer or client must also be provided (e.g., “wholesale sale of hardware to retailers”, “appraisal of real estate for lending institutions”).

### PRINCIPAL BUSINESS OR PROFESSIONAL ACTIVITY CODE (LINE B)

The taxpayer enters the appropriate 6-digit principal business or professional activity code on line B. These codes classify sole proprietorships by the type of activity in which they are engaged. The code is based on the category that best describes the taxpayer’s primary business activity and the activity that best identifies the principal source of sales or receipts.

The instructions to Schedule C have a table of principal business and professional activity codes.

**Caution.** Caution should be taken when choosing the appropriate business and professional activity 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 10.** Emma is a self-employed beautician with her own salon. On her 2020 income tax return, she reported \$60,000 of sales. She also reported COGS of \$40,000. Therefore, her cost of sales was 67% of her sales. Based on IRS compliance analysis, shops of a similar size averaged a much smaller percentage cost of sales. Consequently, Emma’s return is more likely to be selected for audit. Her tax practitioner should ask probing questions as to why Emma’s COGS is significantly different than other businesses of her type.

### EIN (LINE D)

Taxpayers with a qualified retirement plan, or who are required to file employment, excise, alcohol, tobacco, or firearms returns, or are a payor of gambling winnings are required to have an EIN. Sole owners of an LLC that is not treated as a separate entity for federal income tax purposes use the EIN issued to the LLC in the LLC’s legal name. The EIN is entered on line D. If the taxpayer does not have an EIN, line D should be blank.

### METHOD OF ACCOUNTING (LINE F)

The first time a taxpayer files a Schedule C, they must select a method of accounting. Generally, they can select the cash method, accrual method, or any other method permitted by the IRS. The method must clearly reflect income. 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 small business taxpayer, they must use the accrual method for sales and purchases of inventory. A **qualifying small business taxpayer** is one whose average annual gross receipts for the three prior tax years are \$26 million or less. The business cannot be a tax shelter under IRC §448(d)(3).

<sup>53</sup> Instructions for Schedule C.

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## 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.

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.<sup>54</sup> If an expenditure is for a capital asset with a useful life that extends beyond 12 months or the end of the next taxable year, depreciation decisions (discussed later) will determine whether a full or partial deduction is taken for the year of payment.

## Accrual Method<sup>55</sup>

Under the accrual method, taxpayers report income when all events that fix their right to receive the income have occurred and the amount can be determined with reasonable accuracy. This occurs at the earliest of the following dates.

- When the taxpayer receives payment
- When the income amount is due to the taxpayer
- When the taxpayer earns the income
- When title passes

Additionally, economic performance must have occurred (i.e., when the property or services are provided, or the property is used).

## Hybrid Method<sup>56</sup>

Generally, taxpayers can use any combination of cash, accrual, and special methods of accounting if the combination clearly reflects income and is used consistently. A **hybrid method** combines elements of two or more of the above accounting methods. However, the following restrictions apply.

- If an inventory is necessary to account for income, a taxpayer must use an accrual method for purchases and sales, unless the taxpayer is a qualifying small business taxpayer. Generally, taxpayers can use the cash method for all other items of income and expenses.
- If a taxpayer uses the cash method for reporting income, they must use the cash method for reporting expenses.
- If a taxpayer uses an accrual method for reporting expenses, they must use an accrual method for figuring income.
- Any combination that includes the cash method is treated as the cash method for purposes of IRC §448.

**Two or More Businesses.** If taxpayers operate two or more separate and distinct businesses, they can use a different accounting method for each business. A taxpayer must maintain a complete and separate set of books and records for each business.

**Note.** If a taxpayer uses different accounting methods to create or shift profits or losses between businesses (for example, through inventory adjustments, sales, purchases, or expenses) so that income is not clearly reflected, the businesses will not be considered separate and distinct.<sup>57</sup>

<sup>54</sup> Rev. Rul. 78-39, 1978-1 CB 73.

<sup>55</sup> Treas. Reg. §1.451-1; IRS Pub. 538, *Accounting Periods and Methods*.

<sup>56</sup> Ibid.

<sup>57</sup> Treas. Reg. §1.446-1(d)(3).



## 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.<sup>58</sup>

A taxpayer changing from the accrual method to the cash 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 take this duplication into account in determining their IRC §481(a) adjustment.

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 normally consumed during the year and not inventoried. Nonincidental materials and supplies are discussed later in the chapter.

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.** For more information about making a change in accounting method using Form 3115, including §481(a) adjustments, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues.

## 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.

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 QJV.

<sup>58</sup> IRC §481(a).

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An individual is treated as materially participating in an activity if they meet any **one** of the following seven rules.<sup>59</sup>

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 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. Based on all 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:
  - a. No person other than the taxpayer received compensation for performing management services in connection with the activity, or
  - b. 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.

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<sup>59</sup> Temp. Treas. Reg. §1.469-5T.

## 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.

**Note.** For more information on income and deductions from oil or gas wells, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E.

## 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-NEC is required if the business hires unincorporated independent contractors and pays them \$600 or more during the year. 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 \$50 to \$270 per form depending on how late the forms are filed.<sup>60</sup>

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.

**Caution.** Practitioners should exercise caution in selecting ‘no’ on line J to the question “Did you or will you file required Form(s) 1099?” after answering ‘yes’ on line I “Did you make any payments in 2020 that would require you to file Form(s) 1099?”. A taxpayer who does not file required Form(s) 1099 is potentially subject to substantial penalties, especially if the IRS can prove intentional disregard.

## PART I: INCOME<sup>61</sup>

### GROSS RECEIPTS (LINE 1)

Gross receipts include all income attributable to the trade or business from all sources. The taxpayer may receive Forms 1099 from people who are required to provide information to the IRS listing amounts that may be income to the trade or business. Payment settlement entities (PSE) must report payments made to merchants on Forms 1099-K. Besides Form 1099-K, taxpayers may report income from other common Forms 1099 such as 1099-MISC and 1099-NEC.

If a taxpayer reports an amount on line 1 that differs from the amounts reported to them on a Form 1099, they must include a statement explaining the difference.

<sup>60</sup> IRC §6721.

<sup>61</sup> Instructions for Schedule C.

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**Example 11.** In 2021, Tony's Italian Restaurant submits total credit card sales to the PSE. The sales include \$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.

CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.  <b>MasterCard Processing Center 110 State Street Anytown, MO 55555</b>		FILER'S TIN <b>12-3456789</b>	OMB No. 1545-2205	<b>2021</b>	<b>Payment Card and Third Party Network Transactions</b>
		PAYEE'S TIN <b>98-7654321</b>	Form <b>1099-K</b>		
1a Gross amount of payment card/third party network transactions <b>\$ 37510.00</b>		1b Card Not Present transactions <b>\$</b>	2 Merchant category code <b>I</b>	<b>Copy B For Payee</b>  This is important tax information and is being furnished to the IRS. 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.	
Check to indicate if FILER is a (an): Payment settlement entity (PSE) <input type="checkbox"/> Electronic Payment Facilitator (EPF)/Other third party <input type="checkbox"/>		3 Number of payment transactions <b>\$</b>	4 Federal income tax withheld <b>\$</b>		
Check to indicate transactions reported are: Payment card <input checked="" type="checkbox"/> Third party network <input type="checkbox"/>		PAYEE'S name <b>Tony's Italian Restaurant</b>  Street address (including apt. no.) <b>21 Charro Way</b>  City or town, state or province, country, and ZIP or foreign postal code <b>Anytown, MO 55555</b>	5a January <b>\$</b>	5b February <b>\$</b>	
PSE'S name and telephone number <b>555-55-5555</b>		5c March <b>\$</b>	5d April <b>\$</b>		
Account number (see instructions)		5e May <b>\$ 37510.00</b>	5f June <b>\$</b>		
		5g July <b>\$</b>	5h August <b>\$</b>		
		5i September <b>\$</b>	5j October <b>\$</b>		
		5k November <b>\$</b>	5l December <b>\$</b>		
		6 State <b>\$</b>	7 State identification no. <b>\$</b>	8 State income tax withheld <b>\$</b>	

Form **1099-K** (Keep for your records) [www.irs.gov/Form1099K](http://www.irs.gov/Form1099K) Department of the Treasury - Internal Revenue Service

## Practitioner Planning Tip

In the interest of matching income to information supplied to the IRS, Tony should report gross 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.

## COGS (LINE 4)

The COGS 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. COGS issues are discussed later.

## OTHER INCOME (LINE 6)

Line 6 of Schedule C is used to report income not reported anywhere else on the return. This includes income from the following.

- Finance reserve income
- Scrap sales
- Recovered bad debts
- Interest (such as on notes and accounts receivables)
- State gasoline or fuel tax refunds received
- Any biofuel credit claimed on Form 6478, *Biofuel Producer Credit*
- Any biodiesel and renewable diesel credit claimed on Form 8864, *Biodiesel and Renewable Diesel Fuels Credit*
- Credit for federal tax paid on fuels claimed on the Form 1040 or Form 1040-SR, *U.S. Tax Return for Seniors* for the prior year
- Prizes and awards related to the business
- Amounts the trade or business received on Form 1099-PATR, *Taxable Distributions Received From Cooperatives*

**Note.** Line 6 of Schedule C (Other income) is also used to include any credit for qualified sick and family leave wages (see Form(s) 941, *Employer's QUARTERLY Federal Tax Return*, (2021) lines 11b and 13c or Form 944, *Employer's ANNUAL Federal Tax Return*, (2021), lines 8b and 10d). However, per the draft 2021 instructions for Schedule C, the ERC is reported on line 26 as a reduction in payroll expense for the period being claimed and is not reported as other income.

- Other kinds of miscellaneous business income

## Depreciation Recapture

If the business-use percentage of any **listed property** dropped to 50% or less during its normal depreciable life, a **calculation of excess depreciation is required. The excess depreciation is reported for that year on line 6.** This includes the IRC §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.

## Collectibles<sup>62</sup>

Taxpayers who are investors as well as dealers in collectibles will likely receive a Form 1099-K from a PSE such as PayPal when they sell collectibles. **However, the income investors realize should not be reported on Schedule C.** Income from the sale of collectibles as an investor is reported on Schedule D, *Capital Gains and Losses*, and is subject to capital gains rates.

<sup>62</sup> See the instructions for Schedule D.



## Practitioner Planning Tip

Because the IRS uses a matching program, it may trigger a notice if the income from Form 1099-K is not reported on a Schedule C. Therefore, the taxpayer is advised to report the 1099-K total on Schedule C, then enter a corresponding expense for the same amount indicating the activity is conducted as an investor and to see Schedule D for the proper reporting of the investor's sale of collectibles.

## ASSIGNMENT OF INCOME

Many Schedule C filers incorporate to provide liability protection or to seek ways to manage their tax liability. By operating in a subchapter S-corporate structure, they control the amount of FICA tax they pay by controlling the payroll they take from the S corporation. The payroll may or may not be reasonable, but they pursue this route knowing that any remaining profit of the S corporation, while income taxable to the shareholder(s), is not subject to SE tax.<sup>63</sup>

After establishing an S corporation, taxpayers may still receive Forms 1099 issued in their personal social security number (SSN). Some of the Forms 1099s issued are the result of clerical error or miscommunication, while others are the result of licensing requirements which mandate the issuer being required to report earnings to actual persons.<sup>64</sup>

**Example 12.** Steven Jonas is a self-employed real estate agent. In 2020, his net profit was nearly \$175,000, and he owed more than \$50,000 in taxes. Hoping to avoid another repeat of 2020, Steven met with his attorney and tax advisor who advised him to establish an S corporation. He established the S corporation in late 2020 with an effective date of January 1, 2021. Steven's real estate broker informed him that commissions can only be paid to licensed individuals.

In January 2022, Steven received his 2021 Form 1099-NEC with earnings exceeding \$225,000. On January 30, 2022 Steven met with his tax advisor, Mabel Hemingway, an enrolled agent, who informed him that the Form 1099-NEC earnings would first be reported on his Schedule C with an associated expense entered for the same amount, bringing the Schedule C net income to \$0. The \$225,000 would then be the gross income of Steven's S corporation.

The final item to discuss, Mabel explained, was how much to show as Steven's reasonable compensation. Steven explained that he did not have much money left because he had to pay the previous year's tax liability and he did not want a repeat of that fiasco. He also took some time off to travel the world so he would like Mabel to come up with a small enough compensation amount, so the IRS does not challenge his actions.

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<sup>63</sup> IRC §1402.

<sup>64</sup> See *Isom v. Comm'r*, TC Memo 1995-383 (Aug. 14, 1995). Bruce Isom was an independent insurance agent for American Family Insurance. After Isom established an S corporation, American Family made commission checks payable to Isom's S corporation but ceased the practice following legal advice from their counsel. Isom endorsed the commission checks over to his S corporation. An IRS audit declared the practice a sham. The court agreed with IRS because the S corporation did not direct the conduct of Isom's activities, and the S corporation did not have a contract as an agent for American Family. More than \$100,000 of S corporation income was declared taxable personally to Isom.

**Caution.** Prior to the *Fleisher*<sup>65</sup> decision in 2016, taxpayers often reported Form 1099 income on Schedule C and then deducted the same amount to zero out the income. The taxpayer would then report the income on their corporate return as illustrated in the previous example. Following the ruling in *Fleisher*, Form 1099 recipients should carefully consider the decision to zero out the income on the personal return and move the income to the corporation return unless the corporation “controls the earning of the income.”

**Example 13.** Ryan is a financial consultant who develops investment portfolios for clients. He has all the required licenses to purchase and sell securities. Ryan starts his own business, Ryan Wealth Planner (RWP), which he incorporates as an S corporation. Ryan enters into an employment contract with RWP for which Ryan is paid a salary to provide wealth management services to clients.<sup>66</sup>

In 2020, Ryan contracts with Money Financial Group (MFG) to sell fixed insurance products. Ryan signed the contract in his name (not as RWP).

On his 2020 Schedule C, Ryan reports gross income from MFG of \$260,000 and “other expenses” of \$260,000, zeroing out any income. On his Form 1120-S, *U.S. Income Tax Return for an S Corporation*, Ryan reports \$450,000 of income for RWP, which includes the \$260,000 from MFG.

The IRS sent Ryan a notice of deficiency, claiming the MFG income should have been reported on the Schedule C, subject to SE tax, and not on the Form 1120-S. Ryan earned the income in his personal capacity and RWP did not control the earning of the income. The question in this area is whether the taxpayer has the right to assign their income to another person or entity.

There are several issues with employing the strategy of zeroing out income on the Schedule C to report elsewhere on the return.

- Who provided the services?
- Who controlled earning the income?<sup>67</sup>
- Whose income is it?<sup>68</sup>
- Is the S corporation providing reasonable compensation to the shareholder/employee?

Gross income includes all income from whatever source derived.<sup>69</sup> This statement includes compensation an individual receives for services rendered. Therefore, income is taxable to the person who received it.<sup>70</sup> Furthermore, the individual who earned the income cannot push the recognition of the income and the subsequent tax liability away from themselves by assigning it to another individual or entity.<sup>71</sup>

<sup>65</sup> *Fleisher v. Comm’r*, TC Memo 2016-238 (Dec. 29, 2016).

<sup>66</sup> The facts of this example are based on the *Fleisher* case.

<sup>67</sup> See *American Savings Bank v. Comm’r*, 56 TC 828 (1971).

<sup>68</sup> See *Comm’r v. Culbertson*, 337 U.S. 733 (1949).

<sup>69</sup> IRC §61(a).

<sup>70</sup> See *Comm’r v. Culbertson*, 337 U.S. 733 (1949).

<sup>71</sup> See *Lucas v. Earl*, 281 U.S. 111 (1930).

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## Best Practices

With the references provided herein of long-standing court cases arguing successfully against the practice of assigning income from the sole proprietor to their S corporation, the question becomes one of best practices.

Clients who incorporated their activity should consider the following actions.

- License the corporation as the agent authorized to conduct the business
- Establish that the corporation is the employer
- Earnings should be made payable to the corporation, not merely endorsed over
- The employee/shareholder should receive reasonable compensation

**Note.** Reasonable compensation is difficult to quantify as there is no definitive answer in this area. For example, in a service business, reasonable compensation may be considered all net profit of the S corporation.

For more discussion in this area, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Entity Comparison. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

The corporation should be empowered to perform the following activities.

- Execute contracts
- Receive earnings as the corporation<sup>72</sup>
- Exercise control over the shareholder/employee

## PART II: EXPENSES<sup>73</sup>

All the expenses incurred in conducting the trade or business other than those related to the COGS 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.<sup>74</sup>

### 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 generate additional revenue. The purpose of some advertising is to make people aware of the business. Other types are direct solicitations for business. A taxpayer should determine whether the advertising is currently deductible or if it must be amortized.

### Promotion

Advertising costs are generally deductible as a current expense under §162. Regulations provide that “advertising and other selling expenses” are among the items included in deductible business expenses.<sup>75</sup> 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 relate to the patronage the taxpayer might reasonably expect in the future.<sup>76</sup>

<sup>72</sup> See *Kubik v Comm'r*, TC Memo 1974-62 (Mar. 12, 1974).

<sup>73</sup> Instructions for Schedule C.

<sup>74</sup> Temp. Treas. Reg. §1.62-1T(d).

<sup>75</sup> Treas. Reg. §1.162-1(a).

<sup>76</sup> Treas. Reg. §1.162-20(a)(20).



## 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.

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 an IRC §501(c)(3) organization.

### Practitioner Planning Tip

Determining if an expenditure is treated as a solicitation (considered as a reasonable and necessary business expense) or a charitable deduction that can only be deducted on Schedule A should be a straightforward exercise. The practitioner should ask questions regarding the solicitation to determine if the business received something in return for its contribution such as name recognition.

**Example 14.** Neil, a self-employed repairman, was approached by a local little league baseball club to contribute funds for new uniforms. The league tells Neil that they will post his business logo or name on the outfield wall of their home ballpark in appreciation for the contribution. This expenditure should qualify as a solicitation and be deductible on Neil’s Schedule C because he appears to be paying for advertising his business with the baseball league.

**Example 15.** Use the same facts as in **Example 14**, except Neil receives nothing for his contribution other than the gratitude and the smiles on the faces of the little leaguers. If the little league is a qualified §501(c)(3) organization, then Neil includes his contribution on his Schedule A. If the little league is not a qualified §501(c)(3) organization, Neil only has the smiles from the players as his benefit.

## CAR AND TRUCK EXPENSES (LINE 9)

The **actual expense** of operating a car or truck within a business is deductible unless the taxpayer uses the **standard mileage rate**. 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. Actual expenses for a leased vehicle cannot be used if the standard mileage rate was previously used.

The standard mileage rate can only be used if:

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

**Note.** For 2020, the standard mileage rate is 57.5 cents per mile, and 56 cents per mile in 2021.<sup>77</sup> These rates are subject to change.

<sup>77</sup> *Standard Mileage Rates*. Mar. 17, 2021. IRS. [www.irs.gov/tax-professionals/standard-mileage-rates] Accessed on Jul. 3, 2021.

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

Taxpayers who claim the standard mileage rate, lease a vehicle, have a fully depreciated vehicle, and are not required to file a Form 4562, *Depreciation and Amortization*, for any other reason complete part IV of Schedule C. A taxpayer claiming depreciation on their vehicle must attach a Form 4562. Other reasons for attaching a Form 4562 include the following.

- Claiming depreciation on property placed in service during the year
- Claiming depreciation on listed property, regardless of the date it was placed in service
- Claiming a §179 expense deduction

If the taxpayer used more than one vehicle during the year, they must attach a statement with the information requested in part IV for each additional vehicle.

## Personal Use of Business-Owned Vehicles<sup>78</sup>

Generally, car and truck expenses may only be deductible on Schedule C for the business-use percentage of the vehicle. When utilizing actual expenses or the standard mileage method, documenting the business-use percentage should be a straightforward task. However, when a Schedule C business owner leases a vehicle, the deductibility and recordkeeping become more cumbersome.

**Luxury Auto Limitations.** As an introduction to this concept, it is important to understand luxury auto limitations when it comes to allowable current year Schedule C deductions. Taxpayers who purchase luxury autos or light trucks (defined as having four wheels, intended for use on public roadways, and has an unloaded gross vehicle weight of less than 6,000 pounds), are limited in how much depreciation, including accelerated methods, can be deducted in a given year.

A taxpayer who leases a car, truck, or van used in their business for a lease term of 30 days or more may have to include an inclusion amount in their income for each tax year the vehicle is leased. The inclusion amount is not added to income, but the lease payment deduction is reduced by a percentage of part of the FMV of the leased vehicle multiplied by the percentage of business and investment use of the vehicle for the tax year (prorated for the number of days of the lease term in the tax year.) The inclusion amount applies to each tax year that the taxpayer leases the vehicle if the FMV when the lease began was more than the following amounts.

- 2018–2020: \$50,000
- 2013–2017: \$19,000
- 2010–2012: \$18,500

For vehicles placed into service after 2019, the depreciation deduction for any passenger vehicle, without bonus depreciation, cannot exceed the following amounts.

- \$10,100 for the 1st taxable year in the recovery period
- \$16,100 for the 2nd taxable year in the recovery period
- \$9,700 for the 3rd taxable year in the recovery period
- \$5,760 for each succeeding taxable year in the recovery period

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<sup>78</sup> IRC §280F and IRS Pub. 463, *Travel, Gift, and Car Expenses*.

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For vehicles placed in service during 2019 and 2020 when a taxpayer claims 100% bonus depreciation, the greatest allowable depreciation deduction is:

- \$18,100 for the first year,
- \$16,100 for the second year,
- \$9,700 for the third year, and
- \$5,760 for each later taxable year in the recovery period.

**Luxury Auto Lease Inclusion Rule.** With the limitations in luxury auto deductions, self-employed taxpayers have considered leasing luxury automobiles rather than purchasing them to fully deduct the lease payments as an ordinary and necessary business expense (assuming 100% business use of the vehicle).

The IRS addressed the leasing strategy by implementing the **lease inclusion rule**. For a taxpayer who deducts 100% of a leased vehicle’s lease payments, the IRS requires an add-back to income based on the FMV of the vehicle. IRS Pub. 463, *Travel, Gift, and Car Expenses*, contains the inclusion amounts for vehicles first leased in 2019, utilized in the following example.

**Example 16.** On August 16, 2019, Will leased a car with an FMV of \$54,500. He used the vehicle exclusively for business purposes from August 16 through December 31, 2019 (138 days). The lease term is 36 months.

On November 5, 2020, Will closed his business and went to work for a new employer. His leased vehicle was no longer used for business after November 5, 2020. In 2020, his business use days were 310 (January 1–November 5, 2020). Will calculates his lease inclusion income amounts as follows.

Tax Year	Amount from IRS Table	Proration	Business Use %	Inclusion Amount
2019	\$17	138/365 (38%)	100%	\$ 6 (\$17 × 38%)
2020	40	310/366 (85%)	100%	34 ( 40 × 85%)

Will must reduce his lease payments by \$6 in 2019 and \$34 in 2020.

## Appendix C-2. Inclusion Amounts for Passenger Automobiles First Leased in 2019

Fair Market Value		Tax Year of Lease <sup>1</sup>				
Over	Not Over	1st	2nd	3rd	4th	5th and Later
\$ 50,000	\$ 51,000	\$ 0	\$ 1	\$ 1	\$ 3	\$ 3
51,000	52,000	4	11	15	20	23
52,000	53,000	9	20	30	36	43
53,000	54,000	13	30	44	53	63
54,000	55,000	17	40	58	70	83
55,000	56,000	22	49	72	88	102
56,000	57,000	26	59	86	105	122
57,000	58,000	31	68	101	122	142
58,000	59,000	35	78	115	139	161
59,000	60,000	39	88	129	156	181
60,000	62,000	46	102	151	181	211
62,000	64,000	55	121	179	216	250
64,000	66,000	63	140	208	251	289
66,000	68,000	72	160	236	284	329
68,000	70,000	81	179	265	318	369
70,000	72,000	90	198	293	353	408
72,000	74,000	98	217	322	387	448
74,000	76,000	107	236	351	421	487
76,000	78,000	116	255	379	456	526
78,000	80,000	125	275	407	489	567
80,000	85,000	140	308	458	549	635
85,000	90,000	162	356	529	635	734
90,000	95,000 <sup>2</sup>	184	404	600	720	833
95,000	100,000 <sup>2</sup>	206	452	671	806	931

<sup>1</sup> For the last tax year of the lease, use the dollar amount for the preceding year.

<sup>2</sup> If the fair market value of the vehicle is more than \$100,000, see Rev. Proc. 2019-26 (2019-24 I.R.B. 1323), available at [IRS.gov/irb/2019-24\\_IRB#REV-PROC-2019-26](https://www.irs.gov/irb/2019-24_IRB#REV-PROC-2019-26).

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The purpose of lease inclusion rule is to limit lease deductions in the same manner as luxury automobile depreciation deductions are limited.

## Reporting

When claiming the auto or truck deduction, part IV of Schedule C, or part V of Form 4562 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 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 unincorporated independent contractor is paid \$600 or more during the year, a Form 1099-NEC **must** be filed.

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 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.<sup>79</sup>

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

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 IRS' criteria 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.

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<sup>79</sup> See Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding* and Instructions for Form SS-8.

## Consequences of Misclassification

If the IRS determines an employer has misclassified an employee as an independent contractor, it can assert substantial penalties. These include all the following.<sup>80</sup>

- 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

**Caution.** In addition to these IRS penalties, practitioners should be aware that the Department of Labor (DOL) and state employment agencies may have their own penalties.

**Example 17.** Perry has a very successful lawn mowing service. He has 20 workers that mow for him. In 2019, he treated the workers as independent contractors and paid them a total of \$400,000. In 2020, he paid the workers \$380,000. At the time of an IRS audit in 2021, he had paid them \$200,000. No employee earned more than the FICA wage base. If the IRS determines Perry's workers are employees, Perry will owe all the following taxes and penalties.

- \$14,700 for income taxes not withheld ( $1.5\% \times (\$400,000 + \$380,000 + \$200,000)$ )
- \$14,994 for FICA taxes not withheld in 2019 through 2021 ( $7.65\% \times (\$400,000 + \$380,000 + \$200,000) \times 20\%$ )
- \$74,970 ( $7.65\% \times \$980,000$ ) for the employer's share of FICA tax

**Note.** This is a tax, not a penalty, and therefore would be a deductible expense for Perry.

- FUTA tax
- Any other applicable penalties and interest

Perry owes the IRS at least \$104,664 ( $\$14,700 + \$14,994 + \$74,970$ ).

**Penalty Relief.**<sup>81</sup> The voluntary classification settlement program (VCSP) provides payroll tax relief to employers who voluntarily reclassify their employees. This program offers the employer a low-cost method of reclassifying employees. The employer must satisfy all the following requirements to be eligible for the program.

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

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

<sup>80</sup> IRC §3509.

<sup>81</sup> *Voluntary Classification Settlement Program (VCSP)*. Jun. 26, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program](http://www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program)] Accessed on Jul. 5, 2021; IRS Ann. 2012-45, 2012-51 IRB 724.

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

When an employer is accepted into the program, they pay 10% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year. The taxpayer is not responsible for any interest or penalties, and the employer will not be audited for payroll taxes related to these workers for the prior years.

**Note.** For more discussion on worker classification issues, see the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Employment Issues. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [taxschool.illinois.edu/taxbookarchive].

## 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.

## 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*.

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.<sup>82</sup> 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;<sup>83</sup> 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.<sup>84</sup>

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<sup>82</sup> IRC §105(b).

<sup>83</sup> IRC §105(h)(3)(A)(i).

<sup>84</sup> IRC §105(h)(3)(A)(ii).

Certain employees can be excluded from the medical reimbursement plan.<sup>85</sup> 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

## Self-Employed Health Insurance Deduction<sup>86</sup>

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. **However, the deduction is taken as an adjustment to income on Form 1040, 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 26.

Self-employed taxpayers who 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

This deduction directly reduces AGI rather than being treated as an itemized deduction. However, 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.<sup>87</sup>

## 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.<sup>88</sup> 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.

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<sup>85</sup> IRC §105(h)(3)(B).

<sup>86</sup> IRC §162(l)(2)(A).

<sup>87</sup> IRC §162(l)(2)(B).

<sup>88</sup> IRC §105(g).

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To qualify for the deduction, the taxpayer should adhere to the following.<sup>89</sup>

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.
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 Form W-2 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.

## 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 to secure a business loan.<sup>90</sup>

## 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.

### Tracing Rules

Generally, the interest expense deduction is determined by how the taxpayer used the loan proceeds on which interest was incurred.<sup>91</sup> Debt is allocated by tracing the disbursements of the debt proceeds to the specific expenditures.

**Example 18.** 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.<sup>92</sup> If the loan proceeds are 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.<sup>93</sup>

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<sup>89</sup> See *Speltz v. Comm'r*, TC Summ. Op. 2006-25 (Feb. 14, 2006).

<sup>90</sup> IRC §264(a)(1).

<sup>91</sup> Temp. Treas. Regs. §§1.163-8T(a)(3) and 1.163-8T(c).

<sup>92</sup> Temp. Treas. Reg. §1.163-8T(c)(2)(i).

<sup>93</sup> Temp. Treas. Reg. §1.163-8T(c)(4)(i).



**Example 19.** Clarice, a calendar-year taxpayer, borrows \$100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. She does not deposit any other amounts in the account during the year and does not repay any portion of the principal amount of the debt during the year. On April 1, Clarice uses \$20,000 of the debt proceeds held in the account to pay 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:<sup>94</sup>

- 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 debt proceeds are deposited.

**Example 20.** On January 10, Edwardo opens a checking account, depositing \$500 of proceeds of Loan A and \$1,000 of unborrowed funds. The following table summarizes the transactions that occur during the year pertaining to the account.

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

Interest is allocated to each expenditure as follows.

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

	Balance			
	Unborrowed	Loan A	Loan B	Loan 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)

<sup>94</sup> Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

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Once the loan 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 loan 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 loan proceeds would be treated as shown in **Example 20** to make one or more other expenditures.<sup>95</sup>

**Example 21.** 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, 2021, 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, 2021	\$3,000	Personal expenditure
Jan. 13, 2021	5,000	Business expenditure

Under the ordering rules<sup>96</sup> the \$3,000 that Darnel used for his January 3 personal expenditure would be treated as coming from the \$3,000 loan 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 loan proceeds to his **personal** expenditure, **none of the interest is deductible.**

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 loan proceeds and \$2,000 of savings. This allows Darnel to deduct the interest on the \$3,000 of loan because the business expenditure was made within 15 days of the deposit of loan proceeds into his account.

**Example 22.** Use the same facts as in **Example 21**, except Darnel's business expenditure was not made until January 18. Darnel must apply the ordering rules which allocate his loan 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.<sup>97</sup> 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.

<sup>95</sup> Temp. Treas. Reg. §1.163-8T(c)(4)(iii)(B).

<sup>96</sup> Temp. Treas. Reg. §1.163-8T(c)(4)(ii).

<sup>97</sup> Temp. Treas. Reg. §1.163-8T(c)(4)(iv).

## 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.<sup>98</sup> 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, the taxpayer **must** be able to substantiate the business valuation is a reasonable and necessary cost of doing business under IRC §§162 and 212. Then, that portion of the appraisal fee is deductible on line 17 (see *Lucas v. Comm'r*, TC Memo 2018-80 (Jun. 11, 2018)). 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. For a home office refresher, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

## 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, Schedule 1, line 15**. In most cases, the taxpayer must file one of the following forms.

- **Form 5500-EZ, Annual Return of One-Participant (Owners/Partners and Their Spouses) Retirement Plan or A Foreign 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 listed in the instructions for Form 5500-SF. This form is no longer available for 1-participant plans.
- **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.

To avoid filing Form 5500, many small employers establish savings investment match plans for employees (SIMPLE). A 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 counted, regardless of whether they are eligible to participate in the SIMPLE plan.

**Note.** For a more detailed discussion of retirement plans for small businesses, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Retirement Plans for Small Businesses. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

<sup>98</sup> Treas. Reg. §1.1861-8(e)(5).

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## Employer-Based Retirement Plan Arrangements

Although an eligible taxpayer can establish a traditional or Roth individual retirement arrangement (IRA), several other types of qualified retirement plans are available to sole proprietors filing Schedule C. These plans may cover the business owner as well as any qualifying employees. Qualified retirement plans are authorized by specific sections of the Code and include the following.

- Simplified Employee Pension (SEP) IRAs (under IRC §408(k))
- Simple IRAs (as provided for by §408(p))
- IRC §401(k)

Contributions made by the employer on behalf of employees are reported on Schedule C, whereas the employer's own contributions are reported as an adjustment to income.

**Note.** Each type of plan has unique provisions with varying benefits. 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 can also be found in IRS Pub. 590, *Individual Retirement Arrangements*.

For more information and a table comparing various plans, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Retirement Plans for Small Businesses. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

## 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 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 **transfers 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 a conditional sales contract and **not** a lease if any of the following is true.<sup>99</sup>

- The agreement applies part of each payment toward an equity interest that the taxpayer receives in the property.
- 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 sum of 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 23.** 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, Kathlyn 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.

The Tax Court identified five specific conditions that might cause a lease to be considered a conditional sales contract.<sup>100</sup>

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.

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<sup>99</sup> *Income and Expenses*. Jan. 4, 2021. IRS. [[www.irs.gov/faqs/small-business-self-employed-other-business/income-expenses/income-expenses-7](http://www.irs.gov/faqs/small-business-self-employed-other-business/income-expenses/income-expenses-7)] Accessed on Jul. 7, 2021.

<sup>100</sup> *Boyce v. Comm'r*, TC Summ. Op. 2010-100 (Jul. 26, 2010).

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## 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 are subject to varying interpretations. 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.<sup>101</sup> Thus, amounts incurred for maintenance and repairs are deductible as ordinary and necessary business expenses.

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.

**Note.** For detailed information about the classification of expenses as capital items or repairs, as well as available elections for taxpayers, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

For further guidance, see Treas. Reg. §1.263(a)-3.

## 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.

The deduction on line 22 cannot include any materials or supplies reported on part III, line 38 of Schedule C (COGS).

**Example 24.** 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*.)

<sup>101</sup>. Treas. Reg. §1.162-4.

The following taxes are **not** deductible.

- Federal income taxes, including SE tax (However, half of the SE tax is deductible on Schedule 1 (Form 1040, line 14.)
- Estate and gift taxes
- Taxes assessed to pay for improvements, such as paving and sewers
- Taxes on the taxpayer's home or personal use property. However, if a sole proprietor maintains a home office for regular and exclusive use with their business, a portion of the real estate tax associated with their principal residence may be deductible on Schedule C. Business use of a taxpayer's home is discussed later.
- 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.

**Note.** These expenses are discussed thoroughly in 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

### Travel

Lodging and transportation expenses associated with overnight travel for business while away from the taxpayer's tax home are entered on line 24a. Generally, the taxpayer's tax home is their main place of business, regardless of where they maintain their family home. Expenses paid or incurred in connection with employment away from home cannot be deducted if that period of employment exceeds one year. Additionally, any travel expenses for the taxpayer's spouse, dependent, or any other individual are not deductible unless that person is an employee, the travel is for a bona fide business purpose, and the expenses would otherwise be deductible by that person.

Taxpayers can use an optional method of claiming a deduction of \$5 per day for incidental expenses only if they did not pay or incur meal expenses on a day they were traveling away from their tax home. Incidental expenses include fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries. They do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls. The optional method is not available on any day the taxpayer uses the standard meal allowance (as explained later).

Expenses associated with attending a convention, seminar, or similar meeting held outside the North American area is not deductible unless the meeting is directly related to the taxpayer's trade or business and it is as reasonable for the meeting to be held outside the North American area as within it. These rules apply to both employers and employees.

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## Business Meals and Entertainment

Deductible business meal expenses are entered on line 24b; entertainment expenses are not entered on this line. This includes expenses for meals while traveling away from home for business. The deductible business meal expenses are a percentage of the taxpayer's actual business meal expenses or standard meal allowance. Generally, the deductible percentage is 50%.<sup>102</sup> Meals provided by the employer for the convenience of the employer are 100% deductible.<sup>103</sup>

**Note.** The meals must be provided on the employer's business premises. This tax-free fringe benefit provided by employers to employees should not be confused with the meals and entertainment expense deduction. TCJA repealed the "entertainment" portion of the ordinary "meals and entertainment" tax deduction for businesses.<sup>104</sup> TCJA did, however, retain the 50% deduction for meals.<sup>105</sup> The CAA amended IRC §274(n)(2) to allow a 100% business deduction for business purpose food and beverages paid in tax years 2021 and 2022 if a restaurant provides the food and beverage.<sup>106</sup>

For more information, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments and Volume B, Chapter 6: Small Business Issues.

A taxpayer can deduct a percentage of the actual cost of a meal if all the following conditions are met.

- The meal expense is an ordinary and necessary expense in carrying on the taxpayer's trade or business.
- The expense is not lavish or extravagant under the circumstances.
- Either the taxpayer or an employee of the taxpayer is present at the meal.
- The meal is provided to a current or potential business customer, client, consultant, or similar business contact.
- Any food and beverages must be purchased separately from the entertainment, or the cost of the food and beverages must be stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

**Standard Meal Allowance.** Taxpayers have the option to apply the standard meal allowance for their daily meals and incidental expenses instead of deducting the actual cost of meals while traveling away from home. Under the standard meal allowance method, the taxpayer deducts a specified amount, based on the travel destination, instead of keeping records of actual meal expenses. **However, taxpayers must maintain records to prove the time, place, and business purpose of travel.**

The standard meal allowance is the federal meals and incidental expenses (M&IE) rate. The M&IE rates are found at **uofi.tax/21b3x1** [[www.gsa.gov/travel/plan-book/per-diem-rates/mie-breakdown](http://www.gsa.gov/travel/plan-book/per-diem-rates/mie-breakdown)]. IRS Pub. 463 details how to figure the standard meal allowance, including special rules for partial days of travel.

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<sup>102</sup> IRC §274(n)(2).

<sup>103</sup> IRC §119.

<sup>104</sup> *Tax Cuts and Jobs Act*, PL 115-97, §13304, amending IRC §274.

<sup>105</sup> IRC §274(n)(1).

<sup>106</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §210, amending IRC §274(n)(2).



**Amount of Deduction.** Generally, only 50% of business meal expenses, including meals incurred while away from home on business, are deductible (except for tax years 2021 and 2022, as discussed previously). However, individuals who are subject to the **Department of Transportation (DOT)** hours of service limits **can deduct 80%** for business meals consumed during, or incident to, any period of duty for which those limits are in effect. Individuals subject to the DOT hours of service limits include the following.

- Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
- Interstate truck operators who are under DOT regulations.
- Certain merchant mariners who are under Coast Guard regulations.

Taxpayers can deduct 100% of the cost of meals and incidentals furnished or reimbursed to an employee if the taxpayer properly treats the expense as wages subject to withholding. Additionally, taxpayers can fully deduct meals and incidentals provided to a nonemployee to the extent the expenses are includible in the gross income of that person and reported on Form 1099-NEC.

## 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*
- Form 5884-A, *Employee Retention Credit*
- Form 8844, *Empowerment Zone and Renewal Community Employment Credit*
- Form 8845, *Indian Employment Credit*
- Form 8932, *Credit for Employer Differential Wage Payments*
- Form 8994, *Employer Credit for Paid Family and Medical Leave*

Taxpayers must also reduce the wage deduction by any nonrefundable and refundable portions of the new CARES Act ERC claimed on Forms 944 or 941 for a business employee.

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.

**Note.** The self-employed owner is not an employee. Therefore, no Form W-2 should be issued to the owner. In addition, draws the owner might take are not reported anywhere on Schedule C.

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## OTHER EXPENSES (LINE 27)

All ordinary and necessary business expenses not deducted elsewhere on Schedule C are listed on part V and carry forward to line 27. The type and amount of each expense is listed separately in the space provided. Personal, living, and family expenses, as well as charitable contributions and any fines or penalties paid to a government for violating any law are not deductible as a Schedule C expense.

### Start-Up Costs Deduction<sup>107</sup>

Start-up costs consist of any amounts paid or incurred in association with creating an active trade or business or while investigating the creation or acquisition of an active trade or business. Businesses can elect to deduct up to \$5,000 of certain business start-up costs. The \$5,000 limit is reduced (but not below zero) by the amount by which the total start-up costs exceed \$50,000. Any remaining start-up costs can be amortized over 180 months, beginning with the month the business began.

**Election.** A statement is not required to make the election. A taxpayer can forgo the election by capitalizing the start-up costs on the income tax return filed by the due date (including extensions) for the tax year in which the active trade or business begins. The election to either capitalize or amortize start-up costs is **irrevocable** and applies to all start-up costs related to the trade or business.<sup>108</sup> Taxpayers have six months from the due date of the return (excluding extensions) to file an amended return to make the election. The amended return must have “Filed pursuant to section 301.9100-2” clearly indicated at the top.

**Qualifying Costs.** A taxpayer may amortize a start-up cost if it meets both of the following tests.

- The taxpayer could deduct the cost if they paid or incurred it to operate an existing active trade or business (in the same field as the one the taxpayer entered).
- It is a cost the taxpayer pays or incurs before the day active trade or business begins.

Start-up costs include amounts paid for the following.

- An analysis or survey of potential markets, products, labor supply, transportation facilities, etc.
- Advertisements for the opening of the business.
- Salaries and wages for employees who are being trained and their instructors.
- Travel and other necessary costs for securing prospective distributors, suppliers, or customers.
- Salaries and fees for executives and consultants, or for similar professional services.

Start-up costs do not include deductible interest, taxes, or research and experimental costs.

**Capital Costs.** The costs of getting started in business, before business operations actually begin, are capital expenses. These capital costs may include expenses for advertising, travel, or wages for training employees. After the business owner goes into business, all costs spent to get the business started are treated as capital expenses. Usually, costs for a particular asset are recovered through depreciation. Generally, other costs are not recovered until the taxpayer sells the business or otherwise goes out of business. Certain costs for setting up a business can be amortized.

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<sup>107</sup>. IRS Pub. 535, *Business Expenses*.

<sup>108</sup>. See Treas. Regs. §§1.195-1, 1.248-1, and 1.709-1.

An individual whose attempt to go into business is **unsuccessful** classifies their start-up expenses into two categories.

1. The costs incurred before deciding to acquire or begin a specific business are personal and nondeductible. This includes any costs incurred during a general search for, or preliminary investigation of, a business or investment possibility.
2. The costs incurred in the individual's attempt to acquire or begin a specific business are capital expenses and are deductible as a capital loss.

**Purchasing an Active Trade or Business.** Amortizable start-up costs for purchasing an active trade or business include only investigative costs incurred during a general search for or preliminary investigation of the business. These are costs to help decide whether to purchase a business. Costs incurred while trying to purchase a specific business are capital expenses and are not amortizable.

**Example 25.** On June 1, Carter hired an accounting firm and a law firm to assist him in the potential purchase of Elmer Food, Inc., a food truck. They researched the food truck industry and analyzed the financial projections of Elmer Food, Inc. In September, the law firm prepared and submitted a letter of intent to Elmer Food, Inc. The letter stated that a binding commitment would result only after a purchase agreement was signed. The law firm and accounting firm continued to provide services, including a review of Elmer Food's books and records and the preparation of a purchase agreement. On October 22, Carter signed a purchase agreement with Elmer Food, Inc.

All amounts paid or incurred to investigate Elmer Food before October 22 are amortizable investigative costs. Amounts paid on or after that date relate to the attempt to purchase the business and therefore must be capitalized.

**Disposition of Business.** If the business owner completely disposes of the business before the end of the amortization period, they can deduct any remaining deferred start-up costs. However, the owner can deduct these deferred start-up costs only to the extent they qualify as a loss from a business.

## **BUSINESS USE OF HOME (LINE 30)<sup>109</sup>**

Sole proprietors may claim a home office deduction on line 30 of Schedule C. To qualify to deduct expenses for business use of a home, the taxpayer must use part of their home:<sup>110</sup>

- Exclusively and regularly as their principal place of business;
- Exclusively and regularly as a place to meet or deal with patients, clients, or customers in the normal course of their trade or business;
- In the case of a separate structure that is not attached to the taxpayer's home, in connection with their trade or business;
- On a regular basis for certain storage use;
- For rental use; or
- As a daycare facility.

<sup>109</sup> IRS Pub. 587, *Business Use of Your Home*.

<sup>110</sup> IRC §280A(c).

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## Actual Expense Method

To claim the home office deduction using the actual expense method, the **business percentage** must be calculated.

The business percentage determines the amount of household expenses that can be deducted because they are attributable to the business area of the home. The taxpayer may use any reasonable method to determine the business percentage. A typical method is to compare the area (square footage) of the business-use portion with the total area of the home.

Home office expenses are **fully deductible** without any limitation if gross business revenue exceeds:

- The regular business operating expenses not related to the home (excluding the 50% SE tax deduction), plus
- The business portion of expenses related to the home.

If the home office and other business expenses exceed gross revenue, the deduction for home office expenses is **limited**. When this limitation applies, the taxpayer's business expenses are applied against the business's profits using a set of ordering rules.

**Note.** For more information on the ordering rules, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

## Simplified Method

For tax years starting on or after January 1, 2013, Rev. Proc. 2013-13 provides an optional simplified method that taxpayers can use to determine the amount of deductible expenses attributable to the business use of a residence.<sup>111</sup> The simplified method deduction is limited to **\$5 per square foot of home office space, up to a maximum of 300 square feet**. Therefore, **the deduction is limited to \$1,500 per year**.

**Note.** If the actual office in home square footage is less than 300 square feet, the taxpayer must use the actual square footage. If the actual square footage used is more than 300 square feet, the taxpayer is limited under the simplified method to 300 square feet.

The deduction may not exceed the gross income from the business. Any excess deduction **cannot be carried forward** to the following year.

One advantage of the simplified method is that the home mortgage interest and real estate taxes are not reduced for the business percentage and remain deductible as an itemized deduction assuming the taxpayer is eligible to itemize. Also, taxpayers are **not** required to substantiate the expenses incurred for their home. Another advantage is that there is no depreciation to recapture.

The election to use the simplified method is an annual election that must be made on a timely filed original return using Schedule C. The election is made by using the simplified method on the return. However, once made, **the election is irrevocable for that tax year**.

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<sup>111</sup>. Rev. Proc. 2013-13, 2013-6 IRB 478.

## Practitioner Planning Tip

The simplified method does not allow for the carryover of unused expenses from one year to the next. However, practitioners are advised to review tax returns from prior years to determine if the actual expense method was used previously. A taxpayer who uses the actual expense method following a year in which they used the simplified method must consider any expense carryovers from the year(s) in which they used the actual expense method.

**Depreciation Issues.** Taxpayers who use the simplified method **cannot** deduct any depreciation for the qualified home office for that tax year.

If a taxpayer uses the simplified method for one year and uses the actual expense method for any subsequent year, the taxpayer must calculate the depreciation deduction allowable in the subsequent year by using the appropriate **optional depreciation table** for the property. This is true regardless of whether the taxpayer used an optional depreciation table to calculate depreciation for the property in the year it was placed in service. The optional depreciation tables for modified accelerated recovery system (MACRS) property are provided in IRS Pub. 946, *How To Depreciate Property*. Selecting the appropriate optional depreciation table depends on the depreciation system, depreciation method, recovery period, and convention applicable to the property when it was placed into service.

The allowable depreciation deduction in the subsequent year is calculated by multiplying the remaining adjusted depreciable basis of the home office by the annual depreciation rate specified in the appropriate optional depreciation table. The applicable year to use in the table (e.g., year 1, year 2) is based on the property's placed-in-service date.

**Caution.** Taxpayers who sell their personal residence with a home office should be aware that gain upon the sale may be subject to taxation and or depreciation recapture. See the section on Home Office Refresher in the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

## Impact of TCJA on the Home Office Deduction

**Note.** The TCJA suspends miscellaneous itemized deductions for tax years beginning after 2017 and before 2026.<sup>112</sup> Therefore, the use of a home office by an **employee** of a business is not deductible. However, **self-employed taxpayers** are still eligible for this deduction.

The TCJA implemented a subtle change on the home office deduction that impacts both taxpayers who take the standard deduction and who itemize deductions on Schedule A. The instructions for Form 8829 describe (in part) this change.

***Taxpayers claiming the standard deduction.*** If you claim the standard deduction, you will not include any mortgage interest, mortgage insurance premiums, or real estate taxes on lines 10 and 11; instead, you will claim the entire business use of the home portion of those expenses using lines 16 and 17.

<sup>112</sup> *Tax Cuts and Jobs Act*, PL 115-197, §11045.

# 2021 Workbook

This change impacts taxpayers in several ways.

1. Mortgage interest and real estate tax expenses are now limited to any net income remaining after fully deductible expenses instead of being classified as a fully deductible expenses for taxpayers who choose the standard deduction on their Form 1040.
2. Taxpayers with a business loss cannot increase the loss by the business percentage of mortgage interest, mortgage insurance premiums, and real estate taxes because using the standard deduction moves these expenses from being fully deductible from a business's net income to an expense limited to the amount of any net income remaining after deducting the fully deductible expenses.
3. The TCJA limitation on taxes<sup>113</sup> means real estate taxes claimed on Schedule A are limited to \$10,000. The instructions for Form 8829 describe these changes.

**Real estate taxes reported on line 11.** If you are claiming the standard deduction, do not report an amount on line 11. If you itemize your deductions, figure the amount to include on line 11 as follows.

**Step 1.** If the total of your state and local income (or, if elected on your Schedule A, general sales) taxes, real estate taxes, and personal property taxes is not more than \$10,000 (\$5,000 if married filing separately), enter all the real estate taxes attributable to the home in which you conducted business in column (b) of line 11.

**Step 2.** If you do not meet the condition of Step 1, use the following worksheet to figure the amount to include in column (a) of line 11.

**Note.** The purpose of the Form 8829 worksheet is to determine if the Schedule A \$10,000 limitation for taxes is already met with state and local taxes, such as withholding and the personal part of real estate taxes. If that is the case, the worksheet results in an expense for real estate taxes being permitted as a direct expense for the office use of home percentage.

## Observations.

- The changes prevent taxpayers from a double benefit, i.e., a higher standard deduction and also a direct deduction for the business-use percentage of real estate taxes and mortgage interest. An additional limitation to a double benefit prevents taxpayers from exceeding the \$10,000 Schedule A limitation by believing that no such limitation exists on Form 8829. Thus, the \$10,000 state and local tax limitation encompasses both Schedule A and Form 8829.
- Taxpayers with profitable business activities before consideration of the office use of home are likely less impacted by this change.
- Taxpayers may be better served by electing to use the simplified method.
- As an item of deduction effectively connected with a trade or business, any allowable office in home expense reduces the QBID for the entity.

**Note.** For an in-depth discussion of depreciation options available to taxpayers, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

<sup>113</sup>. *Tax Cuts and Jobs Act*, PL 115-197, §11042(a).

## AT-RISK RULES (LINE 32)

**Note.** Line 32 does not need to be completed if line 7 is more than the total of lines 28 and 30.

The at-risk rules apply to any trade or business or income-producing activity. Under the at-risk rules, a taxpayer can only claim a loss up to the amount for which they are at risk. Taxpayers are at risk for the following.<sup>114</sup>

1. The amount of money plus the adjusted basis of property contributed to the entity
2. The amounts the individual borrowed for use in the entity's activity if the individual either:
  - a. Is personally liable for repayment, **or**
  - b. Has pledged property as security for the debt

The at-risk rules generally limit the amount of loss a taxpayer can claim to the amount they could actually lose in the business (i.e., the amount "at-risk".)

Taxpayers may have amounts invested in the business for which the taxpayer is **not** at risk and for which they check box 32b on Schedule C. Generally, a taxpayer with a business loss and amounts invested in the business for which they are not at risk, must complete Form 6198, *At-Risk Limitations*, to apply a limitation that may reduce the loss. Amounts not at risk include the following noninclusive list.

- Nonrecourse loans used to finance the business, to acquire property used in the business, or to acquire the business that are not secured by the taxpayer's own property (other than property used in the business). However, there is an exception for certain nonrecourse financing borrowed by the taxpayer in connection with holding real property.
- Cash, property, or borrowed amounts used in the business (or contributed to the business, or used to acquire the business) that are protected against loss by a guarantee, stop-loss agreement, or other similar arrangement (excluding casualty insurance and insurance against tort liability).
- Amounts borrowed for use in the business from a person who has an interest in the business, other than as a creditor, or who is related under IRC §465(b)(3)(C) to a person (other than the taxpayer) having such an interest.

### Calculating the Loss

The loss is calculated depending on how much, if any, of the investment is at risk.

**All Investment is At Risk.** If all amounts are at risk in this business, box 32a should be checked. If the taxpayer materially participated and answered "yes" on line G, the loss is not reduced by either the at-risk rules or the passive activity loss (PAL) rules. If the taxpayer did not materially participate and answered "no" on line G, they may need to complete Form 8582 to calculate the loss amount for line 31.

**Some Investment is Not At Risk.** If some investment is not at risk, box 32b should be checked and the at-risk rules apply to the loss. If the taxpayer materially participated and answered "yes" on line G, they must complete Form 6198 to calculate the loss to report on line 31. The PAL rules do not apply. If the taxpayer answered "no" on line G, indicating that they did not materially participate in the activity, the PAL rules may apply. The taxpayer completes Form 6198 to calculate their profit or loss for the at-risk activity. Additionally, Form 8582 may need to be completed to determine the loss to enter on line 31.

**At-Risk Loss Deduction.** Any business loss not allowed in 2020 only because of the at-risk rules is treated as a deduction allocable to the business in 2021.

<sup>114</sup> IRC §465.

# 2021 Workbook

## Excess Business Limitation (EBL)<sup>115</sup>

An EBL is defined as the excess of the taxpayer's aggregate deductions attributable to trades or businesses over the sum of aggregate gross income or gain attributable to trades or businesses plus a threshold amount. The **threshold amount** for a tax year beginning in 2021 is \$262,000 (\$524,000 for MFJ taxpayers).<sup>116</sup> The threshold amount is indexed each year for inflation.

Under the CARES Act, the EBL limitation did not apply for tax years beginning in 2018, 2019, or 2020. **However, the EBL limitation applies for 2021.** Furthermore, under the American Rescue Plan Act (ARPA) EBLs are extended for one more year, through 2026.<sup>117</sup>

**Note.** Detailed information on calculating EBLs can be found in the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Net Operating and Excess Business Losses. Modifications to the EBLs applicable in 2021 are covered in the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments and Volume B, Chapter 6: Small Business Issues.

At the time of publication, the IRS had not released the 2021 Form 461, *Limitation of Business Losses*.

## PART III: COGS<sup>118</sup>

### METHOD(S) USED TO VALUE CLOSING INVENTORY (LINE 33)

Taxpayers can value inventory at cost, the lower of cost or market, or any other IRS-approved method.

### INVENTORY (LINE 35)

Generally, a taxpayer engaged in a trade or business in which the production, purchase, or sale of merchandise is an income-producing factor must take inventories into account at the beginning and end of the tax year.

Small business taxpayers (average annual gross receipts of \$26 million or less for the three prior tax years, and not a tax shelter under §448(d)(3)) can choose not to keep an inventory. However, they must still use a method of accounting for inventory that clearly reflects income. If a taxpayer **decides not to keep an inventory**, they are not treated as failing to clearly reflect income if their method of accounting for inventory treats inventory as nonincidental materials or supplies, or conforms to their financial accounting treatment of inventories. If a taxpayer **chooses to keep an inventory**, they generally must value the inventory each year to determine the COGS on Schedule C.

If the taxpayer accounts for inventories as materials and supplies that are not incidental (explained later), they deduct the amounts paid to acquire or produce the inventoriable items treated as materials and supplies in the year they are first used or consumed in operations.

<sup>115</sup> CARES Act, PL 116-136, §2304; IRC §461(l).

<sup>116</sup> Rev. Proc. 2020-45, 2020-46 IRB 1016.

<sup>117</sup> American Rescue Plan Act, PL 117-2, §9041(a).

<sup>118</sup> Instructions for Schedule C.



## Donated Inventory<sup>119</sup>

A taxpayer who contributes inventory can deduct the smaller of its FMV on the day it was donated or its basis. The basis is any previous costs incurred for the inventory that would otherwise be included in the opening inventory for the year of contribution. The taxpayer must remove the amount of the deduction from opening inventory and it is not part of COGS. If the opening inventory amount did not include the cost of the donated inventory, the basis is zero, and the taxpayer cannot claim a charitable contribution deduction.

**Note.** Taxpayers cannot claim donations on a Schedule C. Any donations to qualified charities are reported on Schedule A. (See the previous discussion regarding Advertising and Solicitations).

**Note.** For discussion on donations of food inventory, see the 2021 *University of Illinois Federal Tax Workbook* Volume A, Chapter 1: New Developments.

## ITEMS WITHDRAWN FOR PERSONAL USE (LINE 36)

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 26.** Betty Lou sells Sarah Sue Cosmetics. She purchases \$30,000 of products in 2020. 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.

## MATERIALS AND SUPPLIES (LINE 38)<sup>120</sup>

Materials and supplies are separated into three categories. These categories determine when taxpayers can deduct the cost of materials and supplies on their returns.

1. Incidental
2. Nonincidental
3. Rotable, temporary, or standby emergency spare parts

### Incidental Materials and Supplies

Incidental materials and supplies are items carried on hand that are not inventoried, nor are records kept regarding their consumption. Examples of incidental supplies include pens, calculators, coffee pots, and toilet paper. Amounts paid to purchase or produce incidental materials and supplies are deducted in the tax year in which they are paid (or the year incurred for accrual-basis taxpayers), if taxable income is clearly reflected.

### Nonincidental Materials and Supplies

Nonincidental materials and supplies are materials and supplies that do not fall into the incidental category. Examples of nonincidental materials and supplies include disposable cups at a coffee shop where the owner counts cups monthly to eliminate shrinkage, and shaving cream at a barbershop where the barber keeps track of the amount of product used weekly. The taxpayer generally deducts the cost of nonincidental materials and supplies when these items are placed in service for business use or when consumed in the taxpayer's operations.

<sup>119</sup> IRS Pub. 526, *Charitable Contributions*.

<sup>120</sup> Treas. Reg. §1.162-3.

# 2021 Workbook

## Rotable, Temporary, or Standby Emergency Spare Parts

Rotable and temporary parts are components used to improve, repair, or maintain a unit of property (UOP) owned, leased, or serviced by the taxpayer. The parts cannot be acquired as part of the taxpayer's purchase of a UOP (e.g., an engine salvaged from another vehicle a taxpayer owns is not considered a spare part because the other vehicle was the UOP). To qualify as a **rotable** spare part, the item must be:

- Acquired for installation on a UOP,
- Removable from that UOP,
- Repairable or improvable, and
- Either reinstalled on a unit of property or stored for later installation.

**Temporary** spare parts are parts used only until a new or repaired part can be installed. Such parts are then removed and stored for later use.

A taxpayer generally acquires **standby** emergency spare parts to prepare for crisis situations when an essential piece of equipment malfunctions. Standby emergency spare parts are considered materials and supplies if they meet all the following criteria.

- Acquired when a particular piece of machinery or equipment is acquired
- Set aside to minimize operational downtime due to equipment failure or emergency
- Readily available for use (located at or near equipment site)
- Directly related to the machinery or equipment it is intended to repair
- Normally expensive
- Must be special ordered (is not readily available)
- Not subject to periodic replacement
- Not interchangeable in another piece of machinery or equipment
- Not acquired in quantity
- Not repaired and reused

Unless an exception applies, the regulations deem that the taxpayer first uses a rotable, temporary, or standby emergency spare part in the tax year in which the taxpayer **disposes** of the part. This may delay deduction of the expense for these parts for quite some time. Applicable exceptions include an election to capitalize the expense for the qualified parts, using an optional method of accounting for **all** rotable and temporary spare parts, and an election to use a de minimis safe harbor.

## Capitalization Versus Repair

To determine whether to write off certain business expenses or depreciate them often requires a critical analysis of facts and circumstances. IRC §162(a) allows taxpayers engaged in a trade or business to deduct ordinary and necessary business expenses. However, IRC §263(a) disallows deductions for buildings and most tangible property improvements. **Improvement** for this purpose is defined as an addition to or partial replacement of property that is a **betterment** to the property, an **adaptation** to a new or different use, or a **restoration** of the property.<sup>121</sup> Instead of deducting these costs, taxpayers **must capitalize** §263(a) enhancements and recover these investments through depreciation.

**Note.** For detailed information about how to distinguish between capitalizations and repairs, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

For further guidance, see Treas. Reg. §1.263(a)-3.

## MANUFACTURING EXAMPLE

The COGS 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 27.** Clay Potts manufactures and sells decorative vases at wholesale. In 2020, 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 2020, 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 COGS for 2020 is \$50,612 (\$45,000 + \$55,612 – \$50,000).

<sup>121</sup> IRS Pub. 946, *How to Depreciate Property*; Treas. Reg. §1.263(a)-3.

# 2021 Workbook

## For Example 27

Schedule C (Form 1040) 2020

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? If "Yes," attach explanation . . . . .  Yes     No

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	<b>Cost of goods sold.</b> 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

## QBID

The TCJA introduced the QBID, which provides a deduction of up to 20% from a noncorporate taxpayer's taxable income, subject to certain limitations. The QBID is available for tax years starting after December 31, 2017, and before January 1, 2026.<sup>122</sup> Income reported on Schedule C may be qualified business income (QBI) and entitle the taxpayer to a QBID on Form 1040 or Form 1040-SR.<sup>123</sup>

For a Schedule C filer, the QBID calculation begins with the amount of income or loss from line 31. QBI is adjusted by any other items of gain, loss, or deduction attributable to the trade or business, including the following nonexclusive items.<sup>124</sup>

- Ordinary gains or losses from Form 4797
- Deductible portion of SE tax
- Self-employed health insurance deductions
- Deductions to a SEP, SIMPLE, or qualified plan

<sup>122</sup> IRC §199A.

<sup>123</sup> Instructions for Schedule C.

<sup>124</sup> *Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs*. Mar. 26, 2021. IRS. [www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs] Accessed on Jul. 10, 2021.

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Amounts a taxpayer received as Form W-2 income, reasonable compensation from an S corporation, guaranteed payments from a partnership, and payments a partner received for services under IRC §707(a) are not QBI to the recipient and are not eligible for QBID.

**Note.** Because of the various adjustments added back to Form 1040 line 31, it is possible for Schedule C to show a net loss and the taxpayer to still qualify for the QBID because the ordinary gain portion from the sale of business use assets is not reported on Schedule C but rather on Form 4797.

**Example 28.** Joshua Carpenter is a building contractor who works around town doing minor construction work, deck building, and repairs through his business Carpenter Buildz. He does not maintain inventory. Carpenter Buildz employs additional laborers on a job-by-job basis. As such, Carpenter Buildz has an EIN for payroll purposes.

Driven by an unexpected increase in the cost of lumber, Carpenter Buildz reports a net loss for 2020 on Schedule C. The business reported the following income and expenses.

Gross receipts		\$100,000
Cost of labor	\$30,000	
Materials and supplies	<u>60,000</u>	
Total COGS	\$90,000	<u>(90,000)</u>
Gross income		\$ 10,000
Expenses:		
Depreciation on truck	\$ 4,800	
Legal and professional fees	500	
Office expense	750	
Machinery rental	2,500	
Supplies	2,000	
Taxes and licenses	1,500	
Tools	<u>1,800</u>	
Total expenses	\$13,850	<u>(13,850)</u>
Net loss		(\$ 3,850)

In September, Joshua sold his F-150 pickup truck that he used in the business for \$35,000. He purchased the truck for \$50,000 in 2018 and claimed total depreciation of \$38,800 (\$34,000 previously claimed + \$4,800 claimed in current year). Form 4797 reports a gain from the sale of \$23,800.

Even though Schedule C, line 31 shows a loss of \$3,850, Joshua's QBID is calculated on \$19,950 (\$23,800 gain on Form 4797 + (\$3,850) loss on Schedule C). After the income limitation, Joshua claims a QBID of \$1,510 on Form 1040. The relevant forms follow.

# 2021 Workbook

## For Example 28

Form **1040** Department of the Treasury—Internal Revenue Service (99) **2020** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

**Filing Status**  Single  Married filing jointly  Married filing separately (MFS)  Head of household (HOH)  Qualifying widow(er) (QW)  
 Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial <b>Joshua</b>	Last name <b>Carpenter</b>	Your social security number <b>001 112 222</b>
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions.  
**97 Main Street 3B** Apt. no.

City, town, or post office. If you have a foreign address, also complete spaces below. State **IL** ZIP code **61801**

Foreign country name Foreign province/state/county Foreign postal code

**Urbana**

Presidential Election Campaign  
 Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.  
 You  Spouse

At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?  Yes  No

**Standard Deduction** **Someone can claim:**  You as a dependent  Your spouse as a dependent  
 Spouse itemizes on a separate return or you were a dual-status alien

**Age/Blindness** You:  Were born before January 2, 1956  Are blind **Spouse:**  Was born before January 2, 1956  Is blind

**Dependents** (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) <input checked="" type="checkbox"/> if qualifies for (see instructions): Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>

	<b>1</b>	Wages, salaries, tips, etc. Attach Form(s) W-2 . . . . .		<b>1</b>	
Attach Sch. B if required.	<b>2a</b>	Tax-exempt interest . . . . .	<b>2a</b>	<b>2b</b>	
	<b>3a</b>	Qualified dividends . . . . .	<b>3a</b>	<b>3b</b>	
	<b>4a</b>	IRA distributions . . . . .	<b>4a</b>	<b>4b</b>	
	<b>5a</b>	Pensions and annuities . . . . .	<b>5a</b>	<b>5b</b>	
	<b>6a</b>	Social security benefits . . . . .	<b>6a</b>	<b>6b</b>	
		<b>7</b>	Capital gain or (loss). Attach Schedule D if required. If not required, check here . . . . . <input type="checkbox"/>		<b>7</b>
	<b>8</b>	Other income from Schedule 1, line 9 . . . . .		<b>8</b>	<b>19,950</b>
	<b>9</b>	Add lines 1, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your <b>total income</b> . . . . . ▶		<b>9</b>	<b>19,950</b>
	<b>10</b>	Adjustments to income:			
	<b>a</b>	From Schedule 1, line 22 . . . . .	<b>10a</b>		
	<b>b</b>	Charitable contributions if you take the standard deduction. See instructions . . . . .	<b>10b</b>		
	<b>c</b>	Add lines 10a and 10b. These are your <b>total adjustments to income</b> . . . . . ▶		<b>10c</b>	
	<b>11</b>	Subtract line 10c from line 9. This is your <b>adjusted gross income</b> . . . . . ▶		<b>11</b>	<b>19,950</b>
	<b>12</b>	<b>Standard deduction or itemized deductions</b> (from Schedule A) . . . . .		<b>12</b>	<b>12,400</b>
	<b>13</b>	Qualified business income deduction. Attach Form 8995 or Form 8995-A . . . . .		<b>13</b>	<b>1,510</b>
	<b>14</b>	Add lines 12 and 13 . . . . .		<b>14</b>	<b>13,910</b>
	<b>15</b>	<b>Taxable income.</b> Subtract line 14 from line 11. If zero or less, enter -0- . . . . .		<b>15</b>	<b>6,040</b>

# 2021 Workbook

## For Example 28

Form 1040 (2020)		Page 2
16	Tax (see instructions). Check if any from Form(s): 1 <input type="checkbox"/> 8814 2 <input type="checkbox"/> 4972 3 <input type="checkbox"/>	603
17	Amount from Schedule 2, line 3	
18	Add lines 16 and 17	603
19	Child tax credit or credit for other dependents	
20	Amount from Schedule 3, line 7	
21	Add lines 19 and 20	0
22	Subtract line 21 from line 18. If zero or less, enter -0-	603
23	Other taxes, including self-employment tax, from Schedule 2, line 10	
24	Add lines 22 and 23. This is your <b>total tax</b>	603
25	Federal income tax withheld from:	
a	Form(s) W-2	25a
b	Form(s) 1099	25b
c	Other forms (see instructions)	25c
d	Add lines 25a through 25c	25d
26	2020 estimated tax payments and amount applied from 2019 return	26
27	Earned income credit (EIC)	27
28	Additional child tax credit. Attach Schedule 8812	28
29	American opportunity credit from Form 8863, line 8	29
30	Recovery rebate credit. See instructions	30
31	Amount from Schedule 3, line 13	31
32	Add lines 27 through 31. These are your <b>total other payments and refundable credits</b>	32
33	Add lines 25d, 26, and 32. These are your <b>total payments</b>	0
<b>Refund</b>		
34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you <b>overpaid</b>	34
35a	Amount of line 34 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/>	35a
▶ b	Routing number	▶ c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings
▶ d	Account number	
36	Amount of line 34 you want <b>applied to your 2021 estimated tax</b>	36
<b>Amount You Owe</b>		
37	Subtract line 33 from line 24. This is the <b>amount you owe now</b> <b>Note:</b> Schedule H and Schedule SE filers, line 37 may not represent all of the taxes you owe for 2020. See Schedule 3, line 12e, and its instructions for details.	603
38	Estimated tax penalty (see instructions)	38

• If you have a qualifying child, attach Sch. EIC.  
• If you have nontaxable combat pay, see instructions.

3

<b>SCHEDULE 1</b> (Form 1040)	<b>Additional Income and Adjustments to Income</b>	OMB No. 1545-0074
Department of the Treasury Internal Revenue Service	▶ Attach to Form 1040, 1040-SR, or 1040-NR. ▶ Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.	<b>2020</b> Attachment Sequence No. 01
Name(s) shown on Form 1040, 1040-SR, or 1040-NR <b>Joshua Carpenter</b>		Your social security number <b>001-11-2222</b>

Part I Additional Income			
1	Taxable refunds, credits, or offsets of state and local income taxes	1	
2a	Alimony received	2a	
b	Date of original divorce or separation agreement (see instructions) ▶		
3	Business income or (loss). Attach Schedule C	3	(3,850)
4	Other gains or (losses). Attach Form 4797	4	23,800
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5	
6	Farm income or (loss). Attach Schedule F	6	
7	Unemployment compensation	7	
8	Other income. List type and amount ▶	8	
9	Combine lines 1 through 8. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8	9	19,950

# 2021 Workbook

## For Example 28

### SCHEDULE C (Form 1040)

Department of the Treasury  
Internal Revenue Service (99)

### Profit or Loss From Business (Sole Proprietorship)

▶ Go to [www.irs.gov/ScheduleC](http://www.irs.gov/ScheduleC) for instructions and the latest information.

▶ Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

**2020**  
Attachment  
Sequence No. **09**

Name of proprietor <b>Joshua Carpenter</b>	Social security number (SSN) <b>001-11-2222</b>
A Principal business or profession, including product or service (see instructions) <b>Construction</b>	B Enter code from instructions ▶ <b>2   3   8   1   9   0</b>
C Business name. If no separate business name, leave blank. <b>Carpenter Buildz</b>	D Employer ID number (EIN) (see instr.) <b>7   7   -   1   1   1   1   1   1</b>
E Business address (including suite or room no.) ▶ City, town or post office, state, and ZIP code	
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶	
G Did you "materially participate" in the operation of this business during 2020? If "No," see instructions for limit on losses . . . <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	
H If you started or acquired this business during 2020, check here . . . <input type="checkbox"/>	
I Did you make any payments in 2020 that would require you to file Form(s) 1099? See instructions . . . <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	
J If "Yes," did you or will you file required Form(s) 1099? . . . <input type="checkbox"/> Yes <input type="checkbox"/> No	

#### Part I Income

1 Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked . . . ▶ <input type="checkbox"/>	1	100,000
2 Returns and allowances . . . . .	2	
3 Subtract line 2 from line 1 . . . . .	3	100,000
4 Cost of goods sold (from line 42) . . . . .	4	90,000
5 <b>Gross profit.</b> Subtract line 4 from line 3 . . . . .	5	10,000
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions) . . . . .	6	
7 <b>Gross income.</b> Add lines 5 and 6 . . . . . ▶	7	10,000

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

8 Advertising . . . . .	8		18	750
9 Car and truck expenses (see instructions) . . . . .	9		19	
10 Commissions and fees . . . . .	10		20	
11 Contract labor (see instructions) . . . . .	11		a	2,500
12 Depletion . . . . .	12		b	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions) . . . . .	13	4,800	21	
14 Employee benefit programs (other than on line 19) . . . . .	14		22	2,000
15 Insurance (other than health) . . . . .	15		23	1,500
16 Interest (see instructions):			24	
a Mortgage (paid to banks, etc.) . . . . .	16a		a	
b Other . . . . .	16b		b	
17 Legal and professional services . . . . .	17	500	25	
18 Office expense (see instructions) . . . . .			26	
19 Pension and profit-sharing plans . . . . .			27a	1,800
20 Rent or lease (see instructions):			27b	
a Vehicles, machinery, and equipment . . . . .			b	Reserved for future use
b Other business property . . . . .			28	13,850
21 Repairs and maintenance . . . . .			29	(3,850)
22 Supplies (not included in Part III) . . . . .				
23 Taxes and licenses . . . . .				
24 Travel and meals:				
a Travel . . . . .				
b Deductible meals (see instructions) . . . . .				
25 Utilities . . . . .				
26 Wages (less employment credits) . . . . .				
27a Other expenses (from line 48) . . . . .				
27b <b>Reserved for future use</b> . . . . .				
28 <b>Total expenses</b> before expenses for business use of home. Add lines 8 through 27a . . . . . ▶	28			13,850
29 Tentative profit or (loss). Subtract line 28 from line 7 . . . . .	29			(3,850)
30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method. See instructions. <b>Simplified method filers only:</b> Enter the total square footage of (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 . . . . .	30			
31 <b>Net profit or (loss).</b> Subtract line 30 from line 29. • If a profit, enter on both <b>Schedule 1 (Form 1040), line 3</b> , and on <b>Schedule SE, line 2</b> . (If you checked the box on line 1, see instructions). Estates and trusts, enter on <b>Form 1041, line 3</b> . • If a loss, you <b>must</b> go to line 32.			31	(3,850)
32 If you have a loss, check the box that describes your investment in this activity. See instructions. • If you checked 32a, enter the loss on both <b>Schedule 1 (Form 1040), line 3</b> , and on <b>Schedule SE, line 2</b> . (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on <b>Form 1041, line 3</b> . • If you checked 32b, you <b>must</b> attach <b>Form 6198</b> . Your loss may be limited.			32a	<input checked="" type="checkbox"/> All investment is at risk.
			32b	<input type="checkbox"/> Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2020



## For Example 28

Schedule C (Form 1040) 2020

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? If "Yes," attach explanation . . . . .  Yes     No

<b>35</b> Inventory at beginning of year. If different from last year's closing inventory, attach explanation . . . . .	<b>35</b>	
<b>36</b> Purchases less cost of items withdrawn for personal use . . . . .	<b>36</b>	
<b>37</b> Cost of labor. Do not include any amounts paid to yourself . . . . .	<b>37</b>	<b>30,000</b>
<b>38</b> Materials and supplies . . . . .	<b>38</b>	<b>60,000</b>
<b>39</b> Other costs . . . . .	<b>39</b>	
<b>40</b> Add lines 35 through 39 . . . . .	<b>40</b>	<b>90,000</b>
<b>41</b> Inventory at end of year . . . . .	<b>41</b>	
<b>42 Cost of goods sold.</b> Subtract line 41 from line 40. Enter the result here and on line 4 . . . . .	<b>42</b>	<b>90,000</b>

### 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 2020, 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? . . . . .  Yes     No

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

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

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

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

Tools		1,800
<b>48 Total other expenses.</b> Enter here and on line 27a . . . . .	<b>48</b>	<b>1,800</b>

Schedule C (Form 1040) 2020



# 2021 Workbook

## For Example 28

Form **4562**  
 Department of the Treasury  
 Internal Revenue Service (99)

### Depreciation and Amortization (Including Information on Listed Property)

OMB No. 1545-0172

**2020**  
 Attachment  
 Sequence No. **179**

▶ Attach to your tax return.

▶ Go to [www.irs.gov/Form4562](http://www.irs.gov/Form4562) for instructions and the latest information.

Name(s) shown on return <b>Joshua Carpenter</b>	Business or activity to which this form relates <b>Schedule C-Carpenter Buildz</b>	Identifying number <b>001-11-2222</b>
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#### **Part I Election To Expense Certain Property Under Section 179**

**Note:** If you have any listed property, complete Part V before you complete Part I.

1 Maximum amount (see instructions) . . . . .	<b>1</b>	<b>1,040,000</b>
2 Total cost of section 179 property placed in service (see instructions) . . . . .	<b>2</b>	
3 Threshold cost of section 179 property before reduction in limitation (see instructions) . . . . .	<b>3</b>	<b>2,590,000</b>
4 Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	<b>4</b>	
5 Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions . . . . .	<b>5</b>	
<b>6</b>		
(a) Description of property	(b) Cost (business use only)	(c) Elected cost
7 Listed property. Enter the amount from line 29 . . . . .	<b>7</b>	
8 Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7 . . . . .	<b>8</b>	
9 Tentative deduction. Enter the <b>smaller</b> of line 5 or line 8 . . . . .	<b>9</b>	
10 Carryover of disallowed deduction from line 13 of your 2019 Form 4562 . . . . .	<b>10</b>	
11 Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions . . . . .	<b>11</b>	
12 Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11 . . . . .	<b>12</b>	
13 Carryover of disallowed deduction to 2021. Add lines 9 and 10, less line 12 ▶ . . . . .	<b>13</b>	

**Note:** Don't use Part II or Part III below for listed property. Instead, use Part V.

#### **Part II Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)**

14 Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year. See instructions . . . . .	<b>14</b>	
15 Property subject to section 168(f)(1) election . . . . .	<b>15</b>	
16 Other depreciation (including ACRS) . . . . .	<b>16</b>	

#### **Part III MACRS Depreciation (Don't include listed property. See instructions.)**

##### Section A

17 MACRS deductions for assets placed in service in tax years beginning before 2020 . . . . .	<b>17</b>	
18 If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here . . . . . <input type="checkbox"/>		

##### Section B—Assets Placed in Service During 2020 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

##### Section C—Assets Placed in Service During 2020 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 30-year			30 yrs.	MM	S/L	
d 40-year			40 yrs.	MM	S/L	

#### **Part IV Summary (See instructions.)**

21 Listed property. Enter amount from line 28 . . . . .	<b>21</b>	<b>4,800</b>
22 <b>Total.</b> Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions . . . . .	<b>22</b>	<b>4,800</b>
23 For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs . . . . .	<b>23</b>	

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 12906N

Form **4562** (2020)

# 2021 Workbook

## For Example 28

Form 4562 (2020)

Page **2**

**Part V Listed Property** (Include automobiles, certain other vehicles, certain aircraft, and property used for entertainment, recreation, or amusement.)

**Note:** For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.

**Section A—Depreciation and Other Information (Caution: See the instructions for limits for passenger automobiles.)**

**24a** Do you have evidence to support the business/investment use claimed?  **Yes**  **No**      **24b** If "Yes," is the evidence written?  **Yes**  **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/Convention	(h) Depreciation deduction	(i) Elected section 179 cost	
<b>25</b> Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use. See instructions .							<b>25</b>		
<b>26</b> Property used more than 50% in a qualified business use:									
<b>F-150</b>	<b>1/01/18</b>	<b>100 %</b>	<b>50,000</b>	<b>50,000</b>	<b>5.0</b>	<b>200DBHY</b>	<b>4,800</b>		
		%							
		%							
<b>27</b> Property used 50% or less in a qualified business use:									
		%				S/L -			
		%				S/L -			
		%				S/L -			
<b>28</b> Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1 .							<b>28</b>	<b>4,800</b>	
<b>29</b> Add amounts in column (i), line 26. Enter here and on line 7, page 1 . . . . .								<b>29</b>	<b>0</b>

**Section B—Information on Use of Vehicles**

3

# 2021 Workbook

## For Example 28

Form **4797**  
Department of the Treasury  
Internal Revenue Service

### Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return.  
▶ Go to [www.irs.gov/Form4797](http://www.irs.gov/Form4797) for instructions and the latest information.

OMB No. 1545-0184

# 2020

Attachment  
Sequence No. **27**

Name(s) shown on return <b>Joshua Carpenter</b>	Identifying number <b>001-11-2222</b>
1 Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions . . . . . <b>1</b>	

**Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)**

2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
3	Gain, if any, from Form 4684, line 39 . . . . .						<b>3</b>
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37 . . . . .						<b>4</b>
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>5</b>
6	Gain, if any, from line 32, from other than casualty or theft . . . . .						<b>6</b>
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows . . . . .						<b>7</b>
<b>Partnerships and S corporations.</b> Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.							
<b>Individuals, partners, S corporation shareholders, and all others.</b> If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.							
8	Nonrecaptured net section 1231 losses from prior years. See instructions . . . . .						
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions . . . . .						<b>9</b>

**Part II Ordinary Gains and Losses (see instructions)**

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):							
11	Loss, if any, from line 7 . . . . .						<b>11</b> ( )
12	Gain, if any, from line 7 or amount from line 8, if applicable . . . . .						<b>12</b>
13	Gain, if any, from line 31 . . . . .						<b>13</b> <b>23,800</b>
14	Net gain or (loss) from Form 4684, lines 31 and 38a . . . . .						<b>14</b>
15	Ordinary gain from installment sales from Form 6252, line 25 or 36 . . . . .						<b>15</b>
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824 . . . . .						<b>16</b>
17	Combine lines 10 through 16 . . . . .						<b>17</b> <b>23,800</b>
18 For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.							
a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions . . . . .						<b>18a</b>	
b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4 . . . . .						<b>18b</b> <b>23,800</b>	

# 2021 Workbook

## For Example 28

Form 4797 (2020)

Page **2**

**Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255**  
(see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
<b>A F-150</b>	<b>1/01/18</b>	<b>9/01/20</b>
<b>B</b>		
<b>C</b>		
<b>D</b>		

		Property A	Property B	Property C	Property D
<b>These columns relate to the properties on lines 19A through 19D. ▶</b>					
<b>20</b> Gross sales price ( <b>Note:</b> See line 1 before completing.) . . . . .	<b>20</b>	<b>35,000</b>			
<b>21</b> Cost or other basis plus expense of sale . . . . .	<b>21</b>	<b>50,000</b>			
<b>22</b> Depreciation (or depletion) allowed or allowable . . . . .	<b>22</b>	<b>38,800</b>			
<b>23</b> Adjusted basis. Subtract line 22 from line 21 . . . . .	<b>23</b>	<b>11,200</b>			
<b>24</b> Total gain. Subtract line 23 from line 20 . . . . .	<b>24</b>	<b>23,800</b>			
<b>25 If section 1245 property:</b>					
<b>a</b> Depreciation allowed or allowable from line 22 . . . . .	<b>25a</b>	<b>38,800</b>			
<b>b</b> Enter the <b>smaller</b> of line 24 or 25a. . . . .	<b>25b</b>	<b>23,800</b>			
<b>26 If section 1250 property:</b> If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
<b>a</b> Additional depreciation after 1975. See instructions . . . . .	<b>26a</b>				
<b>b</b> Applicable percentage multiplied by the <b>smaller</b> of line 24 or line 26a. See instructions. . . . .	<b>26b</b>				
<b>c</b> Subtract line 26a from line 24. If residential rental property or line 24 isn't more than line 26a, skip lines 26d and 26e . . . . .	<b>26c</b>				
<b>d</b> Additional depreciation after 1969 and before 1976. . . . .	<b>26d</b>				
<b>e</b> Enter the <b>smaller</b> of line 26c or 26d . . . . .	<b>26e</b>				
<b>f</b> Section 291 amount (corporations only) . . . . .	<b>26f</b>				
<b>g</b> Add lines 26b, 26e, and 26f . . . . .	<b>26g</b>				
<b>27 If section 1252 property:</b> Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
<b>a</b> Soil, water, and land clearing expenses . . . . .	<b>27a</b>				
<b>b</b> Line 27a multiplied by applicable percentage. See instructions . . . . .	<b>27b</b>				
<b>c</b> Enter the <b>smaller</b> of line 24 or 27b . . . . .	<b>27c</b>				
<b>28 If section 1254 property:</b>					
<b>a</b> Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions . . . . .	<b>28a</b>				
<b>b</b> Enter the <b>smaller</b> of line 24 or 28a. . . . .	<b>28b</b>				
<b>29 If section 1255 property:</b>					
<b>a</b> Applicable percentage of payments excluded from income under section 126. See instructions . . . . .	<b>29a</b>				
<b>b</b> Enter the <b>smaller</b> of line 24 or 29a. See instructions . . . . .	<b>29b</b>				

**Summary of Part III Gains.** Complete property columns A through D through line 29b before going to line 30.

<b>30</b> Total gains for all properties. Add property columns A through D, line 24 . . . . .	<b>30</b>	<b>23,800</b>
<b>31</b> Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13 . . . . .	<b>31</b>	<b>23,800</b>
<b>32</b> Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6 . . . . .	<b>32</b>	<b>0</b>

**Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less**  
(see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
<b>33</b> Section 179 expense deduction or depreciation allowable in prior years. . . . .	<b>33</b>		
<b>34</b> Recomputed depreciation. See instructions . . . . .	<b>34</b>		
<b>35</b> Recapture amount. Subtract line 34 from line 33. See the instructions for where to report . . . . .	<b>35</b>		

Form **4797** (2020)

# 2021 Workbook

## For Example 28

Form **8995**

### Qualified Business Income Deduction Simplified Computation

OMB No. 1545-2294

2020

Department of the Treasury  
Internal Revenue Service

▶ Attach to your tax return.

Attachment  
Sequence No. **55**

▶ Go to [www.irs.gov/Form8995](http://www.irs.gov/Form8995) for instructions and the latest information.

Name(s) shown on return <b>Joshua Carpenter</b>	Your taxpayer identification number <b>001-11-2222</b>
--	---

**Note.** You can claim the qualified business income deduction **only** if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.  
Use this form if your taxable income, before your qualified business income deduction, is at or below \$163,300 (\$326,600 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.

1	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
i	<b>Carpenter Buildz</b>	<b>77-1111111</b>	<b>19,950</b>
ii			
iii			
iv			
v			
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	<b>19,950</b>	
3	Qualified business net (loss) carryforward from the prior year	( <b>0</b> )	
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	<b>19,950</b>	
5	Qualified business income component. Multiply line 4 by 20% (0.20)		<b>3,990</b>
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	<b>0</b>	
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	( <b>0</b> )	
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	<b>0</b>	
9	REIT and PTP component. Multiply line 8 by 20% (0.20)		<b>0</b>
10	Qualified business income deduction before the income limitation. Add lines 5 and 9		<b>3,990</b>
11	Taxable income before qualified business income deduction	<b>7,550</b>	
12	Net capital gain (see instructions)	<b>0</b>	
13	Subtract line 12 from line 11. If zero or less, enter -0-	<b>7,550</b>	
14	Income limitation. Multiply line 13 by 20% (0.20)		<b>1,510</b>
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ▶		<b>1,510</b>
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	( <b>0</b> )	
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	( <b>0</b> )	

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

Cat. No. 37806C

Form **8995** (2020)

## STATUTORY EMPLOYEES AND QBID

Generally, a statutory employee who reports their income on Schedule C qualifies for a QBID.<sup>125</sup> Payments to statutory employees are excluded from the definition of wages considered income from the trade or business of performing services as an employee.<sup>126</sup> Items of income, gain, deduction, and loss from the performance of services as a statutory employee are considered QBI and are eligible for the QBID.

<sup>125</sup> Treas. Reg. §1.199A-2(b)(2); IRS Notice 2018-64, 2018-35 IRB 347.

<sup>126</sup> Ibid.