Chapter 3: Independent Contractors

Note. Corrections were made to this workbook through January of 2024. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

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 Authors

Kelly Golish, CPA, is the Assistant Director, Tax Materials, 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.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

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

One of the most misunderstood issues facing tax preparers is the ongoing struggle with how business owners classify their hired laborers. Technically, there is no choice to make. Rather, there is a determination, and a knowledgeable preparer should be able to explain the determination rules to their client and assist them with proper employee classification. This chapter discusses the proper classification rules and how to apply them, along with other unique areas of interest specific to independent contractors in general. This chapter also addresses rules that apply to construction workers, gig economy workers, and truck drivers where applicable.

Small businesses may struggle to classify an individual working for them without a bright-line test (i.e., a straightforward, objective rule that prevents subjective interpretation). In October 2022, the U.S. Department of Labor proposed a change in regulations supporting the Fair Labor Standards Act (FLSA).[1] Although this proposed regulation focuses on the FLSA rather than tax law, its language aligns with IRS pronouncements on the employee-independent contractor status issue.[2]

> *It is fundamental to the [Labor] Department's obligation to administer and enforce the FLSA, however, that workers who should be covered under the Act are able to receive its protections, as the misclassification of employees as independent contractors remains one of the most serious problems facing workers, businesses, and the broader economy.*

DETERMINING WORKER CLASSIFICATION

Some businesses attempt to classify workers as independent contractors rather than employees. This choice may appear to result in financial savings (employment taxes, benefits, etc.) and administrative savings.

> **Caution.** In addition to tax issues, there may be insurance, liability, and other issues about which other professionals should advise. Tax preparers may want to refer clients to these other professionals for specific advice.

COMMON LAW RULES OF CONTROL

The most fundamental concept to determining whether an individual is an employee or an independent contractor is the issue of **control**. A worker is generally an employee if the business or individual paying the worker controls the circumstances of the service being performed. Conversely, if the worker controls the circumstances of their work, they are typically independent contractors. However, the final determination may depend on other considerations.

A worker is an employee for federal employment tax purposes if the worker qualifies as an employee under common law. Under common law, an employer-employee relationship exists when the firm or person for whom the worker performs the services has the right to control and direct the worker in how the worker performs the services. **Right to control** refers to the degree of control over the means and details of the worker's tasks. Such control is the litmus test of an employer-employee relationship. The employer does not need to exercise this control. Merely having the right to control the worker is sufficient to conclude that the worker is an employee and not an independent contractor.[3]

1. 87 Fed. Reg. 62,218 (Oct. 13, 2022).
2. 87 Fed. Reg. 62,225 (Oct. 13, 2022).
3. Rev. Rul. 87-41, 1987-1 CB 296.

Tax practitioners should review with the business owner the following general common law rules to determine whether the worker is an employee or an independent contractor.[4]

1. **Behavioral –** whether the business owner or the worker controls what the worker does and how the worker does their tasks
2. **Financial –** whether the business owner or the worker controls the business aspects of the worker's job, such as how the worker is paid, if they are entitled to reimbursement, and which party provides the tools and supplies
3. **Relationship** – whether there are written agreements; whether the business provides employee benefits; whether the work performed is a key aspect of the business

20 FACTORS[5]

The IRS uses 20 factors to determine whether a worker is an employee or an independent contractor. The IRS notes that these factors are only a **guide;** each factor's importance depends on each case's circumstances. The following factors indicate the various aspects of a typical work relationship.

1. **Instructions.** An employer instructing the worker about when, where, and how the worker performs work indicates an employer-employee relationship. Independent contractors have more control over their work.
2. **Training and meetings.** Providing worker training and requiring the worker to attend meetings indicates the existence of an employer-employee relationship.
3. **Integration of work performed into firm operations.** Strong integration of the worker's services into the operations of the person who hired the worker indicates an employer-employee relationship.
4. **Personal performance of services.** Employees must personally perform services. The same requirement might not be expected of an independent contractor, although exceptions exist. This factor alone is often not determinative.
5. **Personnel control.** A firm's control over the hiring, supervision, and payment of a worker's assistants suggests an employer-employee relationship. Independent contractors typically maintain and control their staff.
6. **Length of the working relationship.** A continual, long-term work relationship implies an employer-employee relationship. Such a long-term relationship may also exist with an independent contractor. Therefore, this factor alone is not determinative.
7. **Work schedule.** An established work schedule for the worker indicates that an employer-employee relationship exists. Independent contractors generally retain more freedom in scheduling the performance of their services to a firm.
8. **Hours of service required.** Requiring substantially full-time work from the worker in the firm's service indicates an employer-employee relationship. Conversely, part-time hours worked for one firm or person while simultaneously providing services to other firms or persons suggests that the worker may be an independent contractor.
9. **Location of services.** Requiring the worker to perform services at the firm's or person's location suggests an employer-employee relationship. However, this factor alone is not determinative because employees can only perform some types of work at the firm's or person's worksite.

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4. *Independent Contractor (Self-Employed) or Employee?* Apr. 5, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee] Accessed on May 23, 2023.
5. Ibid.

10. **Control over work technique.** Control by the firm or person over the worker's technique or order of tasks indicates that an employer-employee relationship exists. A worker who has control over the technique or task order in the performance of services suggests that the worker may be an independent contractor.

11. **Periodic reporting.** Requiring regular written or verbal reports from the worker to other firm personnel or persons associated with the firm indicates an employer-employee relationship. However, requiring progress reports by an independent contractor is also common. Therefore, this factor alone is not determinative.

12. **Payment method.** Payment at regular intervals (hourly, weekly, or monthly) suggests an employer-employee relationship. Alternatively, payment to the worker based on the job or project or invoices the worker issues suggests an independent contractor relationship.

13. **Work-related expenses.** Payment of the worker's business and travel expenses suggests an employer-employee relationship. However, this arrangement may also exist between a firm or person and an independent contractor. Therefore, this factor alone is not determinative.

14. **Provision of tools.** Tools furnished by the worker indicate that the worker is an independent contractor. If the firm or person provides the worker with tools, this suggests the existence of an employer-employee relationship.

15. **Work facilities.** A worker who invests in and provides work facilities is likely to be an independent contractor, particularly if the facilities are of a type not generally maintained by employees. The lack of investment in facilities indicates the worker's dependence on the firm or person to provide such facilities, suggesting an employer-employee relationship.

16. **Profit potential and risk of loss.** Workers who profit from the success of a business and bear the risk of loss from failure are more likely to be independent contractors than employees. Employers typically pay employees a fixed amount without regard to profits or losses.

17. **Providing services to multiple firms.** An employee tends to provide services to a single firm or person. In contrast, an independent contractor frequently services several firms or persons.

18. **Providing service to the general public.** Workers who regularly and consistently offer their services to the public are more likely to be independent contractors.

19. **Right of discharge.** The firm's right to terminate the worker suggests an employer-employee relationship. If the firm is liable for penalties upon a worker's termination without cause, this indicates a higher degree of worker independence, suggesting the worker is an independent contractor.

20. **Worker's right of termination.** If the worker can terminate the relationship with the firm or person at will without penalty, this indicates an employer-employee relationship.

Note. The IRS's voluntary classification settlement program (VCSP) provides payroll tax relief to employers who are currently treating their workers (or a group of workers) as independent contractors and want to prospectively treat the workers as employees. This amnesty program offers the employer a low-cost way to reclassify their workers.

For more information on the VCSP, its eligibility requirements, and misclassification penalties, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Employment Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Additionally, the IRS answers some frequently asked questions on the VCSP at **uofi.tax/23x3x1** [www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program-vcsp-frequently-asked-questions].

TAX COURT TEST

The IRS outlined its "20-factor" test in Rev. Rul. 87-41. However, the Tax Court is not bound by pronouncements in revenue rulings. The weight the Tax Court gives to a revenue ruling in a case depends upon "the persuasiveness and consistency" of the IRS position over time.[6]

To determine whether a worker is an employee or an independent contractor, the Tax Court considers the following seven factors.[7]

1. The degree of the firm's (or person's) control over the worker
2. The worker's investment in work facilities
3. Profit or loss potential for the worker
4. The degree of ease with which the firm or person can discharge the worker
5. The degree of integration of the worker's services to the firm's (or person's) principal function
6. The temporary or permanent nature of the relationship
7. The parties' understanding of the nature of their relationship

Note. A worker who is properly classified as an independent contractor must pay the full Federal Insurance Contributions Act (FICA) tax, must acquire insurance on their own, may have income eligible for the qualified business income deduction, may have deductible business expenses, might be eligible for certain retirement plans, and may be able to deduct 50% of their health insurance premiums among other impactful items.

FORM 1099-NEC

Business owners who pay independent contractors $600 or more[8] in a calendar year for their services are required to issue a Form 1099-NEC, *Nonemployee Compensation.*[9] The Code excludes the following forms of compensation normally reported in Form 1099-NEC, box 1.[10]

- Payments reported on a 1099-K, *Payment Card and Third-Party Network Transactions,*[11] such as payments via credit card, Venmo, or PayPal

Caution. Unlike Venmo and PayPal, Zelle does not report any transactions to the IRS, even if the total is $600 or more. Therefore, it is the taxpayer's responsibility to report any Zelle payments they receive to the IRS.[12]

- Generally, payments to a corporation or a limited liability company (LLC) treated as a corporation, although exceptions exist
- Payments for merchandise, telephone, freight, storage, and similar items

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6. *Taproot Administrative Services, Inc. v. Comm'r*, 133 TC 202 (2009), *aff'd* 679 F.3d 1109 (9th Cir. 2012).
7. *Herman v. Comm'r*, TC Memo 1986-590 (Dec. 18,1986).
8. IRC §6041(a).
9. Instructions for Forms 1099-MISC and 1099-NEC.
10. Treas. Reg. §1.6041-3; Instructions for Forms 1099-MISC and 1099-NEC.
11. Instructions for Forms 1099-MISC and 1099-NEC.
12. *Does Zelle report how much money I receive to the IRS?* Zelle. [www.zellepay.com/faq/does-zelle-report-how-much-money-i-receive-irs] Accessed on May 23, 2023.

- Payments of rent to real estate agents or property managers
- Wages, including wages paid as bonuses, prizes, or awards to employees, which should be reported on Form W-2, *Wage and Tax Statement*
- Military differential wage payments made to employees during active military duty, as Form W-2 should report these items
- Business travel allowances paid to employees, as Form W-2 typically reports these items
- Cost of an employee's life insurance protection, as this should be reported on Form W-2
- Payments to tax-exempt organizations, including individual retirement arrangements (IRAs), the United States, any state, possession, territory, a foreign government, or a foreign central bank
- Payments made to or for homeowners from the Housing Finance Agency Hardest Hit Fund or equivalent state program, which should be reported on Form 1098-MA, *Mortgage Assistance Payments*
- Compensation as a public safety officer for injuries, sickness, or death of a public safety officer, paid by the U.S. Department of Justice, or received as a survivor's benefit arising from the death of a public safety officer under a state program providing benefits to beneficiaries of public safety officers if they died of injuries sustained in the line of duty
- Compensation paid for wrongful incarceration
- Fees paid to informants about criminal activity if paid by a government entity

Note. All businesses or persons involved in a trade must provide Form 1099-NEC to the provider of the services by January 31 of the year following **payment.**[13]

Example 1. Osage Petroleum Company engages organist Buzz Cantrell to liven up its December holiday party with some organ music. As an independent contractor, Buzz receives an $800 check dated January 4, 2023, one week after his performance. In January 2024, Osage issues Buzz a 2023 Form 1099-NEC.

Note. If the status of the worker is unclear, the worker or the firm can obtain an IRS determination letter resolving this issue. The worker or firm makes a request by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* A firm can request a determination for the status of a single worker or an entire class of workers.

For more information on requesting IRS classification and the Form SS-8, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Employment Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

13. IRC §6041(d).

SELECTED TRADES OR BUSINESSES

Without a bright-line test, special rules guide employment status determination in specific trades or businesses. The nuances for determining the employment status for three types of trades or businesses are described next.

Construction Workers[14]

A 1970 IRS Revenue Ruling revised existing IRS procedures regarding whether a construction worker was considered an employee. Often, construction workers function independently at construction sites, with managers stopping by only occasionally to inspect their work. The following factors may indicate an individual construction worker is an employee.

- The worker does not keep an office or other place of business.
- The worker has a written contract with a construction company, in which the construction worker provides construction labor to build houses, along with all required tools.
- Under the contract, the construction company pays the cost of labor, materials, supplies, building permits, and insurance.
- The contract entitles the worker to pay at a set hourly rate.
- A construction company regularly visits the site to inspect the work, even though they may not work there full-time.
- The worker must act as a superintendent of construction and foreman. They may hire other individuals to assist, although the construction company retains the right to "select, approve, or discharge" any individuals hired by the worker.
- The construction company is responsible for any faults or "defects of construction or wasteful operations," not the construction worker.
- When the construction is complete, the worker is entitled to a bonus equal to a specified percentage of the total construction costs of the project.
- The worker provides a weekly accounting of what they pay workers and other amounts, although the construction worker is not responsible for their wages.

Under these circumstances, the IRS considers the construction worker an **employee** of the construction company, even though the company may not dictate specific work hours, and the worker provides their tools. Although this differs from some of the 20 factors, it reflects the IRS's framework for interpreting construction work agreements. Rev. Rul. 70-618 specifically subjects this construction worker to FICA, the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source of Wages Act.

14. Rev. Rul. 70-618, 1970-2 CB 227.

Gig Economy Workers[15]

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

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, *Profit or Loss From Business* (assuming their activity is undertaken with a profit motive), are responsible for self-employment (SE) taxes, and may need to pay estimated taxes.

> **Note.** For more information on the gig economy, profit motive, and reporting requirements, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Schedule C. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Truck Drivers

Transportation industry workers must abide by specific rules. For someone to be considered a transportation industry worker for tax purposes, their job must meet the following requirements.[16]

- Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck
- Regularly requires traveling away from home and, during any single trip, usually involves traveling to an area or areas eligible for different standard meal allowance rates (explained in detail later). A truck driver is a classic example of a transportation industry worker.

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15. *Gig Economy Tax Center.* Oct. 4, 2022. IRS. [www.irs.gov/businesses/gig-economy-tax-center] Accessed on Mar. 14, 2023; *Manage Taxes for Your Gig Work.* May 19, 2022. IRS. [www.irs.gov/businesses/small-businesses-self-employed/manage-taxes-for-your-gig-work] Accessed on Mar. 14, 2023.

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

Worker Classification.[17] A truck driver is either an employee who receives a Form W-2 or an independent contractor who receives a Form 1099-NEC. A truck driver engaged in business as an **owner-operator** is an independent contractor and, therefore, self-employed.

Determining whether a truck driver is an employee or an independent contractor is essential for tax purposes. Referring to the 20 factors discussed previously, the IRS noted that these factors serve only as a guide and that each factor's importance depends on each case's circumstances. The 20 factors consider a firm's degree of control over a truck driver across various aspects of a typical work relationship.[18]

> **Note.** For further details on how these factors should be applied, see Rev. Rul. 87-41. These factors are not unique to truck drivers; they apply to all payment-for-work relationships. Accordingly, if a truck driver hires someone to work for them, these factors may apply in determining whether that person is an employee or an independent contractor of the truck driver.

The *Peno Trucking, Inc. v. Comm'r* case illustrates the application of these factors in a case involving a trucking company whose workers had contracts specifically stating they were independent contractors.[19] Peno Trucking (PT) owned 15 trucks and leased them to OTC Transport. PT used these trucks to provide OTC with hauling services. PT agreed to provide drivers and to ensure that their work was performed in accordance with the leases. PT hired, fired, disciplined, and supervised the drivers. PT also determined the days the drivers could work and required them to maintain commercial driving licenses, driving logs, and other documents. PT negotiated the rate of pay with each driver. In addition, PT's contract with each driver indicated that it was not possible for the driver to become indebted to PT in any way. PT provided the drivers with necessary equipment, although drivers were free to provide extra equipment at their own cost. PT paid for all fuel, tolls, and truck maintenance and repairs.

To provide the hauling services required by the OTC agreement, PT offered drivers the opportunity to accept hauls each day. A driver was free to decline any haul that was offered. However, if the driver accepted, PT provided directions to the driver regarding pick-up and delivery locations and times. PT provided drivers with beepers to keep in contact with them on the road.

In each driver's contract, PT designated them as an independent contractor. Each year, PT issued each driver a Form 1099-MISC, *Miscellaneous Income,* that reported the driver's annual pay. PT did not withhold federal taxes, social security, or Medicare taxes from any driver's pay.

The Tax Court focused on seven of the 20 factors to conclude that Peno Trucking's drivers were employees, not independent contractors, as the contract provided. The Tax Court concluded the drivers were employees, regardless of language in the drivers' contracts, because of the control that Peno had over them.

> **Note.** For more details on the 20-factor test as it applies to the *Peno Trucking* case, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 6: Special Taxpayers. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

17. Rev. Rul. 87-41, 1987-1 CB 296.

18. Ibid.

19. *Peno Trucking, Inc. v. Comm'r*, TC Memo 2007-66 (Mar. 21, 2007), *rev'd* 296 Fed.Appx. 449 (6th Cir. 2008).

STATUTORY EMPLOYMENT RELATIONSHIPS[20]

Although the 20 factors guide the common law determination of tax status for most workers, explicit provisions in the Code establish a bright-line test for a relatively narrow set of workers. The Code defines the following four types of workers as employees, regardless of their status under common law tests.

1. Corporate officers
2. Agent-drivers or commission-drivers
3. Full-time life insurance salespersons
4. Home workers

Corporate Officers

The Code states that corporate officers are employees without qualification. The supporting regulations leave a small exception if the officers perform only insignificant services for which they receive no compensation.[21]

Agent-Drivers or Commission-Drivers

Drivers who distribute meat, vegetable, fruit, or bakery products are considered employees by explicit Code provision. Although this provision generally includes persons who distribute beverages, it excludes those who distribute **milk**. Drivers distributing laundry or dry-cleaned clothing are specifically designated as employees.

Full-Time Life Insurance Salespersons

The Code stipulates an individual selling life insurance full-time is an employee.[22] The regulations also apply this provision to individuals who sell annuities.[23] However, these regulations exclude individuals who sell other insurance products under their service contracts. In this event, the insurance salesperson is not necessarily a statutory employee but may still be a common law employee under different subsections of IRC §3121. Life insurance salespersons are statutory employees under §3121(d)(3).

Home Workers

Home workers generally perform tasks in their homes for employers who do not have them work on-premises.[24] They work with materials or goods furnished by their employer. Their employers typically provide specifications for the work, and when complete, home workers return the products to the employer or a person whom the employer nominates. Such individuals may manufacture clothing in their homes for merchant tailors.[25] Home workers are statutory employees according to §3121(d)(3)(C).

Home workers perform very different tasks from home **care** workers, who typically perform personal care services for elderly or infirm individuals.

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20. IRC §3121(d).
21. Treas. Reg. §31.3121(d)-1(b).
22. IRC §3121(d)(3)(B).
23. Treas. Reg. §31.3121(d)-1(d)(3)(ii).
24. IRC §3121(d)(3)(C).
25. Rev. Rul. 72-88, 72-1 CB 319.

Other Statutory Workers

Traveling or City Salesperson. An individual soliciting orders from potential customers on their employer's behalf is also an employee by statute.[26] Other parts of the Code and regulations supporting §3121(d) define other workers as nonemployees.

Real Estate Agents. The Code does not regard real estate agents as employees if they satisfy the following criteria.[27]

1. The person is a licensed real estate agent.
2. Substantially all their total compensation, in whatever form received, is based on real estate sales amounts rather than their work hours.
3. The person performs sales services under a **written** contract, which explicitly states the person is not an employee under federal tax law.

This treatment extends to **individuals in the office who recruit, train, and supervise** individuals who make sales.[28] This person may be the owner of the brokerage, but they must satisfy all three requirements to qualify for the employee exclusion. This regulation also clarifies that real estate sales do not include real property management.[29]

> **Example 2.** Sue is the managing broker at which Sam sells real estate. The real estate brokerage primarily sells single-family homes and condominiums. It does not manage properties for investors who have purchased properties through them. Because Sue is also a licensed real estate agent, receives compensation based on Sam's sales, and works under a written contract, she is considered a nonemployee under Prop. Treas. Reg. §31.3508-1(b).

Corporate Directors. Provided that they are also not employees of the same corporation, corporate directors are statutory **nonemployees** under Treas. Reg. §31.3121(d)-1(b), the same regulation that requires the classification of corporate officers as employees. A corporate director represents the interests of the corporation's shareholders, who commonly are not present at corporate board meetings except for very small corporations. This concept underlies the different statutory treatments of corporate officers and corporate directors.

A director of a corporation should receive Form 1099-NEC if they receive $600 or more in a single calendar year. They should report this income on Schedule C attached to their Form 1040, *U.S. Individual Income Tax Return*, where it is subject to SE tax.[30]

> **Example 3.** Henry was elected to the board of directors of the Bedford Falls Savings and Loan Company in January 2022. He attended all four board meetings that year and is not an officer of the corporation. Each director is paid $2,000 for their services at each board meeting. In January 2023, Henry receives a Form 1099-NEC, which reports $8,000 in box 1.

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26. IRC §3121(d)(3)(D).
27. IRC §3508(b)(1).
28. Prop. Treas. Reg. §31.3508-1(b).
29. Ibid.
30. IRS Pub. 17, *Your Federal Income Tax*, p. 72 (2022).

TAX HOME ISSUES

An independent contractor's **tax home** governs the treatment of many expenses on their tax returns, including the deductibility of travel, lodging, and meal expenses. IRC §162 permits a deduction for these expenses based on the logic that a taxpayer incurs duplicated expenses because of the "exigencies [requirements] of business,"[31] but only while away from one's tax home.

HOW TAX HOME IS DETERMINED

A taxpayer's home for business purposes in §162(a)(2) is usually not their residence. Instead, it is "the vicinity of a taxpayer's principal place of business."[32] In some cases, a taxpayer can generally treat their residence as their tax home if their principal place of business is temporary, as distinguished from indefinite.

Although not explicitly mentioned in the Code, the IRS determines the taxpayer's tax home according to the following three classifications.[33]

1. The taxpayer's principal place of business if they have more than a single place of business.
2. If the taxpayer has no regular place of business, then their tax home is their "regular place of abode in a real and substantial sense."
3. If neither 1 nor 2 apply, the IRS considers the taxpayer an itinerant worker having a home wherever they work.

Principal Place of Business

A principal place of business is the location from which a taxpayer plies their trade.[34] They may work for employers or clients at that location or travel to another site designated by the employer or client.[35]

The question of tax home arose from the 1939 Code's allowance of an income tax deduction for "traveling expenses … while away from home in pursuit of a trade or business."[36] In the 1946 *Flowers* case, the U.S. Supreme Court determined that this reference to "home" did not refer to a taxpayer's abode but their "place of business."[37] The Court mentioned that the Tax Court and treasury regulations for the 1939 Code consistently interpret "home" as referring to the taxpayer's "business headquarters" or principal place of business, not their abode or legal residence.

Thus, a tax home is the general vicinity of a taxpayer's principal place of employment. The Code allows an exception if a taxpayer's place of employment temporarily changes for a limited time.[38] In this circumstance, a taxpayer's tax home does not change if the change of employment location is temporary and **not indefinite.**

Sometimes independent contractors must travel directly from their residence to a temporary work location, even if they have a regular or main job.[39] If the taxpayer travels to a temporary location for work expected to last less than a year, their tax home does not change.[40]

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31. *Comm'r v. Flowers*, 326 U.S. 465 (1946).
32. *Geiman v. Comm'r*, TC Memo 2021-80 (Jun. 30, 2021).
33. Rev. Rul. 93-86, 1993-2 CB 71.
34. IRC §280A(c)(1); Rev. Rul. 94-24, 1994-1 CB 87.
35. IRC §162(a)(2).
36. IRC §23(a)(1) (1939).
37. *Comm'r v. Flowers*, 326 U.S. 465 (1946).
38. *Mark R. Pedersen v. Comm'r*, TC Summ. Op. 2022-11 (Jun. 28, 2022), citing *James E. Peurifoy, et al., v. Comm'r*, 27 TC 149 (1956), *aff'd* 254 F.2d 483 (4th Cir. 1957).
39. *James E. Peurifoy, et al., v. Comm'r*, 27 TC 149 (1956), *aff'd* 254 F.2d 483 (4th Cir. 1957).
40. Rev. Rul. 93-86, 1993-2 CB 71.

Example 4. Joe, an independent union plumber, travels between his small office next to the union hall in Savoy, Illinois, to a customer's place of business in Mahomet, approximately 18 miles away. The project is expected to last three months, according to a contract from the general contractor. Joe's small office in Savoy continues to be his tax home because the Mahomet project lasts less than one year. He has a signed contract to substantiate the expected length of his project. In addition, Joe's principal residence and office are in the general vicinity of the project in Mahomet.

Example 5. Use the same facts as **Example 4,** except that Joe takes on a job in Danville, Illinois, which is 39 miles away from his office. Because Joe expects this project to last two weeks, he does not go to the office next to the union hall, and Joe's office in Savoy continues to be his tax home.

Distinguishing Temporary and Indefinite Employment. A tax home changes if the work lasts longer than one year or is indefinite.[41] In these circumstances, the taxpayer's tax home changes to the location where they perform the work. Even if the work unexpectedly lasts less than one year, the taxpayer's tax home changes because they initially expected the work to last one year or longer.[42] The client's ability to terminate the work on very short notice does not alter its indefinite duration or nullify the change in tax home.[43]

Example 6. Use the same facts as **Example 4,** except that Joe's project is in Fort Wayne, Indiana, and is of uncertain length. Because it involves remodeling a large commercial building, Joe can reasonably expect to work on this project for longer than one year. Under these circumstances, Joe's tax home changes to Fort Wayne because his Savoy, Illinois, office is no longer near his work.

Significantly, Joe loses the ability to deduct travel costs, discussed later, from his home in Urbana to the project in Fort Wayne. Even if the client prematurely cancels the remodeling project, Joe's tax home remains in Fort Wayne for the project's duration.

No Separate Principal Place of Business[44]

Sometimes a taxpayer may not have a principal place of business distinct from their residence. In this case, the taxpayer's tax home sometimes is their residence. This arrangement may often be the case for professionals working from their residences or those engaged in the gig economy.

Example 7. Use the same facts as **Example 4,** except that Joe works from his principal residence in Urbana, as he does not have a separate office. Joe uses a small area of his residence regularly and exclusively for managing his business. Joe's principal residence is his tax home.

However, the taxpayer must have a **business** connection with their residence's location. In a 1981 case, the U.S. Court of Appeals for the First Circuit decided that a married law student with a husband and a home in Boston did **not** have a tax home there.[45] While a student at Harvard Law School outside of Boston, she worked a summer job as a law clerk in New York City. Although she had a clear personal tie to Boston, her business tie was to New York City, making that location her tax home, if only for her summer work. The court rejected the argument that her short tenure for summer employment exempted her from the requirement to have a business tie to the place she called home.

41. IRC §162(a).

42. Rev. Rul. 1993-86, 1993-2 CB 71. See situation 2.

43. Ibid.

44. Rev. Rul. 93-86, 1993-2 CB 71; IRS Pub. 463, *Travel, Gift, and Car Expenses*, p. 3 (2022).

45. *Hantzis v. Comm'r*, 638 F.2d (1st Cir. 1981).

No Tax Home[46]

In other circumstances, a taxpayer may not maintain a permanent residence because their work requires full-time travel. If a taxpayer travels full-time and does not maintain a permanent residence, the IRS may consider them **itinerant** workers, having their tax home wherever they may be working. Even if they tend to stay with the same family members in the same location when not working, the IRS and the courts view these individuals as having no home absent a written agreement for paying rent or a share of expenses.

In these circumstances, the taxpayer's tax home is wherever they happen to work, eliminating the possibility of tax deductions for travel expenses. In a dissenting opinion to *Henderson v. Comm'r*,[47] Judge Kozinski coined the term "tax turtle" to describe Mr. Henderson's lack of a fixed residence, even though he generally returned to his parents' home in Idaho when not on the road working as a stagehand. Because he did not incur duplicated living costs, the courts affirmed the IRS's denial of travel costs. Consequently, to establish a tax home and deductible travel costs, taxpayers must incur living costs associated with one's principal residence.

SELECTED TRADES OR BUSINESSES

Tax home concepts affect construction workers, gig economy workers, and truck drivers because their work locations frequently change. This section will focus on the application of tax home to these three respective industries.

Construction Workers

By their very nature, independent contractors work on-site at different locations. Although an independent contractor working in construction may perform bookkeeping work from a single site, they perform very little actual construction work from a fixed location. A construction worker's tax home can readily change if unexpected delays prolong a project beyond the 1-year limit for temporary work.

> **Example 8.** Corey is an electrician and a sole proprietor living in Peoria, Illinois, normally working in the Peoria area. In early 2022, he signs a contract for a project in Bloomington, which is 43 miles from his residence.
>
> When the Bloomington project starts on March 11, 2022, the general contractor tells Corey it will last approximately eight months. However, on November 20, 2022, the general contractor asks him to remain on the project for another five months. Corey does so, completing the project on April 16, 2023.
>
> Corey's assignment in Bloomington starts as temporary but assumes an indefinite status when the general contractor extends it another five months. Because Corey realistically expected the job to last only eight months at its start, it was temporary from March 11 through November 20, 2022. However, due to changed circumstances, Corey could no longer expect the Bloomington project to last for one year or less after November 20, 2022. Therefore, the job has an indefinite duration from November 21, 2022, through the completion date on April 16, 2023.

A recent Tax Court case suggests that the IRS may attempt to undermine construction workers' tacit assertions that their tax homes have not changed and that they are eligible for deduction of travel expenses.[48] In *Pedersen v. Comm'r*, the court sustained the IRS's disallowance of a construction worker's deductions because he did not maintain a copy of an employment agreement or a work schedule that listed his principal place of employment and the job sites to which he was assigned.

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46. IRS Pub. 463, *Travel, Gift, and Car Expenses*, p. 3 (2023).

47. *Henderson v. Comm'r,* 143 F.3d 497 (9th Cir. 1998).

48. *Mark R. Pedersen v. Comm'r*, TC Summ. Op. 2022-11 (Jun. 28, 2022). That Mr. Pedersen was a common law employee does not affect the application of case law to independent contractors in this case.

Practitioner Planning Tip

Tax practitioners may consider advising their clients who are construction workers to insist on receiving **written** assignments with the expected duration for their work. This document, combined with a work schedule and a mileage log, may strengthen the taxpayer's position that the construction worker's tax home changed because their project was expected to be longer than a year or had an indeterminate length.

Gig Economy Workers[49]

A gig is "a job usually for a specified period of time"[50] or "any job, especially one of short or uncertain duration."[51] Most gigs are short-term endeavors, perhaps lasting even less than a day in some cases, such as ride-sharing drivers. In other cases, a gig worker may be engaged to work on a project for several months. As mentioned previously, if a project's expected duration is shorter than one year, the gig worker's tax home does not change from their regular work location. On the other hand, if the duration of the work is unknown, indeterminate, or expected to last 12 months or longer, the gig worker's tax home changes to the location of the work.

Truck Drivers

Generally, a truck driver's tax home is either:

- The principal place of business, such as a terminal, or
- The regular abode (if there is no principal place of business because of the nature of the truck driver's work).[52]

> **Note.** These tax-home rules apply to truck drivers who work as employees or self-employed owner-operators (independent contractors). An employed truck driver's principal place of business is the employer's principal place of business.

If the truck driver performs work at a principal place of business, such as their home terminal, that place of business is their tax home.[53] This concept applies even if the truck driver's principal place of business is also their residence.[54] However, some truck drivers have no identifiable principal place of business but maintain a residence from which employers send them on temporary assignments. This residence is their tax home.[55]

> **Note.** The location of the truck driver's tax home is always subject to a facts and circumstances analysis.[56] Some general rules applied in this analysis are discussed later in this chapter. No clear definition of the term tax home applies to all taxpayers, and the application of the following general rules has been the subject of significant litigation.

49. Rev. Rul. 93-86, 1993-2 CB 71.
50. *Gig*. Merriam-Webster. [www.merriam-webster.com/dictionary/gig] Accessed on Mar. 8, 2023.
51. *Gig*. Dictionary.com. [www.dictionary.com/browse/gig] Accessed on Mar. 8, 2023.
52. Rev. Rul. 75-432, 1975-2 CB 60.
53. Rev. Rul. 55-236, 1955-1 CB 274.
54. IRS Pub. 463, *Travel, Gift, and Car Expenses*.
55. Rev. Rul. 75-432, 1975-2 CB 60.
56. Ibid.

A truck driver's tax home includes the entire city or general area in which they work.[57] Accordingly, the truck driver must be outside this tax-home area to meet the away-from-home requirement.

> **Note.** The extent of the surrounding territory included in the taxpayer's tax home is unclear. For example, various courts have held that the tax-home area includes the entire city or town,[58] the greater metropolitan area of a major city,[59] a county,[60] and even a port area.[61]

Work Assignments. Generally, their main terminal is the tax home for a truck driver who works from there as a principal business location.[62] However, a truck driver may receive an assignment to another post of duty instead of their principal place of business. Such a work assignment may be either temporary or indefinite.

Example 9. Samantha is an independent truck driver who normally drives for Monrovia Transport, LLC (MT). She works each day from MT headquarters near downtown Chicago hauling farm produce to major grocery stores. To facilitate the loading of trucks with goods from ships, MT is headquartered about six miles south of downtown Chicago near piers on Lake Michigan. Samantha lives a few miles away and uses her home office when invoicing MT for her services.

During 2023, Samantha works from MT's Chicago headquarters from January through September. In October 2023, her contact at the company informs her that she would be at the Schaumburg office "for two or three months" because of the increased demand for trucked goods west of Chicago. (Chicago and Schaumburg are both located in Cook County.)

When Samantha's contact informs her of the Schaumburg assignment, she believes that the assignment's end in December 2023 is realistic and that she can expect to resume working in MT's Chicago headquarters in January 2024. However, Samantha resumes working from MT's Chicago headquarters on March 1, 2024. She also incurs additional travel expenses because of her assignment to the Schaumburg terminal, such as mileage and meal costs.

For the first nine months of 2023, Samantha's tax home is MT's headquarters because this is the principal place of business from which she works. MT's headquarters continues to be Samantha's tax home during her assignment to the Schaumburg terminal.

Example 10. Use the same facts as **Example 9,** except MT assigns Samantha to work from its terminal in Champaign, Illinois. (Champaign is approximately 135 miles away from MT's Chicago headquarters.) In addition, before making the assignment, Samantha's supervisor tells her to plan on working from the Champaign location "until the expansion of the Chicago terminal at headquarters is complete, which should take several years."

Champaign is not within the same general area as Chicago for tax home purposes. In addition, the supervisor's statement to Samantha indicates that her Champaign work assignment lasts more than one year. Therefore, Samantha realistically expects the work assignment to be indefinite.

Because Samantha is an independent contractor and not an employee of MT, the facts and circumstances of her engagement with MT and her home office in Chicago likely govern the determination of her tax home. If, instead, Samantha were a common law employee, it is clear that her tax home would shift to Champaign.

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57. Rev. Rul. 60-189,1960-1 CB 60; See *Harry F. Schurer v. Comm'r*, 3 TC 544 (1944); IRS Pub. 463, *Travel, Entertainment, Gift, and Car Expenses*.

58. *Smith v. Comm'r*, 21 TC 991 (1954); *Podems v. Comm'r*, 24 TC 21 (1955).

59. *Amoroso v. Comm'r*, 193 F.2d 583 (1st Cir. 1952), *cert. denied*, 343 U.S. 926 (1952).

60. *J. Summerour v. M. H. Allen*, 99 F.Supp. 318 (M.D. Ga. 1951).

61. *Steinhort v. Comm'r*, 335 F.2d 496 (5th Cir. 1964).

62. Rev. Rul. 55-236, 1955-1 CB 274.

Caution. In this hypothetical example, the IRS has multiple incentives to determine that Samantha is an employee of MT, not an independent contractor. This determination would make Champaign her tax home, eliminating traveling expense deductions (discussed later). The IRS could attempt to collect social security and Medicare on Samantha's **gross** pay, not just the **net** income shown on her Schedule C.

Example 11. Use the same facts as **Example 10,** except Samantha's contact at MT tells her she has been assigned to work from Champaign for the next two months, filling in for another employee on leave. Samantha's Champaign assignment lasts for the anticipated 2-month duration. The assignment is therefore considered temporary. Samantha had a realistic belief in the temporary nature of her assignment, which lasted for one year or less. While Samantha works from Champaign, her tax home continues to be Chicago, potentially permitting the deduction of travel expenses associated with working from the Champaign location if she maintains the required records.

Observation. Realistically believing that a work assignment has a duration shorter than one year is an element of a temporary work assignment. It may be prudent for a truck driver to document reasons for having a belief because that element may become an issue if their travel expenses are subject to an IRS examination. Obtaining a letter from the client or employer or making appropriate notations in a log or journal may provide adequate documentation.

Example 12. Use the same facts as **Example 11.** Samantha works from Champaign for the 2-month temporary assignment during October and November 2023. However, before the end of November, her MT contact extends her Champaign assignment for three months.

Samantha continues working from Champaign during December 2023 and January and February 2024. MT contacts her on February 15, 2024, commending her work and again extending her assignment, this time for the rest of 2024.

MT's communication to Samantha on February 15, 2024, eliminates her realistic belief that her assignment is temporary. **On that date, her assignment becomes indefinite.** However, her work from Champaign before February 15, 2024, is characterized as temporary. Samantha can deduct her travel expenses from October 2021 through February 15, 2024, if she meets the other requirements for deducting travel expenses.

Multiple Work Locations. Some truck drivers work from two or more business or employment locations. Such an individual must determine which location constitutes their tax home to determine if and when they meet the away-from-home requirement for deducting certain travel expenses.

For transportation workers, their tax home is typically the terminal at which they usually begin and end trips. The IRS has deemed that the home terminal and its vicinity comprise the tax home for a long-haul truck driver.[63]

A secondary terminal or location does not constitute a tax home, even if the transportation worker has a personal residence near the secondary location.[64] In this situation, the IRS considers the truck driver away from home even if they maintain a residence at or near the minor business location.

Example 13. Georgina lives in Arlington, Virginia, where Anywhere Logistics, Inc. (AL) employs her as a truck driver. Georgina's job duties consist primarily of completing short-haul assignments directly from AL's warehouse in Washington, DC. However, each Wednesday and Friday at noon, she travels approximately 60 miles round trip between AL's warehouse in Washington, DC, and AL's satellite logistics office in Bethesda, Maryland. While at the satellite office, she performs administrative duties.

The AL warehouse in Washington, D.C., is Georgina's tax home, and she should consider the satellite office within its surrounding general area for tax purposes.

63. Ibid.

64. Rev. Rul. 55-604, 1955-2 CB 49.

SUMMARY

The concept of tax home arises from Congress including a simple and commonly understood word in the Code: "home."[65] The courts and the IRS discerned in Congress's choice of this word the intention to allow a deduction for personal costs duplicated only because of the demands of a taxpayer's business. For this reason, understanding an independent contractor's tax home is the key to understanding what travel expenses are deductible. This understanding also indicates the importance of project duration and the taxpayer's connection to their home.

The expected duration of the employment affects tax home issues, as summarized in the following table.[66]

Projected Length	Tax Home Issue
The project is expected to be completed in less than one year, but it takes longer than one year[67]	Tax home changes to location of the project when expected project duration changes: travel expenses of contractor **not** deductible
The project is expected to last longer than one year[68]	Tax home changes to location of the project: travel expenses of contractor **not** deductible
The project is expected to be completed in less than one year[69]	Tax home does **not** change: travel expenses deductible

GROSS INCOME ISSUES

The IRS defines gross income very broadly.[70]

> *Except as provided in the Internal Revenue Code, gross income includes income from whatever source derived.*

Independent contractors should, therefore, include all gross income.

SELECTED TRADES OR BUSINESSES

Construction Workers

IRS Pub. 5522, *Construction Industry Audit Technique Guide,* provides a framework to understand the nuances of tax accounting for the industry and to familiarize agents undertaking examinations with the industry's practices. This guide reflects the variety of contracts and the different circumstances for recognizing income that the construction industry faces. The length of a construction contract influences the method of accounting for a specific contract. Beyond that, contracts that span multiple tax years raise a plethora of issues affecting how much revenue the taxpayer recognizes in each tax year.

65. IRC §162(a).

66. IRS Pub. 463, *Travel, Gift, and Car Expenses*, p. 3 (2022); Treas. Reg. §1.162-17.

67. IRC §162(a); Rev. Rul. 93-86, 1993-2 CB 71. See situation 3.

68. Ibid. See situation 2; *Norwood v. Comm'r*, 66 TC 467 (1976).

69. Rev. Rul. 93-86, 1993-2 CB 71. See situation 1.

70. Instructions for Schedule C.

Short-Term Contracts.[71] A short-term contract is one that the construction contractor completes within the same tax year that the contract is signed. If the construction contractor uses the cash method, they deduct costs in the year in which they paid them. If the construction contractor uses another method of accounting, such as the accrual method, then they deduct costs in the year of construction, regardless of when paid. The construction contractor treats the related construction costs as current period costs, other than nonincidental materials and supplies, if the construction contractor did not make the de minimis safe harbor election under all accounting methods.

It is common for independent contractors to use the cash method of accounting, particularly if most of their contracts are short-term endeavors. A discussion of the cash method follows the discussion of long-term contracts.

Long-Term Contracts. A contract is long-term when its completion does not fall within the taxpayer's taxable year, such as a contract that a calendar-year taxpayer started in November 2022 and finished in January 2023.[72] Even though the contract lasted less than three months, it is a long-term contract for tax purposes. Treas. Regs. §§1.460-1 through 5 defines the accounting methods permissible for long-term contracts.

The Code requires long-term contracts to use the percentage-of-completion method (PCM), except when the construction worker qualifies as a small contractor or a home builder.[73] Qualifying small contractors (3-year average gross receipts of $29 million for tax years beginning after December 31, 2023)[74] and home builders may use any allowable accounting method, provided they apply it consistently.[75]

Treas. Reg. §1.460-3 adds important commentary and criteria for construction contracts exempt from the PCM mandate. The construction contract must pertain to real estate or property permanently connected to real estate. Thus, a contract for installing an elevator is long-term if the associated work is connected to a building and extends into the following year. The regulations do not provide the same benefit if the construction worker installs the elevator on a ship, which does not qualify as real estate.[76]

The same regulation also excludes small-scale residential construction projects. If a construction company undertakes a project at a single-family home that extends into the next fiscal year, it is not required to use a long-term construction accounting method. The regulation applies not only to single-family homes but also to buildings having fewer than five dwelling units.

Cash Method of Accounting. Construction industry taxpayers are allowed to use the cash method of accounting if they meet the criteria for small businesses and home builders discussed earlier in this section.

Accrual Methods of Accounting. By its nature, the construction industry involves contracts that last from one tax year into the next, enabling a variety of options for recognizing revenue before a contract is completed. PCM is the most common method, in addition to the completed-contract method (CCM) and the exempt-contract percentage-of-completion method (EPCM). All three methods are discussed next.

PCM. Generally, construction contractors must use the PCM to account for long-term revenue.[77] The amount of revenue earned each year by a contract is determined by multiplying the estimated total contract price times the percentage of completion at the end of the tax year, less any income recognized in the prior tax years of the contract. Firms may elect to defer both revenue and costs until the contract has incurred 10% of the total estimated allocable costs.[78]

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71. IRS Pub. 5522, *Construction Industry Audit Technique Guide*.

72. Ibid.

73. Treas. Reg. §1.460-3(b)(1).

74. Treas. Reg. §1.460-3(b)(3). The threshold stated is for $27 million in 2022 and $29 million in 2023, adjusted for inflation from $25 million in 2018; IRC §448(c)(1); Rev. Proc. 2022-38, 2022-45 IRB 445.

75. Treas. Reg. §1.460-4(c).

76. Treas. Reg. §1.460-3(a).

77. IRC §460(a).

78. IRC §460(b)(5); IRS Pub. 5522, *Construction Industry Audit Technique Guide,* pp. 81-82 (2021).

Although the PCM recognizes revenue based on a construction project's **degree of completion**, there are two methods of computing this percentage.

1. **Cost-to-Cost Method.**[79] Large contractors must use the cost-to-cost PCM to determine the degree of completion.[80] They may not use engineering estimates or other approaches to determine the degree of completion.

   Construction contractors compute the percentage of completion under the cost-to-cost method by dividing the total cumulative costs incurred by the estimated total contract costs.[81]

$$\text{Percentage of completion} = \frac{\text{Total cumulative costs incurred to date}}{\text{Estimated total contract costs}}$$

   The costs incurred to measure the percentage of completion must include specially ordered materials and supplies for a project. Total costs cannot include contingency reserves.

   Because the calculation of **revenue** under PCM depends on the allocation of costs, tax practitioners must consider the following costs when a construction worker uses the PCM, either by choice or requirement.

   - **Direct Material Costs.**[82] All direct material costs which become an integral part of the finished project and all materials consumed in the ordinary course of completing the project must be allocated to the contract.

     Direct material costs include the invoice price for the materials minus any discounts taken plus transportation or other necessary charges incurred to acquire possession of the goods.[83] They also include materials provided by subcontractors.

     The costs of direct materials and supplies purchased specifically for a particular long-term contract are allocable to the contract in the taxable year in which such costs are incurred.[84] The costs of other direct materials and supplies (such as those previously held by the taxpayer) are allocable to the contract in the taxable year in which such materials and supplies are dedicated to the contract.[85]

   - **Direct Labor Costs.**[86] All direct labor costs identified or associated with a long-term contract must be allocated to the contract. The elements of direct labor costs include basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. The cost of labor supplied by subcontractors is also a direct labor cost.

   - **Cost-Plus and Federal Contracts.**[87] All costs specifically identified by the terms of a **cost-plus contract** (agreement for reimbursement of a project's expenses plus an additional fee) and by federal, state, or local laws and regulations must also be allocated to cost-plus and federal contracts, respectively. These costs can include the time value of money if the contract includes an associated charge.

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79. IRS Pub. 5522, *Construction Industry Audit Technique Guide*, pp. 72–78 (2021).
80. IRC §460(b)(1)(A); Treas. Reg. §1.460-4(b).
81. IRC §460(b); Treas. Reg. §1.460-4(b).
82. Treas. Reg. §1.460-5(b)(2).
83. Treas. Reg. §1.263(a)-2(d)(1).
84. IRC §460(c)(1).
85. Treas. Reg. §1.460-5(b)(2)(i).
86. Treas. Regs. §§1.263A-1(e)(2)(i)(B) and 1.263A-1(e)(3)(ii)(D).
87. IRC §460(c)(2); Treas. Reg. §1.460-5(b)(2)(iv); IRS Pub. 5522, *Construction Industry Audit Technique Guide*, p. 80 (2021).

- **Indirect Costs.**[88] Indirect costs include all costs other than direct material and labor costs. Some indirect costs may benefit both the long-term contract activity of the taxpayer and other business activities of the taxpayer.[89] Accordingly, these costs require a reasonable allocation between the portion attributable to each long-term contract and the portion attributable to the other business activities of the taxpayer.

  Indirect costs must be allocated to a long-term contract by either the specific identification method or using burden rates such as ratios based on direct cost or hours.

The **indirect** costs **requiring allocation to long-term contracts of large contractors** include the following.[90]

a. Indirect supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay, shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan

b. Officers' compensation

c. Stock bonus, pension, profit-sharing, or annuity plan contributions or other plans deferring the receipt of compensation

d. Employee benefit expenses paid or accrued on behalf of labor

e. Indirect materials and supplies

f. Purchasing and handling costs

g. Storage costs

h. Depreciation and amortization on equipment and facilities

i. Depletion, whether or not in excess of cost

j. Rent

k. Taxes attributable to labor, materials, supplies, equipment, or facilities

l. Insurance on equipment, facilities, materials, and so forth

m. Utilities

n. Repairs and maintenance of equipment or facilities

o. Engineering and design costs, including preproduction costs, excluding experimental costs

p. Experimental expenses directly attributable to a long-term contract in existence at the incurrence of the expenses[91]

q. Rework labor, scrap, and spoilage

r. Tools and equipment not capitalized

s. Cost of quality control and inspection

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88. Treas. Reg. §1.263A-1(e)(3).

89. IRS Pub. 5522, *Construction Industry Audit Technique Guide*, p. 74 (2021).

90. Treas. Reg. §1.263A-1(e)(3); IRS Pub. 5522, *Construction Industry Audit Technique Guide*, pp. 73–74 (2021).

91. Treas. Reg. §§1.263A-1(e)(3)(ii)(P) and 1.263A-1(e)(3)(iii)(B).

t. Bidding expenses incurred in soliciting a long-term contract awarded to the taxpayer.[92] If the taxpayer does not win the contract, bidding costs are deductible when there is hard evidence that the taxpayer's bid is not accepted.[93]

u. Licensing and franchise costs

v. Administrative costs directly attributable to the long-term contract

w. Direct and indirect costs incurred by any service, administrative, or support function to the extent such costs are allocable to a long-term contract

Costs not requiring allocation to long-term contracts include the following.[94]

a. Marketing, selling, and advertising expenses

b. Research and experimental expenses that are not directly attributable to an agreement in existence at the time the expenses are incurred

c. The cost of assets deducted under IRC §179

d. Casualty, theft, and capital losses[95]

e. Depreciation and amortization on temporarily idle equipment and facilities. An asset used in construction is idle when it is not en route to or located at a job site.

f. Income taxes

g. Costs attributable to strikes

h. Warranty and product liability costs

i. Bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer

There is a table of these costs later in this section, summarizing the treatment of them under different accounting methods.

2. Simplified Cost-to-Cost Method.[96] Construction workers who are independent contractors using the PCM for all long-term contracts may use a simplified cost-to-cost method. However, they cannot use the simplified method if they elect not to report contracts less than 10% complete. A further restriction applies to those using the percentage-of-completion/capitalized-cost method (PCCM) for residential construction contracts, discussed later.

Under the simplified cost-to-cost method, the determination of the percentage of completion consists of only the following costs.

- Direct material costs and direct labor costs (including subcontractors)
- Depreciation and amortization on equipment and facilities directly related to the construction project

A taxpayer using the simplified cost-to-cost method must use the same costs in determining the costs allocated to the contract, the costs incurred before the close of the taxable year, and the estimated total contract cost.

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92. Treas. Reg. §1.263A-1(e)(3)(ii)(T).
93. Treas. Reg. §1.263A-1(e)(3)(iii)(J).
94. Treas. Reg. §1.263A-1(e)(3)(iii).
95. Treas. Reg. §1.263A-1(e)(3)(iii)(D).
96. Treas. Reg. §1.460-5(c).

Practitioner Planning Tip

Once a taxpayer elects this method, they must use it for all subsequent long-term contracts.[97] They must also use it for subsequent alternative minimum tax (AMT) and look-back method calculations.

CCM.[98] The CCM is an alternative to the PCM for long-term contracts, as it enables eligible construction workers to defer recognition of income and expenses until they have completed the contracts. It is available to construction contractors who qualify for the small contractor exception, which applies if the contractor's annual average revenue in 2023 is under $29 million (indexed for inflation) for the last three years combined.[99]

Example 14. Franklin is an independent contractor in the construction industry with gross receipts for the 2020–2022 tax years equaling $22 million, $28 million, and $13 million, respectively. Franklin's annual average revenue for the last three years is $21 million (($22 million + $28 million + $13 million) ÷ 3 = $21 million). Franklin can use the CCM per the gross receipts test.

When the contract is complete, the construction worker recognizes income. The Code gives the word "complete" a special meaning, being the **earlier** of the following two dates.[100]

1. Final completion and acceptance of the subject of the contract; or
2. The construction worker's customer has used the subject of the contract for its intended purpose, **and** the construction worker has incurred at least 95% of the contract costs associated with the contract.

Example 15. Use the same facts as **Example 14,** except that Franklin signs a contract to build a small office building for a consulting engineer on January 15, 2022. The contract amounts to $500,000, and Franklin plans for $420,000 in costs, including cost allocations. The consulting engineer occupies the building on December 15, 2022, even though some uncompleted items were on the punch list. The costs associated with the incomplete items are only $6,300, or 1.5% of the total costs associated with the contract. Franklin completes these items in January 2023, and the consulting engineer accepts the project and arranges with their mortgagee to pay Franklin on January 15.

Because the customer of the contract had occupied the building for its intended use and the construction contractor has incurred at least 95% of the allocable contract costs, the contractor must recognize the revenue for the project in 2022, even though the consulting engineer did not pay him until January 15 of the following year.

The costs that Franklin must include in the allocation of construction costs are identified in the second column from the right in the *Allocation of Costs to Contracts* table, as shown later. The costs incurred govern the amount of revenue to recognize.

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97. Ibid.
98. Treas. Reg. §1.460-4(d).
99. Treas. Reg. §1.460-3(b)(3). The threshold stated is for $27 million in 2022 and $29 million in 2023, adjusted for inflation from $25 million in 2018; IRC §448(c)(1); Rev. Proc. 2022-38, 2022-45 IRB 445.
100. Treas. Reg. §1.460-1(c)(3)(i).

EPCM.[101] The Code exempts certain taxpayers from the requirement to use the PCM for recognizing revenue. Under the EPCM, construction contractors report expenses in the year incurred and revenues in proportion to the amount of the contract completed. Taxpayers can apply EPCM to any of the following exempt construction contracts.[102]

- Exempt construction contracts as defined in Treas. Reg. §1.460-3(b) for post-completion-year income
- The non-PCM portion of a qualified ship contract, as defined in Treas. Reg. §1.460-2(d)
- The non-PCM portion of a residential construction contract, as defined in Treas. Reg. §1.460-3(c)

These contractors calculate the current year revenue by multiplying the estimated total contract price times the percentage of completion at the end of the tax year and subtracting any recognized revenue in the prior tax years of the contract.

$$\textbf{Current year revenue} = \textbf{Estimated total contract price} \times \textbf{Percentage of completion} - \textbf{Prior year revenue}$$

The EPCM gives the construction contractor flexibility in choosing how to calculate the percentage of completion, provided the method clearly reflects income. They can determine the percentage of completion **at the end of the tax year** by either of the following methods.[103]

- **Cost Comparison Method.** The cost comparison method uses the ratio of the costs incurred at the end of the tax year to the estimated total contract costs for each contract. A taxpayer can use any cost comparison, provided they use the method consistently for that contract. The three most common types of cost comparisons include:
  1. Contract costs compared to total estimated contract costs
  2. Direct labor costs compared to total estimated direct labor costs
  3. Direct labor hours compared to total estimated direct labor hours
- **Work Comparison Method.** The work comparison method compares, as of the end of the taxable year, the work the taxpayer performs on the contract with the estimated total work the taxpayer expects to perform. Examples of this method include measuring output based on units produced, units delivered, phases completed, and value added.

Practitioner Planning Tip

Practitioners should include change orders in the EPCM calculation and exclude nondeductible expenses and allowances for contingencies.[104]

101. Treas. Reg. §1.460-4(c)(2).
102. Treas. Reg. §1.460-4(c)(1).
103. Treas. Reg. §1.460-4(c)(2)(i).
104. Treas. Reg. §1.460-4(b)(5)(iii).

AMT.[105] Many small construction independent contractors, other than those involved in home construction, must compute alternative minimum taxable income (AMTI) using the PCM. This adjustment for AMT is also subject to look-back rules (defined under large contractors) for long-term contracts, which a taxpayer reports on line 2p of part I, Form 6251, *Alternative Minimum Tax*.

Residential Construction Contractors.[106] A residential construction contract is a home construction contract where the buildings contain more than four dwelling units each. A taxpayer may report income for this type of long-term contract using either the PCM or the PCCM. Under the PCCM, the calculation of 70% of the reportable income uses PCM, and the remaining 30% uses any other permissible method.[107]

> **Note.** For more discussion on construction industry issues, see the 2003 *University of Illinois Federal Tax Workbook,* Chapter 2: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Land Contracts. Construction contracts are exempt from the long-term contract revenue recognition rules if the contractor sells land and the construction costs constitute less than 10% of the contract's value.[108] The calculation of construction costs includes a portion of the construction cost of a "common improvement." This requirement applies regardless of whether the contractor's obligation to construct the common improvement arises from the contract or a legal requirement.

Allocation of Costs to Contracts. The following table compares the allocation of costs to contracts for revenue purposes across various methods of accounting for long-term contracts.

105. IRC §56(a)(3); Treas. Reg. §§1.56-1(c)(1) and 1.460-4(f).

106. IRC §460(e)(4); Treas. Regs. §§1.460-1(a)(2)(ii) and 1.460-3(c).

107. Treas. Reg. §1.460-4(e).

108. Treas. Reg. §1.460-1(b)(2)(ii).

Allocation of Costs to Contracts for Revenue Purposes Under Different Methods of Accounting for Long-Term Contracts

	PCM	PCM Simplified	CCM	EPCM
Authority	Treas. Reg. §1.460-5	Treas. Reg §1.460-5	Treas. Reg §1.460-5	Treas. Reg §1.460-4
Who may use	Anyone	[a]	[b]	[b]
Direct costs				
Materials	Yes	Yes	Yes	Electable
Labor	Yes	Yes	Yes	Electable
Subcontracts	Yes	Yes	Yes	Electable
Indirect Costs				
1. Indirect supervisory wages (and related costs)	Yes	No	Yes	Electable
2. Officers' compensation	Yes	No	Yes	Electable
3. Deferred compensation plans	Yes	No	No	Electable
4. Employee benefits	Yes	No	No	Electable
5. Indirect materials and supplies	Yes	No	No	Electable
6. Purchasing and handling	Yes	No	No	Electable
7. Storage	Yes	No	No	Electable
8. Depreciation and amortization on production assets	Tax	Tax	Financial	Electable
9. Depletion (whether or not in excess of cost)	Yes	No	Cost only	Electable
10. Rent	Yes	No	Yes	Electable
11. Taxes	Yes	No	Yes	Electable
12. Insurance	Yes	No	Yes	Electable
13. Utilities	Yes	No	Yes	Electable
14. Repairs and maintenance of production assets	Yes	No	Yes	Electable
15. Engineering and design	Yes	No	No	Electable
16. Contract-related research	Yes	No	No	Electable
17. Rework labor, scrap, and spoilage	Yes	No	No	Electable
18. Tools and equipment (not capitalized)	Yes	No	Yes	Electable
19. Quality control and inspection	Yes	No	Yes	Electable
20. Successful bidding	Yes	No	No	Electable
21. Unsuccessful bidding	No	No	No	Electable
22. Licensing and franchising	Yes	No	No	Electable
23. Administrative costs (attributable to long-term contracts)	Yes	No	No	Electable
24. Marketing, selling, and advertising expenses	No	No	No	Electable
25. Research (not contract related)	No	No	No	Electable
26. Cost of assets deducted under IRC §179	No	No	No	Electable
27. Casualty, theft, and capital losses	No	No	No	Electable
28. Depreciation and amortization on idle assets	No	No	No	Electable
29. Income taxes	No	No	No	Electable
30. Costs attributable to strikes	No	No	No	Electable
31. Warranty and product liability costs	No	No	No	Electable
32. Interest	[c]	[c]	[c]	[c]
33. Costs identified in contract or in law	Yes	No	No	Electable

[a] Anyone who uses PCM for all long-term contracts and who has not elected to defer contracts less than 10% complete. Excludes residential developers using PCCM, under which 70% of revenue is calculated using PCM and 30% another method.

[b] Small contractors: contract shorter than 24 months and contractors having average annual gross receipts under $29 million (2023).

[c] Depends on the length and total cost of the contract.

Gig Economy Workers[109]

Gig workers perform a variety of unconventional services and may receive income in a variety of unconventional forms. Taxpayers must report gig income regardless of whether the income arises from part-time or temporary work and regardless of whether customers pay taxpayers in currency, property, or digital assets. Even in situations where the taxpayer does not receive a Form W-2 or 1099 for this income, they must report it as income on their tax return unless one of the few statutory exceptions applies.[110]

> **Example 16.** In December 2022, Maggie signs a contract to provide a website for her landlord, Waterford Apartments, LLC. Waterford's managing member is familiar with her work at a local advertising firm. Maggie's work must start in January 2023 and be complete by June 30, 2023. The landlord agrees that Maggie does not need to pay rent during this time. This rent forgiveness is barter income. Maggie is responsible for reporting the value of six months' rent on her 2023 tax return.

There are no specific rules and guidelines for whether a gig worker must use either the cash or accrual method of accounting. The facts and circumstances of the situation should guide the taxpayer in making their choice. The circumstances include prevalent practices in the taxpayer's industry.

Truck Drivers

Method of Accounting. As with all businesses, truckers with their own businesses must decide whether they should use the cash method of accounting or the accrual method. The cash method provides an indication of a business's cash flow. Although it has additional complexities, the accrual method may provide greater insight into the company's financial operations.

Lumper Fees. Laborers who receive payment to load and unload containers are referred to as lumpers. Lumpers often work independently of trucking companies, although employee drivers can perform loading and unloading services for additional compensation.

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109. *IRS Tax Tip 2023-42: All income is taxable, including gig economy and tip income*. Mar. 30, 2023. IRS. [www.irs.gov/newsroom/all-income-is-taxable-including-gig-economy-and-tip-income] Accessed on Apr. 10, 2023.

110. IRC §61(a).

TREATMENT OF EQUIPMENT

The way independent contractors treat equipment for tax purposes is a key issue because ownership of equipment is one of the indices of their status as an employee or a contractor. Independent contractors tend to own the equipment they use because they make their own investments and have a profit motive and have risk of loss. In this section, the assumption is that the equipment is either personal property (as opposed to real property) or intangible property, such as software.

CAPITALIZATION OF EQUIPMENT AND DEPRECIATION

In general, taxpayers must capitalize equipment they purchase for use in their trade or business and depreciate it.[111] The cost would normally not be deductible in the year the asset is placed in service unless it is available for bonus depreciation[112] or §179 expense.

> **Note.** Depreciation is covered in greater detail in the 2023 *University of Illinois Federal Tax Workbook,* Chapter 7: Depreciation. For more information on capitalization issues, including the safe harbor election under Treas. Reg. §1.263(a)-1(f), see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 2: Capitalization vs. Repair Review.

Regular Depreciation

A taxpayer can recover the equipment's cost through regular depreciation before the property's disposition. The Code subjects independent contractors to the same depreciation rules as all other taxpayers. An independent contractor reports their depreciation expense on line 13 of Schedule C, unless a portion is attributable to the cost of goods sold.[113]

Regular depreciation is not used unless the taxpayer chooses not to use bonus depreciation for the class of the asset under consideration[114] or §179 expense. If bonus depreciation is available for the asset class, it must be used to recover the newly acquired asset's cost unless the taxpayer elects to forgo it.

Bonus Depreciation

A taxpayer may use bonus depreciation to recover the equipment's cost. This choice is not an election; instead, it is the default option. For equipment placed in service before January 1, 2023, a taxpayer could deduct 100% of the amount for the tax year the property was placed in service.[115] Starting with that date, the rate declines 20% per year. As a result, the maximum bonus depreciation available for assets placed in service during 2023 is **80%.** After January 1, 2027, bonus depreciation is no longer available, except for property with longer production periods.[116]

> **Caution.** The decision to opt out of bonus depreciation is made on a class-by-class basis, not for an individual asset. A tax practitioner should review other units of property in the same class to determine if the election to forgo bonus depreciation is in the client's best interests.

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111. IRC §167(a).
112. IRC §168(k).
113. Treas. Reg. §1.263A-1(e)(3)(ii)(I); See Instructions for Schedule C.
114. IRC §168(k)(7).
115. IRC §168(k)(6)(A)(i).
116. IRC §§168(k)(2)(B), (2)(C), and (7)(B).

IRC §179 Expense

IRC §179 provides an alternative method of cost recovery available. Similar to bonus depreciation mentioned previously, taxpayers can generally elect to recover the cost of the equipment with §179 expense deduction in the tax year they place the equipment in service.[117] There are some caveats, however.

- The property must be either tangible property under IRC §168 or computer software and treated as IRC §1245 property.[118]
- Special limits apply to passenger vehicles.[119]
- The deduction is limited to net income from a trade or business.[120]

The annual limit for the deduction is indexed for inflation. For assets placed in service during 2023, §179 expensing is available if the total cost of elected §179 expense does not exceed $1,160,000.[121] Additionally, when assets placed in service during 2023 exceed $2,890,000, the limit under §179(b)(1) is reduced from $1,160,000 dollar for dollar.[122] If business use of a §179 asset decreases to 50% or less of total usage, the taxpayer must recapture some amount of the prior §179 depreciation.[123]

> **Note.** For more information on §179 expense, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 7: Depreciation.

Example 17. Laura has two businesses, one that purchased §179 qualified property of $100,000 and another that purchased §179 qualified property of $1,050,000 in 2023. These transactions do not limit the amount of the potential §179 expense because the total ($1,150,000) is less than the annual limit.

Qualifying and Eligible Property. **Eligible** property is either tangible personal property, subject to §168, or computer software, defined in IRC §197(e)(3)(B). The property must also qualify as §1245 property or meet tests in §§1245(a)(3)(B) – (E).

Once a property is determined to be eligible, it must also be **qualifying.** The property can fail this test in either of two ways.

- Less than 50% is used in trade or business[124]
- It was acquired from a related person, where "related" is defined broadly by IRC §§267(b) or 707(b)[125]

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117. IRC §179(a).
118. IRC §179(d)(1).
119. IRC §179(b)(5).
120. IRC §179(b)(3).
121. Rev. Proc. 2022-38, 2022-45 IRB 445, providing the annual limit for §179 expense under IRC §179(b)(1).
122. Rev. Proc. 2022-38, 2022-45 IRB 445, providing the annual limit for §179 expense under IRC §179(b)(2).
123. Treas. Reg. §1.791-1(e).
124. Ibid.
125. IRC §179(d)(2)(A).

Thus, not only is property acquired from a relative ineligible for §179 treatment, but so also are the following.

- Inherited property[126]
- Property acquired from a trustee when a taxpayer is a beneficiary of that trust[127]
- Property exchanged between an executor of an estate and a beneficiary unless the property is part of a pecuniary bequest[128]
- Property distributed from a partnership or an S corporation in which a taxpayer owns an interest[129]

Advantages of Using §179 Expense. Independent contractors usually can choose between using §179 expensing and bonus depreciation. As mentioned previously, starting January 1, 2023, bonus depreciation can only be taken for 80% of an asset's adjusted basis, while the full basis can be deducted for §179 purposes. An independent contractor may realize a few other benefits.

- For an independent contractor with significant fourth-quarter purchases, §179 expensing may prevent triggering the mid-quarter convention.[130]
- The §179 expense deduction permits a taxpayer to select some assets to be chosen for the deduction while excluding others.[131] In contrast, bonus depreciation requires that all assets acquired during a tax year be subject to bonus depreciation.[132] By electing the §179 expense deduction for specific assets, instead of including an entire class, it facilitates taxpayers determining more precisely their deductions, and, consequently, their taxable income.
- It may increase the maximum Roth IRA contribution for which a taxpayer having income just over the phase-out range is eligible.[133]

EQUIPMENT LEASING

Leasing may be an attractive alternative to some businesses. With an **operating lease,** the asset owner, or lessor, transfers only the right to use the property to the lessee. The lessor retains ownership of the leased property, and possession of the property reverts to them at the conclusion of the lease. Payments under an operating lease are deductible to the lessee.[134]

Alternately, a **capital lease** is one in which the lessor's sole task is to finance the "leased" asset, and all other rights of ownership transfer to the lessee.[135] As a result, if the leasing transaction constitutes a capital lease, the asset is the lessee's property and, for accounting purposes, is recorded as a fixed asset in the lessee's general ledger. For tax purposes, the lessee deducts the interest portion of the capital lease payment, not the entire lease payment as with an operating lease.[136] Some portion may also be eligible for depreciation, provided that the lease conveys incidents of ownership to the lessee.[137]

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126. IRC §179(d)(2)(C)(ii).
127. IRC §267(b)(6).
128. IRC §267(b)(13).
129. IRC §§267(b)(10) and 707(b).
130. Treas. Reg. §1.168(d)-1(b)(4)(i).
131. IRC §179(c)(1).
132. IRC §168(k)(7).
133. IRC §408A(c)(3).
134. IRC §162(a)(3); Treas. Reg. §1.162-11(a); Rev. Rul. 55-540, 1955-2 CB 39.
135. Rev. Rul. 55-540, 1955-2 CB 39.
136. Ibid. See §4.01(f).
137. IRS Pub. 946, *How to Depreciate Property*, p. 4 (2022); *Cargill Inc. v. Comm'r*, 91 F.Supp.2d 1293 (D. Minn. Mar. 29, 2000).

According to the Financial Accounting Standards Board (FASB),[138] a transaction is a capital lease if it meets any of the following conditions.

- Ownership of the asset shifts to the lessee by the end of the lease period.
- The lease contains a bargain purchase option, allowing the lessee to buy the property from the lessor for a below-market price.
- The lease term is equal to 75% or more of the estimated economic life of the leased property and the lease cannot be canceled during that time.
- The present value of the minimum lease payments required under the leases is at least 90% of the fair value of the asset at the lease's inception.

If none of these conditions is satisfied, the transaction is considered an operating lease. In that event, the lessee can deduct each lease payment as a business expense. The lessee does not treat the leased property as an asset.

Potential Tax Benefits

The distinction between operating and capital leases carries significance. With a capital lease, the lessee deducts depreciation expense in addition to the interest expense.[139] Thus, the early years of a capital lease may yield larger deductions than an operating lease, although the bookkeeping is more involved because these expenses decrease over time, even as the lease payments are constant. However, the effect of FASB Accounting Standards Codification (ASC) 842, *Leases,* moves additional leases onto the balance sheets of business entities by removing bright-line tests.[140] In contrast, an operating lease enables a constant deduction for the lease payment over its term.

DISPOSITION OF EQUIPMENT[141]

Equipment does not last forever, and independent contractors may wish to dispose of it even before it is no longer fit for use. Before the Tax Cuts and Jobs Act (TCJA), trading in equipment for similar equipment generally resulted in an IRC §1031 like-kind exchange. This legislation disallowed like-kind treatment to the disposition of personal property for transactions occurring after December 31, 2017.[142]

Outright Sale of Equipment

When taxpayers sell equipment, they realize a gain if the amount realized is greater than the equipment's adjusted basis. Conversely, they realize a loss if the amount realized is less than the adjusted basis. The amount realized includes the money received and the fair market value of any property received. Furthermore, the amount realized also includes any liabilities associated with the equipment they transfer to the new owner, such as a mortgage or tax liability.

Trade-In Exchange for New Equipment

When an independent contractor trades in one item of equipment for another, the transaction is reported as a sale for the fair market value of the trade-in property plus a purchase of the full purchase price of the new property. The trade difference amount is no longer reported.

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138. *Original Pronouncements as Amended: Statement of Financial Accounting Standards No. 13*. Nov. 1976. FASB. [www.fasb.org/Page/ShowPdf?path=aop_FAS13.pdf&title=FAS+13+%28AS+AMENDED%29] Accessed on May 1, 2023.

139. IRS Pub. 946, *How to Depreciate Property*, p. 4 (2022); *Cargill Inc. v. Comm'r*, 91 F.Supp.2d 1293 (D. Minn. Mar. 29, 2000).

140. *Review Engagements: Implementation of the New Lease Standard*, p. 2. Jan. 18, 2023. AICPA Center for Plain English Accounting. [us.aicpa.org/content/dam/aicpa/interestareas/centerforplainenglishaccounting/resources/2023/cpea-january-2023-report-review-engagements-implementation-of-the-new-lease-standard.pdf] Accessed on May 5, 2023.

141. IRS Pub. 544, *Sales and Other Dispositions of Assets*.

142. *Tax Cuts and Jobs Act*, PL 115-97, §13303.

Example 18. Bosworth operates a vegetable distributorship as a sole proprietorship. On June 1, 2023, Bosworth trades in a used tomato packing machine with a fair market value of $50,000 and a tax basis of $0 and acquires a new tomato packing machine with a full purchase price of $90,000. Bosworth reports the disposition of the used property on Form 4797, *Sales of Business Property,* resulting in a gain of $50,000. The full purchase price of $90,000 must be capitalized under bonus or regular depreciation or expensed under §179. The depreciation amount is reported on Bosworth's Form 4562, *Depreciation and Amortization,* and Schedule C.

Abandonment of Equipment

When a taxpayer abandons equipment, they relinquish ownership without transferring it to a new owner. The taxpayer must intend to "discard the asset irrevocably."[143]

Gain or Loss.[144] Abandoning old equipment results in a loss under IRC §165 usually, but not necessarily. If a taxpayer transfers a liability to a new owner with the abandonment, a gain could result if the remaining basis was less than the relinquished liability. Otherwise, the loss on an abandonment is equal to the asset's adjusted basis, less any **recourse** indebtedness. If **nonrecourse** debt is attached to an abandoned asset, its sale or exchange is controlled by Treas. Reg. §1.168(i)-8(e)(1). Either gain or loss, the transaction is reported in the year of abandonment on Form 4797 part II, *Ordinary Gains and Losses*, Line 10.[145]

Casualty Losses.[146] A casualty is the damage, destruction, or loss of property resulting from an unforeseen event that is sudden, unexpected, or unusual. Fires, theft, storms, floods, tornadoes, vandalism, earthquakes, and other accidents are examples of casualties. Although an uninsured casualty loss may result in abandonment, an insurance recovery may result in a taxable gain, particularly if the taxpayer had substantially depreciated the property.

PERSONAL USE OF EQUIPMENT[147]

Changing an asset from business to personal use is treated as a disposition in the year of conversion, provided it was being treated as modified accelerated cost recovery system (MACRS) property. If the property is used partially for personal use and partially for business use, special provisions may change how the owner recovers its cost.

Depreciation Recapture[148]

If an independent contractor elected §179 expense deduction for property where business use decreases to 50% or less, they are required to recapture of a portion of the expense already taken.

But the amount recaptured is not simply the entire amount of §179 expense taken, rather it is the **benefit** derived from the §179 expense deduction over what the depreciation under §168 would have been if the §179 election had not been taken.

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143. Treas. Reg. §1.168(i)-8(e)(2).

144. Ibid; IRS Pub. 5712, *Capitalization of Tangible Property Audit Technique Guide*, p. 143 (2022).

145. 2022 Instructions for Form 4797.

146. Treas. Reg. §1.165-7.

147. Treas. Reg. §1.168(i)-4.

148. Treas. Reg. §1.179-1(e)(1); Treas. Reg. §1.168(i)(c); IRC §280F(b)(2) and (d)(4).

Example 19. On April 15, 2021, Hank purchased a small desk for business use, electing to expense its $5,000 purchase price under §179. Assume that in 2021, Hank elected out of bonus depreciation for other 7-year assets. In 2023, Hank's business use drops to 40%.

In 2023, Hank must recapture $2,710, determined as follows.

§179 deduction claimed in 2021		$5,000
Allowable deduction (MACRS 7-year property) instead of §179 deduction		
2021 depreciation ($5,000 × 14.29%)	$ 715	
2022 depreciation ($5,000 × 24.49%)	1,225	
2023 depreciation ($5,000 × 17.49% × 40% business use)	350	
Total allowable depreciation	$2,290	(2,290)
Recapture amount		$2,710

The recapture amount on Hank's Form 4797, line 35, is reduced by almost half because the recaptured amount is the excess benefit, not the total benefit. The recapture amount is reported back on the Schedule C on which it was originally claimed. Hank needs to increase his basis in the property by the recapture amount. If Hank had retained the business use of the desk for seven years, no recapture would have been required.

> **Note**. The recapture is triggered when business use drops to 50% or less, not when the asset is sold.

Depreciation is recaptured in the year the taxpayer personally disposes of it, following the provisions of either IRC §§1245 or 1250. If the property is converted to personal use in the year it was placed in service, it is not eligible for depreciation.

If the business use of listed property falls to 50% or less, the taxpayer must recapture excess depreciation in the year the use falls below that threshold. The taxpayer must also use the alternative depreciation system (ADS) under §168(g).[149] As a result, the taxpayer must use straight-line depreciation to recover the balance of the equipment's cost. If the business use is greater than 50% but less than 100%, the depreciation is limited to that associated with business use.

> **Note.** The possibility of either recapture or a reduced depreciation deduction highlights the importance of maintaining records, particularly if the taxpayer may elect §179 expensing for the property or the property is listed property.

This change of use can have unfortunate economic consequences. For example, a taxpayer who purchases a luxury vehicle can benefit from substantial first-year depreciation, up to $20,200 for vehicles placed in service during 2023.[150] The change to personal use can affect the depreciation normally allowable for the vehicle.

Allocating Equipment Use Expenses Between Personal and Business

The method of allocation varies according to the nature of the property. It makes sense to allocate a vehicle's use between business and personal use based on the mileage for each use.

149. IRC §280F(b)(2)(A).

150. Rev. Proc. 2023-14, 2023-06 IRB 466.

SELECTED TRADES OR BUSINESSES

Construction Workers

Generally, independent contractors working in construction can expense any tool costing less than $200.[151] With the appropriate accounting policy in place, these construction workers can treat more expensive tools as an immediate expense.[152]

However, it may be preferable to depreciate equipment over time. For a lengthy construction project, a deduction in a future year may be more valuable because the income generated by the equipment may be recognized in a future year. Generally, small tools can be expensed. In some cases, large equipment must be capitalized.

Most people assume that casualty losses result in tax losses. However, unexpected results may occur if an insurance recovery exceeds the adjusted basis in the lost property.

Example 20. Fred, a 70-year-old carpenter who works as an independent contractor, lost his tools when they were stolen from his shop on July 4, 2023. He acquired these tools between 2009 and 2012, and they were either fully depreciated or Fred had elected §179 expensing for them. He received a settlement from his insurance company of $18,000 in September 2023. Their total original cost exceeded $25,000.

Disheartened by the loss, Fred decides to retire and does not replace the tools. As a result, he recognizes a 2023 gain of $18,000 from the casualty.

Gig Economy Workers

Gig workers use a wide variety of equipment to which these principles apply. Most gig-related income-producing activities require a computer to manage, making it a depreciable asset.

For a gig worker who provides ride-sharing services, their vehicle becomes property held for the production of income and is thus eligible for depreciation.[153] However, eligibility for depreciation is accompanied by strict documentation standards under IRC §274(d) and the possibility of depreciation recapture if the business use declines to less than 50%.

Example 21. In early January 2019, Jim purchased a $30,000 luxury vehicle to provide ride-sharing services. During that year, he put 32,161 miles on the car, documented by a December 31, 2019, receipt for the oil change at the dealership. Using an app on his cell phone, Jim determined that he had put 27,595 miles on the car with his ride-sharing services. This resulted in 85.8% business use of the vehicle (27,595 business miles ÷ 32,161 total miles). Because Jim provided such good documentation, his tax practitioner had no trouble determining that Jim qualified for the $18,100 bonus depreciation deduction for 2019, although this amount was reduced to $15,530 ($18,100 full bonus depreciation × 85.8% business use).

The next year started briskly, but Jim provided few rides after mid-March because of COVID-19. For 2020, his mileage app showed 8,796 miles, of which only 4,230 miles or 48% were for his ride-sharing business. As a result, the ride-sharing business was no longer the dominant use of the vehicle.

This change forced a difficult decision on Jim's tax practitioner. He was required to recapture the excess depreciation expense on the previous year's tax return, causing an increase in Jim's taxable income even though the cash generated by his business was down significantly. In addition, Jim's tax return could no longer use an accelerated depreciation method. Any future depreciation would be subject to the ADS requirement for straight-line depreciation.

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151. Treas. Reg. §1.162-3(c)(1)(iv).

152. Ibid.

153. IRC §167(a)(2).

Short-Term Rental of Residence.[154] Some gig workers are landlords, renting out their homes or other property on a short-term basis. In some cases, the individual does not need to recognize income from the short-term rental of a residence, provided they do not deduct any expense associated with the rental, but only if the period rented is 14 or fewer days during the tax year.

> **Note.** For more information on rental use of personal property, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Schedule E. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Truck Drivers

Independent trucker drivers generally own or lease equipment, making depreciation alternatives important considerations. The largest expenditures are for equipment, such as tractors, trucks, and trailers.

A **tractor** is a highway vehicle designed to tow another vehicle, such as a trailer or a semitrailer. It does not carry cargo on the same chassis as the engine.[155] A tractor is depreciated over three years.[156]

A **truck** is a highway vehicle designed to transport a load on the same chassis as the engine, even if it is also equipped to tow a vehicle, such as a trailer or a semitrailer.[157] A truck is depreciated over five years.[158]

A **trailer** or **semitrailer** is customarily used in connection with a vehicle that is equipped to tow it.[159] A trailer is a vehicle pulled by a tractor in hauling freight. A trailer or trailer-mounted container is depreciated over five years.[160]

Trucks, tractors, trailers, and semitrailers are eligible for expensing under §179 or for bonus depreciation under §168(k).

> **Note.** Ownership of a heavy vehicle normally subjects owner of the truck, tractor, or trailer to an excise tax defined in IRC §4051. These owners must file Form 2290, *Heavy Highway Vehicle Use Tax Return*, if they register a qualifying vehicle in a state or Washington D.C. They must also file Form 720, *Quarterly Federal Excise Tax Return*, to report fuel consumption tax.

Truckers may also need tools in their businesses, which are eligible for the safe harbor election treating them as current expenses.

TRAVEL EXPENSES

Independent contractors are likely to incur expenses for traveling to operate their trade and generate income. While this type of expenditure may be common, the rules and regulations surrounding the deductibility of expenses can be nuanced and specific. This section identifies what types of expenditures qualify as travel expenses and discusses the various rules and restrictions for deducting them.

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154. Prop. Treas. Reg. §1.280A-3(b).

155. Treas. Reg. §145.4051-1(e)(1).

156. IRS Pub. 946, *How to Depreciate Property*.

157. Treas. Reg. §145.4051-1(e)(2).

158. IRS Pub. 946, *How to Depreciate Property*.

159. Instructions for Form 2290; IRS Pub. 946, *How to Depreciate Property*.

160. IRS Pub. 946 *How to Depreciate Property*.

GENERAL RULES

Independent contractors can deduct travel expenses they incur in the operation of their business and employment.[161] The enactment of TCJA resulted in employees no longer being able to deduct unreimbursed business expenses, such as travel, as a miscellaneous itemized deduction subject to the 2% floor.[162] For independent contractors filing a Schedule C, the TCJA did not alter their ability to deduct business expenses. Consequently, independent contractors who incur travel expenses may generally deduct them if they meet the following criteria.[163]

1. The taxpayer incurs the expense in pursuit of a trade or business.
2. The taxpayer incurs the expense while away from home.
3. The expense is ordinary and necessary.

Pursuit of a Trade or Business[164]

The Code and regulations specify that a taxpayer may deduct transportation costs for trips made primarily for business purposes. Therefore, transportation costs for trips made primarily for personal purposes are not deductible, even when they incur qualifying business expenses that are deductible. The distinction between business and personal purposes of a trip and the associated transportation costs depends on the facts and circumstances surrounding the nature of the taxpayer's business and the trip itself. The taxpayer must distinguish between business and personal activities they perform on the trip and the duration of those activities in relation to the length of the trip as a whole.

Example 22. Ned is a marketing consultant who resides in Illinois and takes a 5-week trip to Orlando, Florida, in 2023. While on this trip, Ned spends two weeks meeting with his business clients and attending conferences for marketing professionals. Ned spends the remaining three weeks of his trip as a vacation, golfing alone and relaxing in a resort. Because Ned spends three out of the five weeks of the trip vacationing, Ned's trip is considered primarily for personal purposes, and he **cannot deduct** any of the transportation costs incurred traveling to and from Florida. However, Ned can deduct other qualifying business expenses (including transportation costs) he incurs during the two weeks he performs business activities in Florida.

Example 23. Assume the same facts as **Example 22,** except Ned stays an additional three weeks on the same trip to Orlando, Florida. Ned spends those additional three weeks engaging in business activities. Looking at his trip, Ned spends five out of the eight weeks of the trip for business. Therefore, the majority of the trip is for business purposes, and Ned **can deduct** the transportation costs to and from Florida.

Away from Home[165]

A taxpayer may deduct travel expenses they incur for trips where the taxpayer is traveling away from home. In the context of §162(a)(2), home refers to the taxpayer's tax home.[166] Because of this requirement, determining a taxpayer's tax home is essential in evaluating the deductibility of travel expenses. The determination of a taxpayer's tax home is described in detail earlier in this chapter.

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161. Treas. Reg. §1.162-2.
162. IRC §67; *Tax Cuts and Jobs Act*, PL 115-97, §11045.
163. IRC §162(a).
164. Treas. Reg. §1.162-2(b).
165. IRC §162(a)(2).
166. *Daly v. Comm'r*, 72 TC 190 (1979), *aff'd* 662 F.2d 253 (4th Cir. 1981).

An additional criterion that the IRS imposes on a taxpayer for their travel to be considered away from home is the need for the taxpayer to sleep or rest as part of the travel.[167] The IRS clarifies that the respite from work only fulfills the rest requirement if it is long enough to provide adequate time for reasonable sleep or rest. Therefore, the taxpayer does not need to be away from home from sunup to sundown on a given day to meet this requirement. However, a 1-hour break or nap in one's car would not fulfill the rest requirement, and the IRS would not deem the travel away from home.

> **Example 24.** Use the same facts as **Example 23.** Ned's tax home is in Illinois, where he is a resident and maintains his principal office. Because the trip to Florida was eight weeks, Ned stayed at a hotel for the duration of the trip. Ned's trip to Florida meets the requirements for being away from home in that he was physically away from his tax home in Illinois while in Florida, and he slept and rested during the trip to meet the demands of his work.

Ordinary and Necessary Expenses[168]

Along with other business expenses, travel expenses must be ordinary and necessary for a taxpayer to deduct them. Due to the subjectivity of this criteria, the ability to deduct travel expenses depends on the facts and circumstances surrounding the taxpayer's business and trip. The IRS provides a listing of potential expenses that a taxpayer may deduct while incurred during travel.[169]

- Transportation, including airfare, train or bus tickets, and automobile expenses
- Fares for taxis and buses
- Baggage and shipping costs
- Automobile expenses, including actual expenses or standard mileage rates, or car rental expenses
- Lodging and meals, provided neither is lavish or extravagant
- Cleaning services, such as dry cleaning and laundry
- Telephone and other communication expenses for business calls and correspondence
- Tips associated with any of the expenses listed above
- Other expenses associated with traveling that would be reasonably ordinary and necessary

> **Note.** The IRS and legislative courts do not provide a bright-line test to determine whether expenses are ordinary and necessary, instead stating that the facts and circumstances surrounding the expenses dictate whether they would fit those criteria.[170] As such, the determination of whether an expense is ordinary and necessary is subjective, and the IRS could challenge it with relative ease. Because the burden of proof is on the taxpayer to substantiate their position on this matter, it may be highly beneficial for taxpayers to maintain records of their travel expenses with detailed information as to where they were traveling to, who they were meeting with, and what activities they performed during the trip. This information, along with documented reasons and justification for the expenses, can help taxpayers defend their position if the IRS challenges them.

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167. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

168. IRC §162(a).

169. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

170. IRC §162(a).

When assessing whether an expense is necessary or ordinary, a taxpayer should consider the function of the expense and how it pertains to their business. To illustrate this concept, the regulations draw specific attention to travel expenses for a taxpayer's spouse.[171] Generally, travel expenses that the taxpayer incurs for their spouse, family member, or other individuals to accompany them are not deductible unless there is a bona fide business purpose. If the individual is an employee or performs substantive work for the business, their travel expenses would be ordinary and necessary, and therefore deducible. Otherwise, if the spouse or individual has no business purpose or only provides incidental menial tasks or services, the expenses for their travel would not qualify as necessary or ordinary from a business perspective.

DOMESTIC VS. FOREIGN TRAVEL

While identifying the costs and their business purpose is critical in determining the deductibility of travel expenses, other factors also warrant review. One such factor is whether the taxpayer's travel is abroad or within the United States. While travel within the United States follows the general rules specified earlier in this section, traveling abroad has different rules and nuances for deducting travel expenses.

Travel Within the United States[172]

Independent contractors traveling within the United States, which includes all 50 states and the District of Columbia, follow the general rules described earlier in this section. The criteria of the expenses required to pursue a trade or business are of key importance when comparing domestic to foreign travel. For travel costs within the United States, a taxpayer may deduct the entirety of travel costs provided that the purpose of the trip was primarily for business. Travel costs outside of the United States have different rules, which this section describes later.

For trips where part of the travel is outside of the United States, taxpayers must account for the travel costs associated with the portion within the United States separately from those outside the United States. The portion of the trip within the United States follows the general rules, while the portion outside of the United States follows the rules for foreign travel.

Travel Outside the United States

Similar to travel inside the United States, deducting the expense of traveling outside the United States depends on how much of the trip was for business purposes. However, additional criteria and nuances are associated with travel outside the United States compared to within.

Entirely For Business Purposes.[173] Taxpayers can deduct all travel costs for trips where the purpose is entirely for business. This concept may sound similar to trips within the United States that are entirely for business purposes. However, travel outside the United States adds four exceptions to trips where the purpose is not entirely for business purposes. If **any of the four exceptions are met,** the IRS considers the trip entirely for business purposes, and all travel costs are deductible. The four exceptions follow.

1. The taxpayer does not have substantial control over the travel arrangements of the trip. This lack of control does not apply specifically to the timing of the trip but rather to other factors that include the following.
    - The taxpayer is reimbursed by their employer for the cost of the trip or receives an allowance for travel expenses, **and**
    - There is no familial (including half-siblings and spouses) or fiduciary relationship between the employer and taxpayer, and the taxpayer does not own more than 10% of outstanding stock in the employed company, **or**
    - The taxpayer is not a managing executive with the authority of necessitating business travel not subject to veto.

171. Treas. Reg. §1.162-2(c).

172. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

173. Treas. Reg. §1.274-4.

Note. The IRS generally considers self-employed taxpayers as having substantial control over their travel arrangements. Consequently, self-employed taxpayers are unlikely to meet this exception.

2. The taxpayer was outside of the United States for no more than a week during the trip. While this exception may seem simple in concept, the regulations specify how a taxpayer can meet this exception, which is as follows.
   - The taxpayer must factor in both business and nonbusiness activities in assessing the number of days of the trip.
   - The IRS states that one week means seven consecutive days in this context.
   - The taxpayer does not include the day they left the United States in counting the number of days the trip was outside the United States.
   - The taxpayer includes the day they return to the United States in counting the number of days the trip was outside the United States.
3. The taxpayer's personal activities account for less than 25% of all activities during the trip. Additionally, the taxpayer must travel outside the United States for more than one week. Unlike the second exception, the taxpayer counts **both** the days for traveling from and returning to the United States in this assessment.
4. A personal vacation was not a major consideration in arranging the trip.

Note. The fourth exception is fairly subjective, and taxpayers should consider the facts and circumstances surrounding the trip and the personal vacation in determining whether the exception applies. For example, bringing family members who are not involved in the business may indicate that a vacation was a major consideration for the trip.

Primarily For Business Purposes.[174] For travel outside of the United States that is primarily for business purposes but also has personal purposes, the taxpayer is generally not able to deduct all the travel expenses. This rule differs from travel in the United States primarily for business purposes, where all travel expenses are deductible. Instead, the taxpayer must use an allocation formula to determine the deductible portion of travel expenses. The allocation is based on the percentage of time the taxpayer spent for business purposes for the entire trip. The formula is as follows.

$$\text{Deductible percentage of travel costs} = \frac{\text{Total \# of business days outside the U.S.}}{\text{Total \# of business and nonbusiness days outside the U.S.}}$$

[174] Treas. Reg. §1.274-4(d).

For calculating the deductible percentage of travel costs, the regulations stipulate that a day is a full business day, even if it consists of both business and personal activities, if the day meets any of the following criteria.

- Transportation days are business days when the taxpayer travels to and from a destination for business purposes. However, if the taxpayer takes a non-direct route for a destination for personal activities, only the days that a taxpayer would travel if using a direct route between destinations for business purposes can count as business days.
- Days on which the taxpayer's presence is required for business activities are full business days, even if the taxpayer spends most of that day on personal activities.
- Days on which the taxpayer's primary activity during working hours is for business purposes are business days. If there are circumstances beyond the taxpayer's control that prevent them from working on a given day, then those days are also business days.
- Weekends and holidays are business days if they fall between days for business purposes. If a taxpayer remains at a destination after the conclusion of their business for personal reasons, the weekends and holidays that occur during that time do not constitute business days.

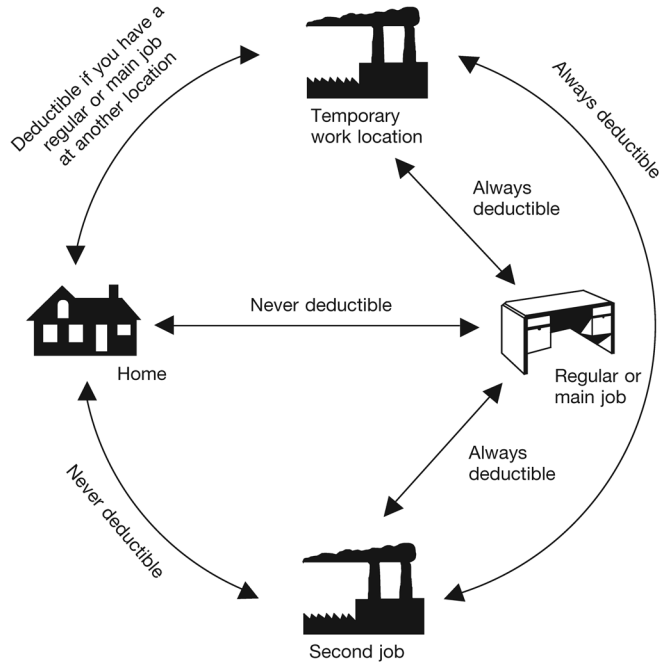
Example 25. Ned, the marketing consultant from **Example 22,** travels to Bermuda for 20 days, including both the departure and return dates. For the first six days, Ned attends a conference and spends most of his time on business activities during those days. Ned did not work the following two days due to a hurricane but resumed his work by meeting with a customer and working on a marketing campaign with them for four days. Ned took the following four days off to sightsee and relax on the beach. None of those four days took place over a weekend. Ned spent the remaining three days attending a different marketing conference and flew back to Illinois on the last day.

Ned spent 14 days performing business activities by attending two conferences, traveling to and from the United States, and meeting with a client (6+3+4+1). The two days that Ned could not work because of the hurricane are included as business days, as Ned was unable to work due to circumstances beyond his control. Therefore, the total number of business days for Ned's trip was 16 (14+2). The remaining four days that Ned spent as a vacation were personal. Ned can deduct 80% of his travel expenses for his trip to Bermuda (16 business days ÷ 20 total days).

Primarily For Personal Purposes. Similar to travel within the United States, expenses for travel outside the United States for trips primarily for personal purposes are not deductible. However, nontravel expenses incurred for business purposes on those trips are deductible.

TRANSPORTATION FOR TRAVEL NOT AWAY FROM TAX HOME[175]

While taxpayers can deduct expenses for trips away from their tax home as travel expenses, they can also deduct certain costs within their tax home as transportation expenses. Such costs can include car, air, rail, bus, and taxi transportation. The deductibility of these costs primarily depends on the point of departure and destination of the travel. The following diagram from IRS Pub. 463, *Travel, Gift, and Car Expenses,* illustrates these principles.



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is realistically expected to last (and does in fact last) one year or less. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary work location outside your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. If you don't go directly from your first job to your second job, you can only deduct the transportation expenses of going directly from your first job to your second job. You can't deduct your transportation expenses between your home and a second job on a day off from your main job.

175. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

Personal Residence

Generally, travel from a taxpayer's residence to their workplace is not deductible. The IRS considers this travel a regular commute and does not qualify for a deduction. However, a notable exception to this rule involves a taxpayer having a temporary work location.

Temporary Work Location

Taxpayers may have more than one work location for a given business. Similar to temporary and indefinite employment rules for determining one's tax home, a taxpayer may consider a work location as temporary if they reasonably expect their employment at that location to last for no more than one year. Taxpayers can deduct expenses for travel from their residence to a temporary work location, provided the taxpayer has a different location as their principal place of business. This chapter defines a taxpayer's principal place of business and its criteria earlier in the tax home section.

Second Job

Travel expenses to and from a second job are deductible when the taxpayer travels from or to their principal place of business or temporary work location. Travel expenses to and from the second job and the taxpayer's residence are commuting and are not deductible.

SELECTED TRADES OR BUSINESSES

Construction Workers

Taxpayers in the construction industry have an added consideration for travel expenses regarding when to capitalize them as part of a construction project. The regulations stipulate that taxpayers must capitalize all direct costs and certain indirect costs allocable to real property.[176] Therefore, construction workers must identify whether the travel costs they incur are direct or indirect costs requiring capitalization.

Direct costs include direct material and labor costs, while indirect costs are all other costs.[177] Travel costs typically fall under indirect costs. Construction workers would then need to determine whether the travel costs directly benefitted the construction project or were incurred because of performing the construction itself. This assessment is subjective, and the facts and circumstances surrounding the nature of the project and travel expenses drive the assessment. The construction worker should include the travel expenses as indirect costs for capitalization if they determine that the travel costs in question directly benefitted or were necessary for the construction project.

> **Note.** For a more in-depth analysis of capitalization rules, exceptions, and de minimis alternatives available to taxpayers, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 2: Capitalization vs. Repair Review.

Gig Economy Workers

While gig workers must adhere to the general rules for deducting travel expenses, they should be mindful of the locations to which and from which they travel, particularly if they have a home office. A gig worker can deduct transportation costs from their residence to another work location if the office in their home serves as their principal place of business.[178] These deductible expenses include travel for meeting with customers or attending business meetings.

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176. Treas. Reg. §1.263A-1(a)(3)(i).

177. Ibid.

178. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

Truck Drivers[179]

As discussed earlier in this chapter, truck drivers, in particular, are likely to have unconventional tax homes due to the nature of the business requiring frequent mobility. Consequently, truck drivers may find themselves where an entire city or general area is their tax home, making local travel expenses nondeductible under the general rules for travel expenses.

However, truck drivers can deduct certain expenses for transportation and travel through their trucks. Semi-trucks are qualified nonpersonal use vehicles, indicating that the majority of use for the vehicle by design is nonpersonal.[180] Truck drivers, therefore, must use actual expenses incurred in using and maintaining their trucks instead of a standard mileage rate for any deductions.

Truck drivers cannot deduct any fines for traffic violations. As with other business deductions, truck drivers should maintain records of the costs associated with these truck expenses to substantiate their deductibility if the IRS challenges them.

MEALS AND ENTERTAINMENT EXPENSES

An independent contractor will likely incur meals and entertainment expenses. Depending on the facts and circumstances, these costs can significantly impact a contract's or project's profitability and are subject to more scrutiny than other expenses because of the unique and varied rules for deductibility applicable to them. This section covers the general regulations surrounding meals and entertainment and highlights aspects of these expenses unique to independent contractors in specific industries.

BASIC PRINCIPLES FOR ENTERTAINMENT DEDUCTION

Entertainment expenses are costs associated with activities that constitute recreation or amusement.[181] These expenses include attending sporting events, social events such as parties, stage shows, and other similar costs.[182] Historically, the deductibility of entertainment expenses was not straightforward and subject to specific criteria. After the enactment of the TCJA, entertainment expenses are subject to more simplified and encompassing restrictions for deductibility. However, some aspects of entertainment expenses still exist that taxpayers should be aware of and consider.

Generally Nondeductible[183]

The TCJA generally made entertainment expenses nondeductible since its enactment in 2017.[184] This change eliminates various costs qualifying as entertainment activities that taxpayers could previously deduct. Entertainment events that taxpayers host or attend with clients or other business affiliates for purposes of business are no longer deductible. Additionally, costs for using facilities for entertainment, including rent, depreciation, lease payments, etc., are also nondeductible.[185] Notably, membership dues for clubs fall under nondeductible entertainment expenses, regardless of whether the club is for business, entertainment, or other social purposes.[186]

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179. Ibid.

180. Treas. Reg. §1.274-5(k)(2).

181. IRC §274(a).

182. Treas. Reg. §1.274-2(b)(1).

183. IRC §274(a).

184. *Tax Cuts and Jobs Act,* PL 115-97, §13304(a).

185. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

186. IRC §274(a)(3).

Example 26. Pamela is a floral designer whose business specializes in making floral arrangements for various customer needs. In 2023, Pamela hosted a customer-appreciation party costing $1,200. She also spent $130 for an annual membership to a local horticulture club which functions primarily as a social organization. Under the TCJA rules, Pamela cannot deduct either the costs of hosting her party or her annual club membership expense. Both expenditures fall under nondeductible entertainment expenses.

Deductible Entertainment Expenses

Entertainment expenses taxpayers incur that are ordinary and necessary for the type of business in **which** they engage may be deductible.[187]

Example 27. Use the same facts as **Example 26,** except that Pamela hosts a floral show, renting space at a local venue to display a showcase of her floral arrangements for the upcoming season. While hosting this event would generally constitute nondeductible entertainment expenses for most business industries, Pamela's business relies on these events to promote and sell her floral arrangements. Therefore, Pamela could deduct the costs of hosting the floral show.

In addition to business-specific considerations, there are exceptions to the general nondeductible rule for entertainment expenses that taxpayers may deduct.[188]

- The cost of **food and beverages for their employees,** provided the taxpayer furnishes them on their business premises
- Entertainment expenses that taxpayers included as **compensation** for their employees as wages
- **Reimbursed entertainment expenses** from an employer (provided the employer did not include them in the taxpayer's wages as compensation) or other individuals (if the taxpayer can substantiate them)
- **Recreational expenses** for a taxpayer's employees, such as holiday parties or other social gatherings
- Entertainment expenses directly related to **business meetings** for employees, stockholders, agents, or directors
- Entertainment expenses for attending business meetings for IRC §§501(c)(3) and 501(a) **exempt organizations**
- Entertainment expenses for goods or services that the taxpayer makes **available to the general public,** which would not include employees or an exclusive list of guests.
- Entertainment expenses for goods or services that the taxpayer **sells to customers**
- Entertainment expenses a taxpayer pays a **non-employee as compensation,** except for expenses that are required to be included (or would be required except that the amount is less than $600) in any information return filed by such taxpayer

Example 28. Use the same facts as **Example 26.** Pamela hosts a customer appreciation event at a local venue, inviting 50 customers as guests. Because the event is not open to the public and is restricted only to the customers she invited, Pamela cannot deduct the cost of renting the space from the venue as an entertainment expense. If she opened the event to the public in addition to the customers she specifically invited, she could deduct the expense.

187. Treas. Reg. §1.274-2(d).

188. IRC §274(e).

BASIC PRINCIPLES FOR MEALS DEDUCTION

Taxpayers can deduct meals that are not lavish or extravagant for which they or their employees are present at the furnishing, subject to some limitations covered in this section.[189] Unlike the deductibility of entertainment expenses, the deductibility of meals has remained consistent and unchanged by the provisions of the TCJA. However, Congress temporarily allowed taxpayers to deduct 100% of business meals purchased from a qualified restaurant for the 2021 and 2022 tax years to provide relief to the restaurant industry during the COVID-19 pandemic.[190] For the 2023 tax year, this provision is no longer in effect. Taxpayers must adhere to the general rules as follows.

50% Limit[191]

Taxpayers are generally subject to a 50% deduction limit for business meals. Such meals include those for business meetings and while traveling for business. As with other business expenses, meals are deductible only if they are ordinary and necessary. The IRS clarifies that meals are ordinary if the expenditure is common in the trade or business in which the taxpayer engages. Furthermore, the IRS distinguishes meals as necessary when appropriate for the business.

> **Note.** This clarification is helpful, as some might interpret the term **necessary** to be synonymous with required. The IRS explicitly states that a meal does not necessarily have to be a requirement for it to be a necessary expense to qualify for the deduction.[192]

The meal costs subject to the 50% limit include food and beverage and any tax or tips the taxpayer incurs on said purchase. Conversely, the cost of traveling to and from the meal location is not included in the meal cost subject to the 50% limit.

> **Example 29.** Buddy is an independent contractor who repairs and refurbishes condiment dispensing machines. He meets with one of his clients for lunch to discuss future projects. Buddy paid a $22 cab fare to arrive at the restaurant, $50 for his meal and his client's, which included sales tax, and $10 for a tip. Buddy's meal costs include the food, beverage, sales tax, and tip, totaling $60 ($50 + $10). Therefore, Buddy can deduct $30 as a meal expense ($60 × 50%). The $22 cab fare is deductible as a transportation cost.

Business entertainment may include food and beverage at an event. The meal is only deductible if separately stated on the invoice or is otherwise billed independently from the rest of the entertainment expense.

> **Example 30.** Use the same facts as from **Example 29.** Buddy hosts two customer appreciation parties during 2023. He only invites specific customers to both parties, and the events do not meet an exception to the general nondeductible rule for entertainment expenses. The invoice for the first party is $500 for the entire event, of which $100 is **estimated** to be the portion for food and beverage. The vendor does not itemize the invoice, as the pricing for their events is all-inclusive. The invoice for the second party is $650, which includes an itemized $120 for food and beverage. While Buddy is not able to deduct any amount as entertainment expenses for the two parties, he can deduct $60 in meal expenses for the second party ($120 × 50%). If the $100 of food and beverage for the first party had been itemized or billed separately, Buddy could deduct an additional $50 ($100 × 50%) in meals for 2023.

189. IRC §274(k).

190. *Consolidated Appropriations Act of 2021,* PL 116-260, §210.

191. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

192. Ibid.

Practitioner Planning Tip

Because the deductibility of meals during entertainment relies on the explicit statement or separation of the cost of food and beverages from the other entertainment costs, practitioners should relay the importance of maintaining records and documentation to their clients to support such deductions. Taxpayers with copies of invoices or itemized receipts can better defend their positions if challenged by the IRS regarding these expenditures.

Exceptions to the 50% Limit[193]

The meal cost is fully deductible if the taxpayer meets any of the following criteria.

- The cost of meals that taxpayers included as **compensation** for their employees as wages
- **Reimbursed meal expenses** from an employer (provided the employer did not include them in the taxpayer's wages as compensation) or other individuals (if the taxpayer can substantiate them)
- **Meals a taxpayer provides for their employees** during events such as holiday parties or other social gatherings
- Meals at functions that the taxpayer makes **available to the general public,** which would not include employees or an exclusive list of guests
- Meals that the taxpayer **sells to customers**
- Meals a taxpayer pays a **non-employee as compensation,** except for expenses that were or would be reported on an information return under Chapter 61, subchapter A part III of the tax code
- Meals that the taxpayer **pays or reimburses for an employee as part of their moving expenses** provided the taxpayer included them in the employee's taxable wages
- Meals that the taxpayer provides to specific **commercial crew members** or on particular **oil or gas platforms or drilling rigs** (see §274(n)(2)(C) for further details)

Example 31. Nicole is an IT consultant with an office in Omaha, Nebraska. In 2023, Nicole hires Stanley as a new administrative assistant to work in her office in Omaha. Stanley was living in Idaho at the time, so Nicole agrees to reimburse his moving expenses from Idaho to Nebraska, including $50 for meals during the move. Nicole includes the $50 reimbursement for the meals in Stanley's wages and reports them on his 2023 Form W-2. Nicole deducts the full $50 reimbursement for the meals as wage expense on her 2023 tax return and does not reduce the amount by 50% per the general meals deduction rule.

193. IRC §274(n)(2).

SELECTED TRADES OR BUSINESSES

For independent contractors working in the construction and gig economy industries, taxpayers adhere to the general rules, limitations, and exceptions to those limitations. However, independent contractors in the trucking industry have unique rules compared to the aforementioned industries.

Truck Drivers

Truck drivers are subject to federal hours of service by the Department of Transportation per Title 49 of the Code of Federal Regulations (CFR) Part 395. This includes certain air transportation workers, interstate truck operators and bus drivers, certain railroad employees, and certain merchant mariners under Coast Guard regulations.[194] For truck drivers and motor carriers subject to federal hours of service, the Code does not subject the taxpayers to a 50% limitation on meal expenses. Instead, truck drivers deduct **80% of their meal expenses.**[195] However, for the meals to be deductible, the truck driver must consume the food or beverage while away from their tax home while working.

The 80% deductibility provision only pertains to the general limitation, where the Code only changes the language to the amount that a taxpayer can deduct for meal expenses in general.[196]

> **Example 32.** Lindsey is a truck driver whose tax home is the city of Louisville, Kentucky. While traveling outside Louisville in March 2023, Lindsey paid $440 for meals. Lindsey can deduct $352 ($440 x 80%) because she is subject to federal hours of service by the Department of Transportation and can deduct 80% of her meal expenses compared to the standard 50%.

Special Standard Meal Allowance.[197] Truck drivers and other taxpayers working in the transportation industry can use a special standard meal allowance to deduct meal costs during travel. Instead of calculating their meal deduction using actual expenses, taxpayers use a standard travel allowance rate per day. For 2023, the allowance rate is $69 per day of travel within and $74 per day of travel outside the continental United States.[198] To take the special standard meal allowance for travel, taxpayers must meet the following conditions.

- The taxpayer has direct involvement in transporting people or goods by plane, bus, ship, train, or truck.
- The taxpayer regularly travels away from home in their line of work, with trips typically consisting of travel to locations subject to different standard meal allowance rates.

Taxpayers must use the special standard meal allowance for **all** trips they take in a tax year if they choose to use this method for **any** trip they take during the year. Consequently, truck drivers cannot pick and choose which trips to use the special standard meal allowance in one year. An additional restriction to consider concerns the departure and return travel days. Taxpayers must calculate a reduced allowance for those days, where they can either use a standard 75% portion or another reasonable proration method they apply consistently for all departure and return travel days.

> **Example 33.** Use the same facts as **Example 32.** Lindsey's travel outside her home in March 2023 consisted of an 8-day trip, including departure and return days. If Lindsey used the special standard meal allowance, she would deduct $52 for each departure and return day ($69 × 75%) and $414 for the six days in between ($69 × 6 days). Lindsey's total deduction for the trip is $518 ($52 + $52 + $414).

> **Note.** While taxpayers do not need to substantiate the cost of their meals if they use the special standard meal allowance in calculating their meals deduction, they must maintain adequate travel logs and supporting records to substantiate the number of travel days away from their homes.

194. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

195. IRC §274(n)(3).

196. Ibid.

197. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

198. IRS Notice 2022-44, 2022-41 IRB 277.

OTHER EXPENSE ISSUES

While pursuing their vocations, independent contractors may encounter various expenses, some of which may be specific to their industries. These expenses may be tax-deductible,[199] unlike those incurred by Form W-2 employees.[200]

SELECTED TRADES OR BUSINESSES

Construction Workers

Among the variety of other expenses incurred by construction workers, the treatment of interest expense provides some of the greatest challenges, yet some opportunities. This discussion of other expenses incurred by independent contractors in construction focuses on two interest expense issues, capitalization of production period interest and interest tracing rules.

Capitalization of Production Period Interest.[201] Independent contractors in the construction industry often incur debt to purchase materials or meet payroll. With the debt comes interest, for which construction workers and firms record interest expense as they pay it. However, under certain circumstances, the Code requires taxpayers to capitalize interest associated with debt in producing the following property.

- Real property
- Non-inventory tangible personal property with a 20-year or more class life
- Tangible personal property that the taxpayer estimates to have a production period exceeding two years
- Tangible personal property that the taxpayer estimates to have a production period exceeding one year **and** a production cost exceeding $1 million

Several factors can trigger the requirement to capitalize interest expenses. The **production period** starts on the day the taxpayer begins production of that property and ends when the property is ready for placement in service or to hold for sale. Additionally, the production period is pivotal in determining what interest expense may be subject to capitalization in producing real or tangible personal property. Only the interest expense the taxpayer incurs or pays during the production period is subject to the interest capitalization rules under IRC §263A(f).

The use of the debt's proceeds also influences whether a taxpayer must capitalize interest expense. For a given project or contract, interest on the direct indebtedness for **production expenditures** could be subject to capitalization. Production expenditures include the direct costs of a unit of property (UOP) and its share of allocable indirect costs.[202] Additionally, interest on indebtedness for purchasing property used to produce the UOP must be capitalized, and the taxpayer would allocate that interest to the UOP.

> **Note.** For details on the UOP concept and its associated rules, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 2: Capitalization vs. Repair Review.

199. IRC §62(a)(1).

200. IRC §67(g).

201. IRC §263A(f).

202. IRC §263A(a).

However, interest from other indebtedness not directly related to the production of a UOP may also be subject to capitalization. Such indebtedness may be known as **avoided cost,** the interest cost a taxpayer could have avoided or reduced if they had not incurred the production expenditures for a UOP.[203] This requirement is complex and requires using the avoided cost method to calculate and allocate this cost. The source of other indebtedness would not include the acquisition of a taxpayer's residence or a home equity loan on the taxpayer's residence.[204]

Example 34. Darren is an independent contractor who works on the construction of nonresidential buildings. In early 2023, Darren entered a contract to work on constructing a new building for a dentistry practice. Construction began on May 1 of that year and is expected to end on October 31, 2024, when Darren anticipates that the building will be ready to be placed in service.

In anticipation of the project, on February 3, 2023, Darren obtained a 2-year loan from Third Mid National Bank of $250,000 for the construction of the building, primarily for Darren to purchase materials and hire labor. Darren made monthly payments on the loan beginning on March 1.

A portion of Darren's interest expense in 2023 on the Third Mid National Bank loan must be capitalized because Darren incurred the debt to produce nonresidential real property. Darren used the loan proceeds for production expenditures that constituted direct costs. Darren must capitalize the interest he paid starting on May 1, when the production period started. Therefore, Darren would not capitalize the interest he paid in March or April.

Interest Tracing.[205] Interest tracing involves associating the use of the debt proceeds with the associated interest expense. As such, the deductibility of interest is traced to the **use of the proceeds**, not their source or how they are secured. Taxpayers must continuously monitor where they spend the debt proceeds, as they may spend them for different purposes on a given loan over time.

> **Note.** Interest tracing is not specific only to individuals within the construction industry, but is included in this section for comparison purposes.

If a taxpayer uses debt proceeds for business purposes, they can deduct the associated interest expense from their business income. Even if the loan is secured by a nonbusiness asset, such as a personal residence via a refinanced mortgage or home equity loan, the taxpayer may deduct the interest expense from their business income if they use the proceeds for business purposes.[206] Consequently, mortgage refinancing or a home equity loan may be useful strategies for construction workers if they use the proceeds for business purposes. The result may be a beneficial interest expense deduction.

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203. Treas. Reg. §1.263A-9.

204. IRC §163(h)(3)(A).

205. Temp. Treas. Reg. §1.163-8T.

206. IRS Pub. 936, *Home Mortgage Interest Deduction,* p. 8 (2022).

Example 35. Alex is a carpenter, working as an independent contractor for several larger construction firms in the metropolitan area. While scrutinizing the repair bills for his diesel truck in his home office one evening, Alex notices that maintenance costs are up significantly, even though he has not driven any more than in previous years.

Alex decides to replace his truck but has no ready sources of cash for a significant purchase. He inquires about a home equity loan while visiting the bank on March 11, 2023, and the banker informs Alex that this is possible. Still, the interest is generally not deductible, given the provisions of the TCJA.[207]

Because the mortgage balance on his home is so small, Alex and his wife decide this is the best course of action. He opens a new bank account for the business specifically to hold funds for the purchase of the truck. Because he sometimes carries loads of bricks with his tools, the truck has a loaded gross vehicle weight of 15,000 pounds and is a qualified nonpersonal use vehicle. Alex has never used his business truck for personal purposes.

Alex draws $50,000 on the line of credit on March 22, 2023. Two days later, on March 24, Alex takes possession of the truck, paying for it with the $50,000 proceeds from the home equity loan. During 2023, Alex pays $2,500 of interest on the home equity loan, as attested by Form 1098, *Mortgage Interest Statement*, which he receives the next January.

At a February 2024 meeting with Joan, his tax practitioner, Alex provides Form 1098 from his bank, even though he does not believe it has value on the tax return. Because she had not received a Form 1098 with this account number previously, Joan asks Alex how he and his wife used the loan.

Alex informs Joan that the proceeds were used to buy the large truck in her parking lot. Joan responds that Temp. Treas. Reg. §1.163-8T permits this interest to be placed on Schedule C for Alex's carpentry business. Even though his principal residence secures the loan, using the loan's proceeds to purchase a vehicle used entirely in Alex's business enables the interest to be treated as a business expense.

In setting up the loan, Alex has done several things right. Under Treas. Reg. §1.163-15, he has a 60-day window during which he is presumed to have used the proceeds to purchase his new truck with the proceeds. This window starts 30 days before the loan proceeds are received and ends 30 days after their receipt. Alex used the proceeds within two days. Also, he used a specific bank account to receive the proceeds, removing any doubt that funds were used to buy the truck used for his business.

Although Alex was not required to set up a special bank account to hold the proceeds of the loan, having one makes it easy for Joan to see that the loan's proceeds were used to acquire the truck.

Note. The concept of interest tracing relies on the **use** of the debt proceeds. Because a taxpayer may use the debt proceeds for different purposes or change how they use the proceeds over time, taxpayers should continue to keep track of how they use debt proceeds to determine whether the associated interest expense may be traced to a source of income eligible for deduction. For example, if Alex does not repay the loan when he sells his truck and uses the proceeds to go on vacation, the interest expenses cease to be associated with his business.

207. *Tax Cuts and Jobs Act*, PL 115-97, §11043, amending IRC §163(h)(3).

Gig Economy Workers

Home Office Expenses.[208] In recent years, there has been a substantial rise in the number of people working from home, with the U.S. Census Bureau finding that number tripled between 2019 and 2021.[209] Consequently, gig workers may not have a separate physical office or work primarily from home. The Code allows taxpayers to deduct specific expenses they incur in maintaining and working from a home office, subject to limitations and qualifying criteria.

Generally, a gig worker's expenses for their residence are nondeductible due to being primarily for personal use by nature.[210] However, taxpayers may deduct some of these expenses if they have a home office by meeting one or more of the following criteria.[211]

- The taxpayer uses part of their residence as their **principal place of business** exclusively and regularly.
- The taxpayer uses part of their residence exclusively and regularly to **meet with customers** to conduct business.
- The taxpayer uses a **separate structure** from their home exclusively and regularly for business purposes.
- The taxpayer uses part of their residence for **storing inventory regularly.**
- The taxpayer **rents** out part of their residence.
- The taxpayer uses part of their residence as a **daycare facility.**

Exclusive Use.[212] One criterion the Code imposes on taxpayers to deduct home office expenses is restricting the space **exclusively** for business purposes. As the term indicates, the taxpayer must use the part of their home as a home office only for business purposes and cannot partially use it for nonbusiness purposes.

> **Example 36.** Darla is a graphic designer who develops visual aspects of various media on demand. She uses a spare bedroom in her house as a home office, where she has a desk with a computer on it to create project designs. Darla does not use the spare bedroom for any other purpose or spend any time for personal reasons in that space. Her home office would therefore meet the criteria of being used exclusively for business.

The space in a taxpayer's home they use for business does not need to be separated by walls or other partitions to meet the definition of exclusive use.[213] However, taxpayers must exercise caution in using that space only for business purposes; otherwise, the home office expenses would not be deductible.[214]

> **Example 37.** Use the same facts as **Example 36** except that Darla has a bookshelf with fiction books that she likes to read for pleasure in the chair sitting next to it. Even though she uses the space for business purposes, Darla's partial use of the home office for personal reasons makes her expenses nondeductible.

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208. IRC §280A.

209. *The Number of People Primarily Working From Home Tripled Between 2019 and 2021*. Sep. 15, 2022. United States Census Bureau. [www.census.gov/newsroom/press-releases/2022/people-working-from-home.html] Accessed on May 5, 2023.

210. IRC §280A(a).

211. IRC §280A(c).

212. Ibid.

213. IRS Pub. 587, *Business Use of Your Home*, p. 3 (2022).

214. *Rayden v. Comm'r*, TC Memo 2011-1 (Jan. 3, 2011).

Gig workers who are daycare providers or use their space to store inventory are exempt from the exclusive use rules. However, for storing inventory, taxpayers must meet an additional set of criteria to deduct home office expenses which include the following.[215]

- The taxpayer's business is selling the inventory at wholesale or retail.
- The taxpayer's home is the only location where they store their inventory.
- The taxpayer uses the space to store inventory regularly.
- The taxpayer uses a separately identifiable space to store their inventory that is appropriate for such use.

Regular Use.[216] Along with exclusive use, a taxpayer must also use a space regularly for business to deduct home office expenses. For a taxpayer to use the space regularly, they must use it for business on a continual, ongoing, or recurring basis.[217] In other words, the basis for use cannot be occasional or incidental. The facts and circumstances surrounding the nature of the business and the taxpayer's use of their home office will determine whether they meet the criteria for regular use.

Principal Place of Business.[218] If taxpayers exclusively and regularly use part of their residence as their principal place of business, they can take a home office deduction. A principal place of business is where a taxpayer performs substantial administrative or management activities for their business and uses no other location for such purpose.[219] These administrative or management activities include billing, ordering supplies, scheduling appointments, and maintaining books and records.

Having other business locations does not prevent a taxpayer's home office from being a principal place of business. The IRS identifies that taxpayers performing activities other than substantially administrative or managing at other locations would not disqualify a home office as the principal place of business. Or, if a taxpayer conducts administrative or managing activities in a nonfixed location such as a vehicle or hotel room, the principal place of business for the home office does not fail. Additionally, having personnel perform such activities at different locations would not result in the home office failing the principal place of business test. As with other aspects of the home office deduction, facts and circumstances will drive the basis for a taxpayer being able to consider their home office as their principal place of business for a given business activity.

> **Example 38.** Use the same facts as **Example 36.** Darla uses her home office as a space to create graphic designs for hired projects. She also manages her calendar with the computer in her office to schedule customer meetings. Darla uses that same computer for her accounting program to keep track of her revenue and expenses. While away from home, she sometimes takes phone calls from customers on her cell phone and brings a laptop with her on trips to work while staying at hotels. Darla's principal place of business is her home office.

A taxpayer's home office can be the principal place of business for multiple businesses in which the taxpayer engages. The taxpayer needs to assess each business separately and apply the criteria discussed previously to determine whether their home office is the principal place of business for each activity.

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215. IRC §280A(c)(2).

216. IRS Pub. 587, *Business Use of Your Home*, p. 3 (2022).

217. *Donald T. and Marlene B. Robinson v. Comm'r*, TC Memo 2011-99 (May 5, 2011).

218. IRS Pub. 587, *Business Use of Your Home*.

219. IRC §280A(c)(1).

Location for Meeting Customers.[220] To claim the home office deduction under the meeting with customers criteria, taxpayers must adhere to the following considerations.

1. The taxpayer physically meets with customers at their home office.
2. The customer's home office use is substantial and integral in conducting the business activity.

Substantiality and frequency come into play again in assessing whether a taxpayer meets the criteria for the deduction. The proposed regulations clarify that a taxpayer making phone calls to customers does not fulfill the above criteria and that occasional meetings are insufficient to identify a home office as a primary location for meeting with customers.

Separate Structure as a Home Office.[221] Independent contractors sometimes use a structure separate from their residences for business purposes. In this circumstance, they may deduct associated costs as home office expenses. To qualify for the deduction, the taxpayer must use the space exclusively and regularly for business.

Methods for Deducting Home Office Expenses. Once taxpayers have determined they can deduct home office expenses from their business income on their tax return, they must calculate their deduction using one of two methods. The first method utilizes a taxpayer's **actual expenditures.** In contrast, the other, **simplified method** assigns an estimated deduction based on the percentage of a taxpayer's space they use as a home office compared to their total residence. This section analyzes both methods for deducting home office expenses.

- **Actual Expense Method.**[222] Taxpayers electing to use actual expenses they incurred for the home office deduction must separate their home office expenses into two categories, direct and indirect expenses. An expense is **direct** when the taxpayer only incurs it for the business portion of their home. Direct expenses could include repairs to the home office space or installing carpeting for the office. Taxpayers can deduct direct expenses in full. An expense is **indirect** when the taxpayer incurs it for maintaining their overall residence. Property taxes, homeowners' insurance, mortgage interest, depreciation, and utilities are generally indirect expenses as the expense is for the total home space for both personal and business use. Consequently, taxpayers may not fully deduct indirect expenses. Instead, they must determine the business portion of the expense they can deduct.

  Taxpayers determine the business portion of an indirect home office expense by applying a business percentage to the indirect cost. The business percentage is equal to the space of the home used for business divided by the total space of the home. Generally, taxpayers use square footage to measure the space of their home in calculating the business percentage, although the IRS allows any reasonable method in calculating the area of the home and office space, such as the number of rooms of equal size.[223]

  > **Example 39.** Use the same facts as **Example 36,** except Darla measures the spare bedroom she uses as a home office at 280 square feet. The square footage of her home is 1,400. If Darla uses the actual expense method, the business percentage that she applies to any indirect costs would be 20% (280 ÷ 1,400).

220. Prop. Treas. Reg. §1.280A-2(c).

221. Ibid.

222. IRS Pub. 587, *Business Use of Your Home*, p. 6 (2022).

223. Ibid.

The amount of home office expense that taxpayers can deduct using the actual expense method is subject to limitation. Specifically, the business portion of home office expenses that a taxpayer would not otherwise be able to deduct on their return is subject to this limitation. These expenses may include insurance, utilities, and depreciation. They would not include mortgage interest, real estate taxes, and any casualty losses, as these expenses may be taken as itemized deductions on a taxpayer's Schedule A, *Itemized Deductions*. The business portion of otherwise nondeductible home office expenses is limited to the business's gross income, less the business portion of home expenses that is otherwise deductible and nonhome business expenses. However, a taxpayer may carry over the unused business portion of home expenses to a future tax year in which the taxpayer uses the actual expense method. These expenses are again subject to limitations for that tax year. A taxpayer may carry over these expenses even if they use a different space for a home office in the future tax year.

Example 40. Assume the same facts as **Example 39.** In 2023, Darla incurs $10,000 in real estate taxes, $7,500 in mortgage interest, $2,000 in utility expenses, $700 in homeowner's insurance, and $500 to repair carpet damage in her home office. Darla's accountant calculated $3,200 of depreciation expense for Darla's home in 2023. Darla has gross receipts from her graphic design business of $50,000 and has other non-home business expenses totaling $12,000.

Darla uses the actual expense method to calculate her home office deduction in 2023. She first identifies her direct costs for the home office as the $500 repair to carpeting because the expense is solely for the space of Darla's home used for business. All other home costs are indirect, requiring Darla to multiply them by the business percentage of 20% that she calculated in **Example 39.** The resulting indirect costs are $2,000 in real estate taxes ($10,000 × 20%), $1,500 in mortgage interest ($7,500 × 20%), $400 in utilities ($2,000 × 20%), $140 in insurance ($700 × 20%), and $640 of depreciation ($3,200 × 20%). The total home office expense, including direct and indirect costs, is $5,180 ($2,000 + $1,500 + $400 + $140 + $640 + $500).

To determine whether her home office expenses are subject to limitation and need to be carried over, Darla identifies that her gross income of $50,000 exceeds her total business expenses of $17,180 ($12,000 non-home business expense + $5,180 home office expense). Therefore, Darla could deduct the entire $5,180 of home office expenses that she calculated.

When using the actual expenses method, taxpayers calculate and report the home office expenses on Form 8829, *Expenses for Business Use of Your Home*.

Taxpayers must consider depreciation recapture when selling their home with a home office where they used the actual expense method for deducting home office expenses. Usually, when a taxpayer sells a primary residence, they can offset a sizable amount of capital gain with an exclusion provided under IRC §121, provided they meet the requirements therein. However, when using the actual expense method for deducting home office expenses, any amount of depreciation that the taxpayer recognized or could have recognized is not exempt under §121 and is subject to §1250 depreciation recapture when the taxpayer sells the property.[224] The taxpayer must report the unrecaptured §1250 gain on Form 8949, *Sales and Other Dispositions of Capital Assets*, and subsequently on Schedule D, *Capital Gains and Losses*. Unrecaptured §1250 gain is subject to a maximum 25% tax rate.[225]

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224. Treas. Reg. §1.121-1(d)(1).

225. *Topic Number 409 — Capital Gains and Losses*. Apr. 4, 2023. IRS. [www.irs.gov/taxtopics/tc409] Accessed on May 10, 2023.

- **Simplified Method.**[226] A taxpayer can use an alternative method for calculating and deducting home office expenses. This method is known as the simplified method, primarily due to the relative ease of calculating the expense and not requiring a taxpayer to allocate or substantiate actual expenses that they incur. Consequently, taxpayers may opt to use this method over the actual expense method when they do not incur significant property expenses or have difficulty maintaining appropriate documentation to support those expenditures.

  Taxpayers make the election using the simplified method by filing their tax returns on a timely basis. This election is made on a per-year basis, meaning that a taxpayer may switch from using the simplified method to the actual expense method or vice versa without it constituting a change in accounting method, possibly requiring approval from the Commissioner. Calculating the deductible home office expense under the simplified method requires multiplying the square footage of a taxpayer's home used for business by the prescribed rate of $5 per square foot. While taxpayers who use the simplified method for a business may not deduct any home office expenses to reduce their income from that business, they can still itemize property taxes and mortgage interest, as well as deduct casualty losses on their returns.

  The deduction for home office expenses under the simplified method is limited to the business's gross income, less the taxpayer's nonhome business expenses. The taxpayer's use of the simplified method is limited to 300 square feet. A taxpayer may not generate a business loss from the home office deduction. Unlike the actual expense method, the taxpayer may not carry over any amount of unused home office deduction when they use the simplified method.

  As the simplified method does not include recognizing depreciation expense, a taxpayer does not need to consider §1250 depreciation recapture when selling their residence with a home office, where they only used the simplified method to calculate home office expenses. However, because taxpayers may switch methods annually, they must still recognize a §1250 gain for any year they used the actual expense method. This consideration is why a taxpayer may favor using the simplified method over the actual expense method to avoid the administrative inconvenience of calculating and tracking depreciation expenses on their home office.

  Example 41. Assume the same facts as **Example 40.** If Darla uses the simplified method, her home office deduction is $1,400 (280 square footage of home office × $5 standard rate). Considering only her business income and expenses, the actual expense method in Darla's situation would yield a larger home office deduction than the simplified method.

Note. When comparing **Example 40** and **Example 41,** it may be tempting to recommend that Darla use the actual expense method over the simplified method. However, practitioners should also consider other factors when recommending one method for deducting home office expenses over the other. For example, depreciation recapture may come into play for taxpayers who sell their homes for which they used the actual expense method for deducting home office expenses. Depreciation recapture is not relevant when a taxpayer uses the simplified method.

Additionally, practitioners should consider whether taxpayers can itemize their property taxes or mortgage interest. If they can itemize those expenses, it may be beneficial for the taxpayer to recognize a portion of the expense to offset their business income to reduce any SE tax or result in having a lower adjusted gross income (AGI).

Note. For a home office refresher, see the 2020 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

226. Rev. Proc. 2013-13, 2013-06 IRB 478.

Truck Drivers

Specialized Clothing. Deducting clothing as a business expense largely depends on the facts and circumstances surrounding a taxpayer's business. Given that this decision involves a judgment call, the IRS has an incentive to challenge clothing deductions, prompting taxpayers to provide bona fide reasons for the clothing when performing their duties.

Truck drivers should be aware that some of their clothing, depending on the circumstances, may be a deductible business expense. For example, in *Henke v Comm'r*, the taxpayer was a truck driver who purchased safety shoes and gloves. The court found the deduction was reasonable because the taxpayer worked with blacktop material that was very hot, and therefore safety clothing was necessary to perform the taxpayer's job.[227]

Truck drivers may deduct specialized clothing and safety equipment for their jobs if they can establish the following criteria.[228]

1. The clothing is required or essential in the taxpayer's employment.
2. The clothing is not suitable for general or personal wear.
3. The taxpayer does not wear the clothing for general or personal wear.

As with other business expenses, the taxpayer must be able to substantiate their expenses with supporting documentation. In addition to documentation supporting the existence of the expense, truck drivers should also document why the clothing they are trying to deduct is required or essential to their profession. Finally, they should state that they could not and did not use it for personal purposes.

SE TAX

In addition to income tax, a tax of 15.3% is imposed on SE income. **SE income** is defined as net earnings from self-employment activities.[229] **Net earnings from self-employment** are defined as gross income derived by an individual from a trade or business that the individual conducts less deductions allowed.[230]

A taxpayer generally pays SE tax if they have SE net earnings of $400 or more.[231] The amount subject to SE tax is 92.35% of a taxpayer's SE net earnings. The maximum net earnings subject to the social security tax in 2023 are $160,200.[232] All net earnings are subject to the Medicare tax.

A taxpayer is in business for SE tax purposes if they meet the following 2-prong test:[233]

- Continuity and regularity and
- Profit motive.

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227. *Henke v. Comm'r*, TC Memo 1973-186 (Aug. 21, 1973).
228. *Nolder v. Comm'r*, TC Summ. Op. 2012-50 (May 29, 2012).
229. IRC §1402(b).
230. IRC §1402(a).
231. *Topic No. 544, Self-Employment Tax.* Apr. 6, 2023. IRS. [www.irs.gov/taxtopics/tc554] Accessed on Apr. 19, 2023.
232. *Fact Sheet.* Social Security Administration. [www.ssa.gov/news/press/factsheets/colafacts2023.pdf] Accessed on Apr. 20, 2023.
233. Rev. Rul. 58-112, 1958-1 CB 323. See also *Comm'r v. Groetzinger,* 480 U.S. 23 (1987) and *Batok v. Comm'r,* TC Memo 1992-727 (Dec. 28, 1992).

For the purpose of deducting losses, a taxpayer is in business if the facts and circumstances show that the taxpayer operated the venture like a business instead of like an activity **not engaged in for profit.** The IRS looks at nine primary factors, which, when viewed together, paint a picture of the taxpayer's intent.[234] In looking at these factors, courts evaluate the taxpayer's intent to earn a profit.

1. The **manner** in which the taxpayer carried on the activity
2. The **expertise** of the taxpayer or their advisors
3. The **time and effort** expended by the taxpayer in carrying on the activity
4. The taxpayer's **expectation** that the **value** of the assets used in the business will increase
5. The **previous success** of the taxpayer in carrying on similar or dissimilar activities
6. The **history of income and losses** with respect to the activity
7. The amount of **occasional profits**, if any, which are earned
8. The **financial status** of the taxpayer
9. Any elements of **personal pleasure** or recreation in the activity

No one factor is determinative, and other factors may also be considered. The IRS and the courts place greater weight on objective facts than on taxpayers' assertions of intent. Accordingly, taxpayers who maintain proper contemporaneous documentation are more likely to be able to prove their intent.

Note. For an in-depth discussion of these factors, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Schedule C. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Practitioner Planning Tip

Taxpayers with a loss or a small amount of SE income may benefit from using an optional method to compute net earnings from SE activities. For taxpayers engaged in farming activities, the **farm optional method** is available for any number of years if gross farm income is $9,060 or less or net farm profits are less than $6,540 (2022).[235] The **nonfarm optional method** is available only five years in a taxpayer's lifetime if net nonfarm profits are less than $6,540 (2022) and also less than 72.189% of gross nonfarm income. The instructions for Schedule SE, *Self-Employment Tax,* contain additional rules. The optional methods benefit self-employed taxpayers by providing credit toward social security coverage or increasing earned income for the earned income credit or the child and dependent care credit.[236]

234. Treas. Reg. §1.183-2; IRC §183.

235. 2022 Instructions for Schedule SE.

236. *Topic No. 544, Self-Employment Tax.* Apr. 6, 2023. IRS. [www.irs.gov/taxtopics/tc554] Accessed on Apr. 19, 2023.

Taxpayers calculate their SE tax on Schedule SE of Form 1040. Self-employed taxpayers are allowed to deduct one-half of the SE tax to arrive at AGI.[237]

Example 42. Jackson is a self-employed truck driver who files single. His total gross income from trucking for the tax year 2022 was $75,000. Jackson incurred the following expenses related to his trucking business.

Fuel	$15,000
Repairs and maintenance	5,000
Insurance	3,000
Licensing fees	1,500
Meals and entertainment (50% deductible)	2,000
Other miscellaneous expenses	1,500
Total expenses	$28,000

Jackson's net SE income is $43,405 (($75,000 – $28,000) × 92.35%). The SE tax rate for 2022 is 15.3%. Because Jackson is self-employed, he is responsible for the full portion of the tax, resulting in a total SE tax of $6,641 (15.3% × $43,405). Jackson reports his SE tax of $6,641 on Schedule SE, which is attached to his Form 1040 when filing his income tax return.

Jackson deducts half of his SE tax as an adjustment to his income on his Form 1040, which reduces his overall tax liability.

STATE INCOME TAX ISSUES

Because there are 41 states that levy income taxes, plus the District of Columbia, there are 42 ways that states can complicate the tax lives of independent contractors, especially if they travel between states with income taxes. The construction worker who only undertakes projects in South Dakota and Wyoming is very fortunate because those are the only two contiguous states that do not tax incomes. For most independent contractors working in multiple states, their tax practitioners must consider a series of facts and circumstances to determine whether their clients are responsible for filing in the state that is not their tax home.

GENERAL PRINCIPLES FOR STATE INCOME TAX LIABILITY

The general principle is that if an independent contractor performs work in a state, then the work performed there is taxable. For example, a gig worker in Indiana may incur an Illinois income tax liability if they travel into Illinois and perform work for a client. In contrast, a construction worker who works as an independent contractor in Indiana for an Illinois firm but never enters Illinois would not be considered to have earned Illinois income.[238] Other states have different rules, as shown in the following matrix of reciprocity agreements.[239]

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237. Ibid.

238. *IT 13-0009-GIL 98/26/2013 Compensation,* p. 3. Stocker, Brian L. Illinois Department of Revenue. [tax.illinois.gov/content/dam/soi/en/web/tax/research/legalinformation/letterrulings/it/documents/2013/it-13-0009.pdf] Accessed on Apr. 24, 2023.

239. *Do Unto Others: The Case for State Income Tax Reciprocity*. Walczak, Jared. Nov. 16, 2022. Tax Foundation. [taxfoundation.org/state-reciprocity-agreements] Accessed on Apr. 27, 2023. Used with permission.

	IL	IN	IA	KY	MD	MI	MN	MT	NJ	ND	OH	PA	VA	WV	WI	DC	Count
IL			✓	✓		✓									✓		4
IN				✓		✓					✓	✓			✓		5
IA	✓																1
KY	✓	✓				✓					✓		✓	✓	✓		7
MD												✓	✓	✓		✓	4
MI	✓	✓		✓			✓				✓				✓		6
MN						✓				✓							2
MT										✓							1
NJ												✓					1
ND							✓	✓									2
OH		✓		✓		✓						✓		✓			5
PA		✓			✓				✓		✓		✓	✓			6
VA				✓	✓							✓		✓		✓	5
WV				✓	✓						✓	✓	✓				5
WI	✓	✓		✓		✓											4
DC					✓								✓				2

Sources: State statutes and regulations; Bloomberg Tax; Tax Foundation research.

This matrix shows that residents of some states do not need to file a return for another state in which they earn wages if the two states have a reciprocity agreement. More specifically, residents of one state are not required to file a tax return in the other state if they have only earnings from wages, salaries, tips and commissions from working in the other state. For example, the Illinois reciprocal agreement does not include SE income.[240] Thus, even though employees living in Michigan, but working in Illinois, are not required to file Illinois income tax returns, independent contractors living in Michigan and working in Illinois are required to file tax returns with **both** states.

Example 43. Tom and Jerry are twin brothers, both of whom are engaged in the same business. However, Tom is an employee of XYZ Corp. based in Illinois. Tom is a resident of Michigan and works in Michigan 90% of the time. For the balance of his time, he works in the Illinois headquarters. Because Tom has no other source of Illinois income, he is not required to file an Illinois income tax return.

Even though he performs the same type of work, Jerry is an independent contractor residing in Michigan. Jerry works 90% of the time in Michigan and 10% in Illinois. Jerry must file an Illinois Form IL-1040, *Individual Income Tax Return*.

240. *What if I live or work in the state that has a reciprocal agreement with Illinois?* Illinois Department of Revenue. [tax.illinois.gov/questionsandanswers/12.html] Accessed on Apr. 24, 2023; 35 ILCS §5/502(a)(1)–(2).

Practitioner Planning Tip

Tax professionals should research details of reciprocity agreements if a client may benefit from applying the agreement. Each state implements reciprocity in its own way.

Generally, independent contractors must file income tax returns for each state from which they derive income. Reciprocity agreements providing an exemption from filing requirements generally cover wages, but not SE income. Sixteen states have reciprocal agreements.[241]

Based on this, the question of nexus for **income tax** purposes arises, which may be distinct from nexus for sales tax purposes. In some cases, even a simple connection, such as driving through the state with cargo, may be sufficient to establish an income tax filing requirement. Some states have clearly defined rules that establish when a filing requirement exists, as summarized in the following table.

State	Statute	Nonresident Filing Requirement
California	Cal. Rev. and Tax. Code §§17041 and 17951	An independent contractor must file a tax return if any California-source income is earned
Connecticut	Conn. Gen. Stat. §12-711	An independent contractor must file a Connecticut tax return if they have any sources of income from within the state. The amount of income recognized is the net amount of income, gain, loss, and deduction considered for Connecticut AGI.
Georgia	Ga. Code Ann. §48-7-50	Nonresident independent contractors must file a Georgia income tax return if they have federal gross income from sources within Georgia.
Illinois	35 ILCS 5/304(a) and (h)	Nonresident independent contractors must file an Illinois income tax return if they have enough income from Illinois sources to have a tax liability. In this case, the business income is apportioned to Illinois based on the proportion of Illinois sales to total sales.[243]
Massachusetts	Mass. Gen. Laws, chap. 62, §5A	A business is engaged in business within the commonwealth if it has "Any trade or business" in the state. Nonresident independent contractors must file if they have state-sourced income exceeding $8,000 or state-source income exceeding the state exemption amount multiplied by the ratio of state-sourced income to total income.[244]

241. *Do Unto Others: The Case for State Income Tax Reciprocity*. Walczak, Jared. Nov. 16, 2022. Tax Foundation. [taxfoundation.org/state-reciprocity-agreements] Accessed on Apr. 27, 2023.

242. See 2022 Instructions for Schedule NR, Form IL-1040, particularly the Business or Farm Income Apportionment Formula (IAF) Worksheet.

243. *2022 Massachusetts Nonresident or Part-Year Resident Income Tax*, p. 3. Dec. 2022. Department of Revenue, Commonwealth of Massachusetts. [www.mass.gov/doc/2022-form-1-nrpy-instructions/download] Accessed on Apr. 27, 2023.

State	Statute	Nonresident Filing Requirement
Michigan	Mich. Comp. Laws §206.621	A taxpayer has "substantial nexus" in the state if (a) they have had a physical presence for more than 1 day during the tax year; (b) if they have actively solicited sales in the state and have gross receipts exceeding $349,999; or (c) has an interest in a pass-through entity having a substantial nexus in the state. Nonresident independent contractors must pay income tax on all income earned or attributable to Michigan.[245]
New Jersey	N.J. Stat. Ann. §54A:2-1.1	The independent contractor must file a New Jersey tax return if they have state-sourced income and meet the threshold for filing based on gross income from all sources. Spending more than 30 days in the state makes the independent contractor a part-year resident.[246]
New York	N.Y. Tax Law §§209, 631[247]	Nonresident independent contractors are taxed on New York state income from all sources. They must file if their New York AGI exceeds the New York standard deduction.[248]
Ohio	Ohio Rev. Code Ann. §§5747.01, 5747.24(A)(D)[249]	If a nonresident independent contractor earns any Ohio-sourced income, they have an Ohio filing requirement, even if they are not Ohio residents. They may wish to file Ohio Form IT NRS, *Ohio Nonresident Statement,* to establish their nonresidency.
Pennsylvania	61 Pa. Code §§101.8(2), 109.4[250]	An independent contractor is subject to Pennsylvania tax for any income earned in Pennsylvania. The cited code section states that a "business, trade, profession or occupation ... is carried on partly within and partly without [the state] if one or more of the activities" is carried on in the state.
Virginia	Va. Code Ann. §§58.1-302, 58.1-325	Nonresident independent contractors are subject to Virginia income tax based on a percentage of their Virginia taxable income. The percentage is the ratio of the **net** amount of income, gain, loss, and deductions from Virginia sources to the **net** amount of all income gain, loss, and deductions from all sources. However, Virginia nonresidents must file if their **Virginia** AGI is above a filing threshold and they derive any income from Virginia sources.
Wisconsin	Wis. Stat. §§71.02(2), 71.03(2)(a)(2)	Nonresident persons, including independent contractors, must file if their **gross** income is $2,000 or more if they transact business within the state.

244. 2022 Instructions for [Michigan] Schedule NR, *Nonresident and Part-Year Resident Schedule*.

245. 2022 Instructions for Form NJ-1040NR, p. 2.

246. See *Instructions for Form IT-203, Nonresident and Part-Year Resident Income Tax Return*, Mar. 30, 2023. New York State Department of Taxation and Finance. [www.tax.ny.gov/forms/current-forms/it/it203i.htm] Accessed on Apr. 25, 2023.

247. *Filing information for New York State nonresidents*. Dec. 6, 2022. Department of Taxation and Finance, New York State. [www.tax.ny.gov/pit/file/nonresidents.htm] Accessed on Apr. 27, 2023.

248. See *Ohio 2022: Instructions for Filing Original and Amended Individual Income Tax (IT 1040)*. pp. 11, 49. Ohio Department of Taxation. [tax.ohio.gov/static/forms/ohio_individual/individual/2022/it1040-sd100-instruction-booklet.pdf] Accessed on Apr. 25, 2023.

249. *§109.4. Business carried on partly within and partly without this Commonwealth*. Commonwealth of Pennsylvania. [www.pacodeandbulletin.gov/Display/pacode?file=/secure/pacode/data/061/chapter109/s109.4.html&d=reduce] Accessed on Apr. 25, 2023; *Instructions for Nonresidents and Part-Year Residents*. Pennsylvania Department of Revenue. [www.revenue.pa.gov/TaxTypes/PIT/Pages/Nonresident%20and%20Part-Year%20Resident%20Instructions.aspx] Accessed on Apr. 25, 2023.

Caution. Each state has its own complex set of laws, and the summaries in the previous table should not be considered authoritative. Each of the state's laws is subject to change at the discretion of its elected or regulatory officials. Furthermore, this summary only includes states having a bright-line test, which is admittedly subjective.

SELECTED TRADES OR BUSINESSES

Construction Workers

Construction contractors may encounter adverse tax issues when they cross state boundaries to work. In addition to potential state rules that establish nexus in the state where they work, they may encounter other state laws affecting their status as independent contractors, unemployment insurance, and industry regulation. The construction company may even acquire nexus in a state by hiring an independent contractor to work in another state.

This result may be the case in California, where having an independent contractor could result in a construction firm located in another state becoming subject to California's requirement for a tax return, even though none of the firm's employees ever entered the state. The California Franchise Tax Board presumes a firm is doing business in the state if the business's sales exceed the lesser of the following.[250]

- $500,000
- 25% of total sales

For example, a Nevada construction company could engage the services of an independent contractor to perform work in California, for which the Nevada company bills $100,000. Suppose the Nevada company's total annual revenue is less than $400,000. In that case, the California statute indicates that the Nevada company is doing business in California, even though its employees never entered that state, and it has no property in California. The ownership of real or tangible personal property may also establish that a taxpayer is doing business in that state.[251]

Sales and Use Tax. State sales and use tax laws may impose sales tax on the materials that construction firms, including sole proprietors in the construction industry, provide to their customers. In general, California contractors are liable for sales tax.[252]

Illinois treats the matter differently. This state assumes that construction firms that affix any type of personal property to a building or other element of real property incur a **use** tax liability.[253] If the construction firm sells the building material directly to a customer, it incurs sales tax liability.[254]

Income Tax. Many independent contractors in the construction industry work in states other than their state of residence. If the other state imposes an income tax, filing a return for that state is almost certainly required.

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250. Cal. Rev. & Tax. Code §§23101(a) and (b)(2).

251. Cal. Rev. & Tax. Code §§23101(a) and (b)(3).

252. *Construction and Building Contractors*, p. 27. Apr. 2022. California Department of Tax and Fee Administration. [www.cdtfa.ca.gov/formspubs/pub9.pdf] Accessed on Apr. 26, 2023.

253. Ill. Admin. Code title 86 §§130.1940 (2000) and 130.2075 (2001); See *ST-21-0047*. Nov. 23, 2021. Wolters, Richard S. IDOR. [tax.illinois.gov/content/dam/soi/en/web/tax/research/legalinformation/letterrulings/st/documents/2021/st21-0047-gil.pdf] Accessed on Apr. 26, 2023.

254. Ill. Admin. Code title 86 §130.1940(b) (2000), where the term "retailers' occupation tax" is used to denote sales tax.

Practitioner Planning Tip

Reviewing a construction contractor's bank and credit card records may be tedious, but these documents may suggest questions about out-of-state travel that could be related to a project in another state, resulting in a filing requirement in that state. These records should reflect travel noted in mileage logs.

Gig Economy Workers

Generally, gig workers must follow regular state tax rules for nexus and filing requirements, as indicated earlier. Gig workers who travel in multiple states do not usually have the protections afforded by state reciprocity agreements, which normally only apply to common law employees, their state tax liabilities and filing requirements depend on the diligence with which the taxpayer completes their mileage logs, meal records, and similar documents.

Truck Drivers

Because of the mobile nature of a trucker's business, their travels naturally raise the issue of state taxation whenever they cross a state line. However, 49 USC §14503 limits the ability of states, other than their state of residence, to tax truck drivers.

> *No part of the compensation paid by a motor carrier providing transportation subject to jurisdiction under subchapter I of chapter 135 or by a motor private carrier to an employee who performs regularly assigned duties in 2 or more States as such an employee with respect to a motor vehicle shall be subject to the income tax laws of any State or subdivision of that State, other than the State or subdivision thereof of the employee's residence.*

Appearing in Title 49 of the US Code, rather than Title 26 where the IRC exists, this provision has significant implications for truck drivers. Furthermore, the next sentence refers to 49 USC §31132 to define "employee" to include independent contractors working as truckers.

> *"[E]mployee" means an operator of a commercial motor vehicle (including an **independent contractor** [emphasis added] when operating a commercial motor vehicle, a mechanic, a freight handler or an individual not an employer, who —*
>
> ***a.*** *Directly affects commercial motor vehicle safety in the course of employment...*

Thus, independent contractors may be exempt from state income taxation because of a provision in federal law.

A 2020 general information letter from the Illinois Department of Revenue (IDOR) illustrates the importance of carefully analyzing truckers' activities, whether they are employees or independent contractors.[255] In this letter, IDOR concedes the supremacy of federal law but parses its text to ensure that the transportation worker, in this case, an Arizona-based common law employee of an Illinois-based trucking firm, falls within the federal exemption from state income taxation. The letter indicates that the Arizona employee would be exempt if they comply with the requirements of the Illinois Administrative Code.[256]

- The employee is paid compensation by a motor carrier or a motor private carrier.
- The employee performs regularly assigned duties in two or more states.

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255. *IT-20-0006-GIL*, p. 3. Mankowski, Michael D. Mar. 5, 2020. IDOR. [tax.illinois.gov/content/dam/soi/en/web/tax/research/legalinformation/letterrulings/it/documents/2020/it20-0006-gil.pdf] Accessed on Apr. 26, 2023.

256. 86 Ill. Admin. Code §100.2590(a)(2).

Other states have similar provisions.[257] In a 2001 case, the Oregon Tax Court decided a case in favor of a Washington state-based truck driver who occasionally earned income in Oregon, exempting him from that state's income tax because of 49 USC §14503.[258] In her opinion, Magistrate Sally L. Kimsey referred to Senator Slade Gorton's statement made during the debate on the Amtrak Act.

> *The court finds further support in the purpose of the Amtrak Act. The Amtrak Act was passed so that "rail and motor carrier transportation workers will only have to pay State Taxes to their State of residence."*

The Magistrate's decision follows.[259]

> *IT IS THE DECISION OF THIS COURT that Plaintiffs' income, although earned in Oregon, is exempt from state income tax under the Amtrak Act.*

Example 44. David is an independent trucker who typically drives for Prairie Trucklines, Inc., which is based in Danville, Illinois. This firm regularly pays David, and it qualifies under 49 USC §14503 as a motor private carrier. Because David's normal base of operations is at the firm's Indianapolis terminal, a few miles from his residence, his tax home and his residence are in Indiana. David carries loads on a regular basis into Michigan and Ohio but never into Illinois and performs no incidental service in Illinois. Consequently, he has no Illinois nexus, even though the company for which he performs most work is based there. Furthermore, 49 USC §14503 exempts David from Ohio and Michigan taxation.

The issue of whether truckers can even be independent contractors is under contention. A California law tests whether a worker is an employee or an independent contractor. Companies employing truckers as independent contractors must prove their status based on the following three conditions.[260]

1. The trucker has the freedom to control how they perform their service.
2. The trucker provides service that is outside the company's usual scope of service or business.
3. The trucker acts in an independently established trade, occupation, or business.

Independent truckers can readily satisfy the first and third conditions, but they are unlikely to perform their work outside of the normal scope of business for the company's engaging their services. Although this law pertains solely to California, other states and the federal government should be expected to adopt, either in whole or in some part. This adoption would have implications for the deductibility of truckers' expenses, as employee-paid expenses are not tax deductible until 2026.[261]

Practitioner Planning Tip

Tax practitioners may consider ways of carefully determining whether clients who are independent truck drivers fit within the exemption provided by 49 USC §14503. This exemption is contingent on the facts and circumstances of the truck driver's work fitting this section of the U.S. Code.

257. See, for example, Or. Admin. R. 150-316-0173 (2016).

258. *Roe v. Department of Revenue*, Or. Tax TC-MD 000905F (2001).

259. Ibid.

260. Cal. Labor Code §2750.3(a)(1) (2019).

261. *Tax Cuts and Jobs Act*, PL 115-97, §11045, amending IRC §67 through Dec. 31, 2025.