Schedule C – Profit or Loss from Business (Sole Proprietorship)
Guidelines Summary

Taxpayers may engage in full or part time activities in a trade or business as a sole proprietor or independent contractor. An activity qualifies as a business if the taxpayer's primary purpose for engaging in the activity is for income or profit and s/he is involved in the activity with continuity and regularity. The facts and circumstances of the taxpayer's business will determine how the guidelines below apply to his/her situation and therefore these guidelines will require interpretation by the counselor. It is critical that counselors are trained to be aware of the nuances associated with properly preparing a Schedule C.

Business income and expenses associated with these activities are reported on Schedule C which is in scope for Tax-Aide if the taxpayer meets ALL of the following conditions:

- Uses the cash method of accounting for the business
- Does not have a net loss from the business
- Does not have any employees
- Does not have to file Form 1099-MISC for payments of $600 or more for services performed for a trade or business by people not treated as its employees
- Does not have prior year unallowed passive activity losses from the business
- Is not required to file Form 4562 – Depreciation and Amortization
- Does not deduct expenses for business use of a home
- Has no cost of goods sold and no inventory at any time during the year
- Claims mileage at standard rate rather than actual maintenance, repair, fuel, insurance costs for vehicle
- Has less than $25,000 of business expenses
- Has no out-of-scope expenses

The taxpayer must have records to support income and expenses or be able to reasonably reconstruct income and expenses records. If the counselor concludes that the taxpayer is providing inaccurate, incomplete or inconsistent information (i.e. cash income in round numbers, very few or no expenses where expenses would be expected, or few or no records), the counselor should decline to prepare the return. Schedule C should provide an accurate picture of the taxpayer's income and expenses – not just those the taxpayer selects in order to control the result.

The counselor must use his/her best judgment to determine if a Schedule C is in scope. Although the counselor is assisting the taxpayer in preparing the return, the taxpayer has full responsibility for the accuracy of the information in the return and for making facts and circumstances decisions (such as whether an expense is incidental, or whether the conduct of the business is continual and regular). The counselor should exercise due diligence in advising the taxpayer on the guidelines for making the decision. The counselor should decline to complete the return if s/he concludes that the claimed income and/or expenses are not consistent with the nature of the taxpayer's business.

When the activities do not rise to the level of a trade or business, an itemized deduction for expenses may be limited. If the activity is not engaged in for profit (such as a hobby), special rules apply and the return is out of scope for Tax-Aide.

Income

All self-employment income is to be reported on Schedule C. The information may come from Forms 1099-MISC box 3 (Other Income) or box 7 (Nonemployee Compensation), from Forms 1099-K (Merchant Card and Third Party Payments) and from taxpayer records of cash receipts.

Expenses

All allowable **and** documented expenses must be reported on Schedule C. If there are deductible expenses that are out of scope for Tax-Aide as described in Pubs 4491 and 535, the return is out of scope for Tax-Aide and the taxpayer must be referred to a professional tax preparer – there is no option to disregard allowable and documented expenses. [†]

The cost of incidental supplies are deductible in the year they are paid for, not when the items are used or consumed in the business. "Incidental" supplies are personal property items that are carried on hand and for which no record of consumption is kept or for which beginning and ending inventories are not taken. In other words, these are inexpensive items not worth keeping track of. Similarly, inexpensive items used in the business such as hand tools may be also expensed in the year purchased even if their expected life is more than one year (see below for further discussion).

IRS Notice 2015-82 increases the de minimis safe harbor limit for expensing tangible property used for business purposes (not including land, parts of a building or inventory) on Schedule C from $500 to $2,500 per invoice (or per item on an invoice) for tax year 2016. The safe harbor applies to amounts spent to acquire, produce or improve tangible property that would normally qualify as a capital item. As a result, small businesses will be able to implement accounting procedures to immediately deduct many expenditures that would otherwise need to be spread over a period of years through annual depreciation deductions. The change affects

[†] A self-employed individual is required to report all income and deduct all expenses.

- Authority for deduction of expenses is Revenue Ruling 56-407, 2 C.B. 564.
- Revenue Ruling addressed the issue of whether taxpayers may disregard allowable deductions in computing net earnings from self- employment for self-employment tax purposes. Under §1402(a), every taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self- employment for self-employment tax purposes. Because the net earnings from self-employment included in earned income for EIC purposes are defined by cross-reference to the definition of net- earnings from self-employment under I.R.C. §1402(a), this ruling applies equally to the EIC.
- See Chief Counsel Advice CCA 20022051.

businesses that do not maintain an applicable financial statement (audited financial statement). The safe harbor requires that the deduction policy be in place before the start of the tax year and that it cannot be changed during the year. Although the notice states the IRS may not audit taxpayers who expense items up to $2,500 in 2015, the $500 limit applies to Tax-Aide prepared returns to be in compliance with the notice as written.

To elect to use this safe harbor amount, a statement must be attached to the original timely-filed tax return. In TaxWise, add an Election Explanations form, enter "Section 1.263(a)-1(f) de minimis safe harbor election" in the first line and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the de minimis safe harbor election under §1.263(a)-1(f) in subsequent lines.

The net cost of health insurance premiums the taxpayer paid on behalf of him/herself, his/her spouse and dependents is not a Schedule C expense. It can be included as an itemized expense on Schedule A or, under certain conditions, as an adjustment to income on Line 29 of Form 1040. However, Line 29 continues to be out of scope for Tax-Aide.

Discussion and Examples

Expenses as noted above must be allowable and documented. Counselors may accept the taxpayer's statement that there are records to support expenses instead of seeing the actual records. If a taxpayer declines to include reasonable and ordinary expenses because they aren't documented, i.e., the taxpayer has no records to substantiate the expenses, **and** the taxpayer will be entitled to an earned income tax credit, the taxpayer must attempt to construct the records using bank and credit card statements, his/her personal calendar, etc. or the counselor should refer the taxpayer to a professional preparer.

If a taxpayer believes s/he can claim a home office deduction (using either the simplified method or the standard method) and due diligence confirms s/he likely meets the exclusive and regular use requirements, the return is out of scope for Tax-Aide and the taxpayer must be referred to a professional preparer. If the taxpayer has no intent to claim this deduction, the return is in scope for this item. This is a judgment by the counselor based on the information provided during the interview.

Generally, property that is purchased by the taxpayer and used in the business that has a determinable useful life of more than one year and costs more than the safe harbor limit must be depreciated rather than claimed as a business expense (see Pub 946). Depreciation is out of scope for Tax-Aide, but cannot be ignored which means a business that purchased depreciable property is out of scope for Tax-Aide. A taxpayer may elect to immediately write-off qualified assets. That election must be made on Form 4562, which is also out of scope for Tax-Aide, but again cannot be ignored.

Computers, printers and phones purchased in the current year that exceed the safe harbor per item threshold are depreciable assets making the return out of scope. But the supplies and repairs for those assets purchased in a prior year are deductible operating expenses. If the assets are only partially used for business, the cost of the supplies and repairs must be similarly allocated and only the business portion included on the return.

The cost of basic local telephone service for the first telephone line or cellphone (if no land-line) in the home is not deductible. However, separate charges for business long distance phone calls on that line or that cellphone, as well as the cost of a second line into the home or cellphone that is used exclusively for business, are deductible business expenses.

Supplies: Supplies for running the business includes office items such as paper, toner, binders, stationery and pens. Supplies generally have a short, finite life and are exhausted when they are used for their purpose.

Buying a part from a wholesaler for immediate use to repair a piece of a customer's equipment is a supply expense. Buying multiple parts so some are on hand in case it's needed becomes inventory if carried over from one year to the next unless the cost and quantity is minor. A distinction must be made between what is essentially a service (repairing the furnace) versus supplying a product (delivering an installed furnace). There can also be significant sales tax issues. Again, the taxpayer's specific facts/circumstances must be considered in the decision.

Inventory: Inventory is out of scope for Tax-Aide. Generally, the following are considered inventory

- Merchandise or stock in trade
- Raw materials
- Work in process
- Finished products
- Supplies that physically become a part of the item intended for sale

Inventory does not include:

- Goods sold if title has passed to the buyer
- Goods consigned to the taxpayer
- Goods ordered for future delivery if the taxpayer does not yet have title

Cost of goods sold: Items purchased for resale or as an ingredient/raw material for a product intended for sale are considered part of the cost of goods sold which is out of scope for Tax-Aide. Even if materials are resold or used to make a product that is sold within the same tax year, they are still considered part of the cost of goods sold.

Example 1: A taxpayer engaged in a direct-sale business such as Amway, Avon, Mary Kay or Tupperware orders product on a consignment basis. If so, this product is not considered inventory as the taxpayer does not own it and associated costs are deductible as operating expenses. However, if the taxpayer purchases the products and then resells them, they are considered inventory and are out of scope. The taxpayer must know if product was consigned or purchased.

Example 2: John, a professional writer, purchases two packs of pens and three boxes of paper clips he plans to use for his writing activities over the next two years. The cost was minimal and he does not keep inventory of each pen or paperclip. These are incidental compared to his business and deductible in the year he paid for them. If he also buys a computer for more than the safe harbor limit, the return is out of scope.

Example 3: David, a full-time college student who lives at home, also drives part-time three days a week after school as an independent contractor for Uber. He keeps a log of all mileage driven, parking and tolls. His Uber related parking and tolls plus mileage at the standard per mile rate are deductible expenses.

Example 4: Martha has no land-line telephone service, just a cellphone for both personal and business use. The cost of the cellphone and service are not deductible expenses. Any phone expenses directly attributed to the business use are deductible, but this does not include apportioning the annual cost of this single "line" based on personal versus business use.

Example 5: Jeff has no land-line telephone service and has a cellphone for personal use. He purchased a second cellphone for $250 and added a number for mostly business use. The cost of the second cellphone and service are deductible expenses, but must be apportioned based on personal versus business use which means he must have thorough records.

Example 6: Joan is a working mother of a college student. To make ends meet she uses Airbnb to rent out the son's room when he is at school. Normally, rentals would be reported on Sch E. But in the case of short-term rentals (such as Airbnb), the services provided are more than nominal and the activity may be properly classified as a business. Since Joan is required to reduce her basis in her property by the full amount of depreciation that she could have deducted, this is out of scope for Tax-Aide. Only rentals for land-only or for active duty military personnel if the volunteer is Military certified are in scope and these are reported on Sch E.

Example 7: Bob sews drapes on a made-to-order basis. He buys the fabric selected by the client and delivers and installs the drapes. The cost of the thread, needles, etc. is a deductible expense as operating supplies assuming they are not a significant cost, but the fabric is a raw material for the finished product and is therefore out of scope as a cost of goods sold expense.

Example 8: Carol purchased a new computer for $2,500 which she uses partly for her business. Once the counselor learns of this business use, this return becomes out of scope because the business portion of the computer must be depreciated. Although, if Carol has no records of the business portion of the use, one could argue that there is no depreciation expense, but that is a decision best left to Carol working with a tax professional.

Example 9: Felix is a handyman and can paint, patch or fix almost anything. He has a complement of tools that include portable saws, paint sprayers and nail guns (among others) some of which cost more than the safe harbor limit. The more expensive tools are not insignificant and Felix must claim a depreciation deduction for them. Once the counselor learns that Felix has purchased these tools, the return becomes out of scope as Form 4562 is out of scope in its entirety.

Example 10: Judy is retired and enjoys painting landscapes. She views her creations as an artistic exercise done for pleasure, but does occasionally sell some of her paintings. A Schedule C would not be prepared as this is not an activity that qualifies as a business since Judy's primary purpose for engaging in the activity is not for income or profit. Her return is out of scope for Tax-Aide.