



Income – Business; Form 1040, Line 12



Introduction

This lesson will help you prepare an accurate return for taxpayers who have business income, including self-employment income. Form 1040, line 12, is used to report income from a business or profession operated as a sole proprietor or independent contractor.

Preparation of tax returns with Schedule C are in scope for VITA/TCE under certain limited conditions and with expenses of \$25,000 or less.

This lesson covers recordkeeping requirements for taxpayers with business income and expenses. Refer to Publication 583, Starting a Business and Keeping Records, for more information. You will learn how business income affects eligibility for certain tax credits.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine how to report business income
- Determine when to complete Schedule C-EZ or C
- Determine what business expenses are within the scope for the VITA/TCE programs
- Identify “red flags” when preparing a Schedule C return with earned income credit (EIC)
- Determine what records to maintain

Where do I get business income information?

Business income information may come from the following:

- Forms 1099-MISC, Miscellaneous Income, box 7, Nonemployee Compensation
- Forms W-2, Wage and Tax Statement with Statutory Employee checked in box 13
- Taxpayer’s books and records
- Forms 1099-K, Merchant Card and Third Party Payments

Based on your interview and the completion of the taxpayer’s intake and interview sheet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. These taxpayers may not have income statements for their business income and expenses. The information to prepare their tax return comes from their records.

Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor.

What do I need?

- Intake and Interview Sheet
- Publication 4012, Volunteer Resource Guide
- Publication 17
- Publication 463
- Publication 4491-W
- Form 1099-MISC
- Schedule C
- Schedule C Instructions
- Schedule C-EZ
- Schedule SE

Optional

- Publication 535
- Publication 583
- Form 1099-K
- Form 1099-K Instructions

Cash Income

Some taxpayers may indicate that they received cash income for self-employment activity. This income must be reported, unless excluded by law.

If taxpayers do not have adequate records of the cash income they received, you may be able to assist them with simple record reconstruction. See the section on reconstructing records later in this lesson.

TIP

Income received from all sources in a self-employed taxpayer's business must be reported, unless excluded by law.

Form 1099-MISC, Miscellaneous Income

Taxpayers who are independent contractors should receive Form 1099-MISC showing the income they earned from payers who are required to file Forms 1099. The amount from Form(s) 1099-MISC, along with any other business income payments, are reported on their tax return.

A taxpayer does not have to conduct regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may be self-employment. Ask for any Form(s) 1099-MISC that document this income. Subcontractors or individuals who receive less than \$600 may not receive Form 1099-MISC, but still must report all cash income. Also ask for documentation of any business income that was not reported on Form W-2 or Form 1099-MISC (e.g., payments received from individual clients who do not need to file Form 1099).

example

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-MISC that shows he received \$15,000 for the work he did for them. He also received cash payments of \$4,000 from several different individuals for the work he completed. He did not receive Forms 1099-MISC for the \$4,000. Tim must include the \$4,000 cash payments as self-employment income along with the \$15,000 from Form 1099-MISC.

Qualified Medicaid Waiver Payments

Qualified Medicaid waiver payments are treated as difficulty of care payments and are **excludable from gross income**. Medicaid payments for in-home care are classified as Medicaid waiver payments when the care provider and the care recipient reside in the same home.

If the taxpayer received payments described in Notice 2014-7 on or after January 3, 2014, that are excludable from gross income as difficulty of care payments, then the taxpayer must exclude the income under section 131 as provided in Notice 2014-7 for 2014 and later years.

When the care provider and the care recipient do not live together in the same home, the Medicaid payments are fully taxable.

The taxpayer may file a Form 1040X, Amended U.S. Individual Income Tax Return, if they received payments described in Notice 2014-7 in an earlier year if the time for claiming a credit or refund is still open. Generally, for a credit or refund, the taxpayer must file Form 1040X within three years (including extensions) after the date the taxpayer filed their original return or within two years after the date they paid the tax, whichever is later.

In Part III of Form 1040X, the taxpayer should explain that the payments are excludable under Notice 2014-7. Excluding payments described in the notice in an earlier year may affect deductions or credits that were claimed for the earlier year, as well as other tax items for the earlier year.

For more information, go to irs.gov and search for Certain Medicaid Waiver Payments.

TIP

Excluded Medicaid waiver payments are not earned income for the earned income credit, for the dependent care credit, nor the additional child tax credit.

How is business income reported?

Form 1040

Form 1040, line 12, is used to report income from a business operated or a profession practiced as a sole proprietor. Schedule C-EZ or Schedule C shows the income and expenses and the net amount is carried to Form 1040, line 12. An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. A hobby is an activity typically undertaken for pleasure during leisure time.

To report income from an activity not for profit, see the instructions for Form 1040, line 21, and Publication 17, Other Income. This topic is out of scope. Refer any taxpayers with not-for-profit activity to a professional tax preparer.

Form 1040, line 12, is also used to report wages and expenses the taxpayer had as a statutory employee or certain income shown on Form 1099-MISC, Miscellaneous Income.

Schedule C-EZ and Schedule C

Business income is reported on either:

- Schedule C-EZ, Net Profit From Business, or
- Schedule C, Profit or Loss From Business

If preparing Schedule C, Part I, the following are out of scope for VITA/TCE programs: return and allowances, cost of goods sold (involves inventory), and other income. Taxpayers with these items should be referred to a professional tax preparer.

Figure the net profit or loss by subtracting the business expenses from business income. The total profit or loss is then transferred to Form 1040, line 12.

The net profit or loss will be reported on Form 1040, line 12. The net profit will also need to be shown on Schedule SE in order to calculate the self-employment tax. Schedule SE will be covered in a later lesson.



Tax Software Hint: The tax software calculates net profit after income and expense entries are made. Next, the software transfers the net profit to the applicable line on Schedule SE to compute the self-employment tax. Amounts are then transferred to the applicable lines of Form 1040.

The following terms are used in the preparation of business returns:



Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC. Taxpayers who believe they have been misclassified should contact the IRS and ask for help.



Volunteer tax preparers who have Advanced certification can assist with preparation of Schedule C-EZ and the limited Schedule C.

Definition of Terms	
Business expenses	Business expenses are amounts that are ordinary and necessary to carry on the business.
Cash method of accounting	The cash method of accounting reports all income when received and deducts all expenses when paid.
Inventory	Inventory is the items the taxpayer buys or makes for resale to others.
Depreciation	The cost of items that are expected to last more than a year should be spread over a period of years rather than deducted in the year of purchase. If the taxpayers have such a cost, they should be referred to a professional tax preparer.
Asset write-off	An election is available to immediately write off qualifying assets. Taxpayers who wish to write off assets should be referred to a professional tax preparer.

Who can use Schedule C-EZ?

There are a number of conditions taxpayers must meet in order to use Schedule C-EZ. Taxpayers can use Schedule C-EZ only if they:

- Have less than \$5,000 in business expenses
- Use the cash method of accounting
- Have no inventory at any time during the year
- Did not have a net loss from the business
- Operate only one business as a sole proprietor during the tax year (each spouse on a joint return may use a separate Schedule C-EZ to report business income from separately owned sole-proprietor businesses if other conditions for filing Schedule C-EZ are met)
- Have no employees during the year
- Are not required to file Form 4562, Depreciation and Amortization, for this business (depreciation and asset write-offs are out of scope for the VITA/TCE programs)
- Do not deduct expenses for business use of a home
- Do not have prior year unallowed passive activity losses from this business

In the interview, if you discover taxpayers have issues that fall outside the scope of the VITA/TCE programs, refer them to a professional tax preparer.

Who can use Schedule C for purposes of the VITA/TCE programs?

Volunteers can assist taxpayers who have returns that require Schedule C with certain limits. Use the same criteria as Schedule C-EZ, except taxpayers can have expenses up to \$25,000, and more than one Schedule C can be prepared if the taxpayers have more than one business. If taxpayers have a Schedule C that falls outside these parameters, refer them to a professional tax preparer.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

SAMPLE INTERVIEW

VOLUNTEER SAYS...

JASON RESPONDS...

What kind of business do you have and were you the sole owner?

I install air conditioners and yes, I own the business myself. No partners or employees.

Do you have a record of your business income and expenses for last year?

Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.

Do you use the cash method of accounting?

Yes. I have a printout of my year-end summary here.

And what were your expenses?

Well, I do the installations myself; I spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year were \$2,212.

Do you keep any parts in inventory?

No, I purchase the parts when an order is placed with me.

And you say you had a good year? In other words, did you make a profit?

That's correct.

Did you use part of your home for your business?

No, I don't.

Okay, and how much business income did you have?

My gross totaled \$30,762.

[On page 2 of the intake and interview sheet, indicate Jason's responses to these questions.]



EXERCISE

Question 1: Based on the information in the sample interview, does Jason qualify to fill out a Schedule C-EZ? Yes No

How do you clarify taxpayers' business income and expenses?

All IRS-certified volunteers must exercise due diligence when preparing tax returns. Due diligence means doing your part to ensure tax returns are correct.

This means, as a volunteer, you must do your part when preparing or reviewing a tax return to ensure the information on the return is correct and complete. Generally you can rely in good faith on information from a taxpayer without requiring documentation as verification.

However, when preparing a tax return with a Schedule C/C-EZ and the earned income credit (EIC), take additional steps to determine that the net self-employment income used to calculate the amount of, or eligibility for, EIC is correct and complete. Additional clarification or inquiries should be made if the information furnished by the taxpayer appears to be incorrect, incomplete, or inconsistent. Taxpayers sometimes want to over report or under report their income to qualify for or maximize the amount of EIC.

Ask sufficient questions of taxpayers claiming self-employment income to be satisfied that:

- The taxpayer actually conducts a business
- The taxpayer has records to support income and expenses, or can reasonably reconstruct income and expenses records
- All income and related expenses have been included on the taxpayer's Schedule C/C-EZ

Emphasize to taxpayers that in the event of an IRS audit, they would need to provide receipts to support their figures.

What Schedule C situations raise a “red flag”?

As a volunteer preparing a tax return with Schedule C/C-EZ, watch for examples of incorrect, incomplete, or inconsistent information, such as:

- Schedule C/C-EZ income in round numbers
- Schedule C/C-EZ cash businesses as the only income on a return claiming EIC
- Schedule C/C-EZ with little or no expenses when expenses would be expected
- Schedule C/C-EZ taxpayers with little or no records for income and expenses
- Any Schedule C/C-EZ income that brings the taxpayer to the maximum EIC
- Schedule C/C-EZ without a Form 1099

Taxpayer Interview and Tax Law Application

A taxpayer, Dana, comes in to have her tax return prepared. She tells you she runs her own babysitting business and wants to claim the EIC.

To assist the taxpayer in completing an accurate return, you need to ask more questions to determine if Dana did incur allowable business expenses and that the income she reported is correct.

SAMPLE INTERVIEW

VOLUNTEER SAYS...	DANA RESPONDS...
<i>Tell me about your business, and were you the sole owner?</i>	I have a babysitting service that I handle all by myself.
<i>Do you have a record of your business income and expenses for last year?</i>	Well, I'm not very good at keeping records, but I can tell you that I made \$14,000 over the course of the year. I didn't have any expenses.
<i>How did you determine that you made a net profit of \$14,000?</i>	I based my income on deposits to my checking account.
<i>I see. We may be able to reconstruct your business income based on your deposits. Did you bring any bank statements or your checkbook record with you today?</i>	No, I'm sorry.
<i>How many children did you care for, and was this a full-time or part-time job for you?</i>	Babysitting is just part-time. I watch several of my neighbors' children along with my own kids who are 8 and 10 years old.
<i>What is your fee for babysitting?</i>	It averages about \$10 an hour.
<i>Do you have a calendar or schedule of the children present each day?</i>	No, but I may be able to come up with one.
<i>Do you have a business license or permit, and do you watch the children in your own home or in a daycare facility or in the client's home?</i>	My home and sometimes at my neighbors' homes. I don't need a permit.
<i>Do you buy any supplies such as food, diapers, toys, or other items necessary for the business?</i>	Sometimes I need to buy supplies. But I didn't bring receipts with me.

SAMPLE INTERVIEW (continued)

VOLUNTEER SAYS...

DANA RESPONDS...

Did you intend to deduct expenses for the business use of your home?

No, I don't think so.

Be aware that the IRS requires that you report all income and allowable expenses on your tax return. In the event of an IRS audit, you will be responsible for providing support for the income and expenses claimed on your return. Before we can proceed, you'll need to gather some additional facts and records. I'll write down a list of items that could help us more accurately calculate your net profit from your business.

OK – thanks. I'll see what I can pull together.

The information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

1. Has no business expense. Most businesses have expenses, even if it is just a few dollars here and there.
2. Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EIC.

The volunteer cannot complete a return based on information provided, but gives Dana the chance to gather materials to document her business.

What business expenses are within scope for the VITA/TCE programs?

Taxpayers deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. All ordinary and necessary expenses incurred in a self-employed taxpayer's business must be reported. See the Instructions for Schedule C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Advertising

Advertising expenses are the costs associated with promoting the business through various means including yellow pages, newspapers, magazines, billboards, racing sponsors, and television spots.

Car and Truck Expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation. The calculation of depreciation is outside the scope of the VITA/TCE programs. If the taxpayers have used actual expenses in the past, or wish to use actual expenses in the current year, they must be referred to a professional tax preparer.

For the standard mileage deduction, the current standard mileage rate is multiplied by the number of business miles. Only parking and tolls can be added to this deduction. Commuting and other personal automobile expenses should not be included in this amount.



Every self-employed taxpayer must claim all allowable deductions in computing net earnings from self-employment.

example

Wendy is a self-employed masseuse and does not maintain an office in her home. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Wendy drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.

Commissions and Fees

Commissions or fees are paid to both individuals and businesses. If payments to a single individual are \$600 or more, the taxpayer must report the payments on Form 1099-MISC. In this case the taxpayers' return is out of scope for the VITA/TCE programs.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property, automobile (business vehicles only), and malpractice.

If the standard mileage rate is used, no deduction is allowed for automobile insurance premiums.

Health insurance for the sole proprietor and his or her family is not deductible as a business expense. These medical premiums may be deducted on Form 1040 as an adjustment to gross income, subject to qualifications. However, the adjustment to gross income deduction on Form 1040 is out of scope for the VITA/TCE programs.

Other Interest

This category can include interest paid on operating loans, but not mortgage interest.

Legal and Professional Services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., tax returns, wills, or estates) and are not deductible as business expenses.

Office Expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or Lease – Vehicle, Machinery, and Equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Leases of more than 30 days are out of scope.

Repairs and Maintenance

Repairs on equipment, automobiles, office space, and buildings are some possible expenditures reflected in this category. Expenses that should *not* be reflected are:

- Capital equipment that is improperly expensed (see Cost Recovery in Publication 535).
- Repairs that substantially improve a facility or equipment that should be capitalized.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Taxes and Licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

Travel/Meals and Entertainment

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel, meal, and entertainment expenses are in the Volunteer Resource Guide, Deductions tab.

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses for the business. The base rate of the first telephone line to a residence cannot be deducted, but additional costs incurred for business purposes can be included as an expense. There should be no deduction for personal expenses in this category.

example

Kiana runs a small business from her home. She has only one phone line and frequently makes long-distance calls for business. The cost of the phone line cannot be deducted, but Kiana can deduct the long-distance charges for her business calls.

Other Expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Schedule C. See Form Schedule C Instructions (Part V - Other Expenses) and Publication 535 for more information.

How do I complete Schedule C-EZ?

Part I: General Information

Enter the type of business and the Principal Business Code. A list of Principal Business Codes can be found in Schedule C Instructions and in Form 1040 Instructions.



Tax Software Hint: Refer to the Volunteer Resource Guide, Income tab, to review software entries for principal business codes.

Enter the business name, if there is one. If the business has an Employer Identification Number (EIN), enter it (most Schedule C-EZ businesses do not need an EIN, since they do not have employees). If the business has an address that is different from the one shown on Form 1040, enter it.

Check “Yes” or “No” box for the question, “Did the business make any payments in the current tax year that would require filing of Form(s) 1099?”

If the answer is Yes, did or will the business file required Forms 1099? Check “Yes” or “No” box.

In general, taxpayers who seek assistance through the VITA/TCE programs may be required to file Form 1099-MISC for payments in the amount of \$600 or more for services performed for a trade or business by people not treated as its employees. An example is for subcontractors who are nonemployees. For a complete listing of Forms 1099 and the requirements for issuance, refer to the chart in the Form 1099 General Instructions.

If the taxpayer responds Yes to making payments that would require the filing of Form(s) 1099, the income tax return and any related Form 1099 preparation are both out of scope for the VITA/TCE programs. The Form 1040 must still be referred to a professional tax preparer even if taxpayers indicate they have already filed the Forms 1099.

Part II: Figure Net Profit

Enter on line 1 the amount for gross receipts or sales.

If this income was reported to the taxpayer on Form W-2 and the “Statutory Employee” box on that form is checked, see Schedule C-EZ Instructions before completing this line.



Tax Software Hint: Refer to the Volunteer Resource Guide, Income tab, for guidance on entering income reported on Form 1099-MISC and other payments received that are not reported on Form 1099-MISC.

Enter on line 2 the total amount of all deductible business expenses that the taxpayer actually paid during the year. Only the portion of these costs that are attributable to the business can be deducted as a business expense.

TIP

Examples of deductible business expenses include advertising, car and truck expenses, commissions and fees, insurance, interest, legal and professional services, office expenses, rent or lease expenses, repairs and maintenance, tools that last less than a year, supplies, taxes, travel, the allowable percentage of business meals and entertainment, and utilities. The base rate of the first telephone line to a residence cannot be deducted, but additional costs incurred for business purposes can be included as an expense.

For earned income credit and self-employment tax purposes, the taxpayer must include all allowable deductions in computing net earnings.



Tax Software Hint: Refer to the Volunteer Resource Guide, Income tab, for guidance on entering expenses on the Schedule C-EZ. The tax software will total all the expenses and transfer the amount to line 2.

Part III: Information on Vehicles

If the taxpayer had business expenses for a car or truck, complete the questions in Part III. Business miles do not include commuting miles between home and the business location or between business and lunch locations. Business miles do include travel between home and a temporary workplace when the taxpayer has one or more regular places of work. If the taxpayer has no regular place of work, only the travel from one temporary place to another is counted. See the Volunteer Resource Guide, Deductions tab, and Publication 463, Travel, Entertainment, Gift, and Car Expenses for more details.

Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation, which is outside the scope of the VITA/TCE programs. If the taxpayer has used actual expenses in the past, or wishes to use actual expenses in the current year, refer the taxpayer to a professional tax preparer.

The standard mileage rate is multiplied by the number of business miles to calculate the vehicle expense. Add the total vehicle expenses to all nonvehicle expenses in line 2. The standard mileage rate represents all vehicle expenses; taxpayers may add only such fees as parking or tolls. Complete the information in Schedule C-EZ, Part III.

How do I complete Schedule C?

Generally the same business expenses are deductible on both Schedule C and C-EZ. The expenses are totaled and included on one line on Schedule C-EZ, whereas on Schedule C, the business expenses are broken down by category.

General Information Section

Complete lines A–J.

- Enter the type of business.
- Enter the Principal Business Code. A list of Principal Business Codes can be found in Schedule C Instructions and in Form 1040 Instructions.
- Enter the business name, if no separate name, leave blank.
- Employer ID Number (EIN), if any.
- Enter the business address.
- Check accounting method. (Only cash method is in scope for the VITA/TCE programs; if taxpayers use another method, refer them to a professional tax preparer.)
- Check “Yes” or “No” box for: Did the taxpayer “materially participate” in the operation of the business?
 - In general, the taxpayer materially participates if based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year. See Schedule C Instructions for specific tests to determine if the taxpayer meets the requirements for material participation.
 - If the taxpayer meets one of the tests for material participation, check the “Yes” box, otherwise the answer is “No.” If there is uncertainty about the taxpayer materially participating in the business, refer them to a professional tax preparer.
- Check the box if business was started or acquired during the tax year.
- Check “Yes” or “No” box for: Did the business make any payments in the tax year that would require filing of Form(s) 1099?
- If Yes, did or will the business file required Forms 1099? Check “Yes” or “No” box.

In general, taxpayers who seek assistance through the VITA/TCE programs may be required to file Form 1099-MISC for payments in the amount of \$600 or more for services performed for a trade or business by people not treated as its employees. An example is for subcontractors who are nonemployees. For a complete listing of Forms 1099 and the requirements for issuance, refer to the chart in the General Form 1099 Instructions.

If the taxpayer responds Yes to making payments that would require the filing of Form(s) 1099, the income tax return and any related Form 1099 preparation are both out of scope for the VITA/TCE programs. The Form 1040 must still be referred to a professional tax preparer even if the taxpayer indicates they have already filed the Forms 1099.

Part I: Income

Enter on line 1 the amount for gross receipts from the taxpayer's trade or business. If the income was reported on Form W-2 and the "Statutory Employee" box on that form is checked, see Schedule C Instructions before completing this line.

Statutory Employees

If the taxpayer received Form W-2 and "Statutory employee" was checked in box 13, report the income and expenses related to that income on Schedule C or C-EZ. Enter the statutory employee income from Form W-2, box 1, on line 1 of Schedule C or C-EZ. Social security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self-employment tax on these earnings. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Self-employment income and statutory employee income cannot be reported on the same Schedule C. The taxpayer must file two separate Schedules C.



Tax Software Hint: If the taxpayer has a Form W-2 with the "Statutory employee" box checked, be sure to follow the guidance for the applicable line of Schedule C or C-EZ. This income is not subject to self-employment tax since Social Security and Medicare taxes have already been withheld.

Part II: Expenses

On Schedule C there is a separate line for the most common expenses that are incurred in a business. Review the taxpayer's information to determine if the expenses are **ordinary and necessary**.

Part III: Cost of Goods Sold

This relates to inventory and is out of scope for the VITA/TCE programs.

Part IV: Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Schedule C.



Determine if the taxpayer received business income that was not reported on Form 1099-MISC. For example, tips received by self-employed hair stylists or manicurists are to be included in gross receipts on Schedule C-EZ/C.



EXERCISES (continued)

Question 2: Daniel has his own business. He received Form 1099-MISC for \$13,000 for work he completed as an independent contractor. He also received cash payments that total \$2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of \$2,500 on his return? Yes No

Question 3: Ellen has a small business. The gross income from her business is \$40,000, her business expenses total \$11,500, and she must file a Schedule C. Is Ellen's tax return in scope for the VITA/TCE programs? Yes No

Recordkeeping

Why keep records?

Everyone in business must keep records. See the Volunteer Resource Guide, Deductions tab, for a table on recordkeeping. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify source of receipts
- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books (for example, accounting journals and ledgers). The books must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books. In addition, supporting documents must be kept.

Supporting documents

Purchases, sales, payroll, and other transactions in the business generate supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents contain information that must be recorded in the books.

It is important to keep these documents in an orderly fashion and in a safe place because they support the entries in the books and on the tax return. For instance, organize them by year and type of income or expense.



When a business involves the use of a vehicle, a mileage log would be a supporting document.

Reconstructing records

Make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

You may help a taxpayer with simple record reconstruction. Assisting the taxpayer in reconstruction will help teach the taxpayer about recordkeeping. Extensive record reconstruction should be performed by the taxpayer or a paid preparer. If you are not satisfied with the accuracy of the reconstructed records, you have the right to decline to prepare the return. See your Site Coordinator for guidance.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. When reconstructing records, you can use such tools as:

- Appointment books or calendars
- Online map tools
- IRS standard allowances
- Checkbooks
- Canceled checks

- Bank or credit card statements
- Lists of regular clients
- Partial receipts or sales tax records
- Cell phone records, call history, or computer logs
- Prior year returns

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the period of limitations for that return runs out.

The period of limitations is the time in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Publication 583.

Taxpayer Interview and Tax Law Application

Remember our taxpayer, Dana, with a babysitting business? She said she made \$14,000 in net profit from her business, and wants to claim the EIC. After careful interviewing, the volunteer has determined the return cannot be completed without record reconstruction. The volunteer asked Dana to go home and return with some documentation to support her claims.

Based on the taxpayer's materials and additional questions, you can determine if Dana should be claiming expenses for the business use of her home. If so, refer the taxpayer to a professional tax preparer.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Nice to see you again, and I see you have some additional materials. What kind of documentation were you able to put together?

That sounds great. First, let's multiple the number of children that you cared for by the corresponding charged rate to confirm your income figure. Did you also bring documents to support your business expenses?

OK, then we'll calculate a reasonable estimate of expenses incurred.

DANA RESPONDS...

As you suggested, I completed a calendar that shows the number of children that I cared for on each date.

Yes, I have some grocery store receipts, canceled checks, bank statements, and credit card statements. I have highlighted the regular purchases I made for my business.

Good. I'm sure my first estimate of \$14,000 business income is not accurate after all. I appreciate learning what I need to do to keep track of my income and expenses.

What about self-employment tax?

A taxpayer must file Schedule SE if he or she has net earnings from self-employment of \$400 or more. The tax is computed on Schedule SE and transferred to Form 1040, to be added to other taxes owed. The Schedule SE is attached to Form 1040, and discussed in the Other Taxes lesson.

Self-employed taxpayers may claim an adjustment to income for part of their Social Security and Medicare taxes.



Tax Software Hint: Self employment tax and the deductible part of self-employment tax are automatically calculated. The software then enters these amounts on applicable lines of Form 1040.

Summary

This lesson explained:

- Where to get business income and expense information
- Cash income must be reported
- Subcontractors or individuals who receive less than \$600 may not receive Form 1099-MISC, but still must report all cash income
- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- Certain situations involving Schedule C and EIC should raise "red flags"
- How business income or loss is reported
- What business expenses are within scope for the VITA/TCE programs
- Who can use Schedule C-EZ
- How to complete Schedule C-EZ
- How to complete Schedule C
- How to determine what records to maintain
- How to complete simple record reconstruction

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

Schedule C with:

- Hobby income or not-for-profit activity
- Expenses over \$25,000
- Return and allowances
- Cost of goods sold
- Other income
- Expenses for employees
- Business use of home
- Casualty losses
- Vehicle expenses reported as actual expenses
- Depreciation or asset write-offs
- Rental or lease expenses – vehicle, machinery, and equipment leases of more than 30 days
- Accounting methods other than the cash method
- Net losses
- A "No" response that indicates the taxpayer does not meet any of the tests of material participation, or is uncertain about materially participating in a business
- Taxpayers who receive any credit card or similar payments that are not includible in income
- A "Yes" response indicating there is a requirement to file Form(s) 1099

