

5 Sole Proprietorships and Farmers

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Business Use of Home Methods (page 5-12)

	Simplified Method	Regular Method
Regular/exclusive use tests	Same rules.	Same rules.
Maximum square footage allowed for business.	300 square feet.	No maximum.
Expenses allowed	\$5 per square foot.	Actual expenses determined and records maintained.
Depreciation deduction.	No.	Yes.
Depreciation recapture on sale of home.	No.	Yes.
Deduction cannot exceed gross income limitation.	Same rules.	Same rules.
Carryover of expenses in excess of gross income limitation.	No.	Yes.*
Home-related itemized deductions (i.e. mortgage interest and real estate taxes).	Claimed in full on Schedule A.	Allocated between Schedule A and business schedule.

* Loss carryover from use of regular method in prior year may not be claimed in a year the simplified method is used. The loss is carried over until the next year the regular method is used again.

Race horses treated as 3-year property has been extended through 2016.

■ New for 2015 ■

- **Maximum net earnings subject to SE tax.** The maximum net self-employment earnings subject to the Social Security part of the self-employment tax is \$118,500. See *Self-Employment (SE) Tax*, page 5-23.
- **Expiration of 3-year recovery period for certain race horses.** The 3-year recovery period for race horses two years old or younger expired for such horses placed in service after December 31, 2014. See *Farming Asset Recovery Periods*, page 5-27.

Common Elections

- Election by spouses to be a qualified joint venture, page 5-6.
- Election to use simplified method for business use of home deduction, page 5-15.
- Election to postpone determination of hobby or business status, page 5-21.
- Election to use optional method to compute self-employment tax, page 5-24.
- Election to use crop method of accounting for farmers, page 5-25.
- Election to postpone reporting crop insurance payments, page 5-25.
- Election to use income averaging for farmers and fishermen, page 5-26.
- Election to treat tree cutting as sale or exchange, page 5-28.

Employer Identification Number (EIN)

Third party designees. Tax practitioners who apply for EINs on behalf of their clients must first obtain a completed, signed Form SS-4, *Application for Employer Identification Number*, with the practitioner identified as “third party designee.” The IRS may require that a completed Form SS-4 be faxed or mailed to them.

Online: www.irs.gov, search “EIN online.”

Fax or mail: Complete Form SS-4 and use the following fax numbers or mailing address based on where the principal business is located.

One of the 50 states or the District of Columbia	Internal Revenue Service Attn: EIN Operation, Cincinnati, OH 45999 Fax: 859-669-5760
No legal residence or principal place of business, office, or agency in any state	Internal Revenue Service Attn: EIN International Operation Cincinnati, OH 45999 Fax: 859-669-5987 Phone: 267-941-1099

Daily limit for EINs. The IRS limits issuance of EINs to one per responsible party per day, applicable to all requests via online, fax, or mail.

Responsible party is an entity with an EIN obtained over the internet. The IRS will not process an online application for an EIN if the responsible party is an entity with an EIN previously obtained over the internet.

Day Care Providers Standard Meal and Snack Rates (page 5-18)

	2016	2015	2014	2013
Continental U.S.				
Breakfast	\$1.32	\$1.31	\$1.28	\$1.27
Lunch and Dinner (each)	\$2.48	\$2.47	\$2.40	\$2.38
Snacks (each/up to 3)	\$0.74	\$0.73	\$0.71	\$0.71
Alaska				
Breakfast	\$2.11	\$2.09	\$2.04	\$2.03
Lunch and Dinner (each)	\$4.02	\$4.00	\$3.89	\$3.86
Snacks (each/up to 3)	\$1.20	\$1.19	\$1.16	\$1.15
Hawaii				
Breakfast	\$1.54	\$1.53	\$1.49	\$1.48
Lunch and Dinner (each)	\$2.90	\$2.88	\$2.81	\$2.79
Snacks (each/up to 3)	\$0.86	\$0.86	\$0.83	\$0.83

Self-Employment Tax (page 5-23)

- Computation: Net profit \times 0.9235 = Net SE earnings.
- File Schedule SE if net SE earnings are more than \$400.
Exception: File if church employee income is more than \$108.28.
- Self-employment tax rate is 15.3% of net SE earnings, broken down as follows:
 - Social Security portion: Net SE earnings \times 12.4%
 - Medicare portion: Net SE earnings \times 2.9%
- Additional Medicare tax of 0.9% on SE earnings over \$200,000 (Single, HOH, QW), \$250,000 (MFJ), or \$125,000 (MFS).
- Self-employment earnings limit on Social Security portion:

2015	2014	2013	2012
\$118,500	\$117,000	\$113,700	\$110,100
- Self-employment maximum tax on Social Security portion:

2015	2014	2013	2012
\$14,694	\$14,508	\$14,098.80	\$11,450.40
- Self-employment maximum tax on Medicare portion: No limit.
- Deduction for one-half of SE tax is reported on line 27, Form 1040.
- Social Security earnings credit. One credit is earned for each of the following dollar amounts of SE earnings, up to four credits per year:

2015	2014	2013	2012
\$1,220	\$1,200	\$1,160	\$1,130

Self-employment tax optional method limits:

Optional method	2015	2014	2013	2012
Farm gross income limit	\$7,320	\$7,200	\$6,960	\$6,780
Farm net profits limit	\$5,284	\$5,198	\$5,024	\$4,894
Nonfarm net profits limit	\$5,284	\$5,198	\$5,024	\$4,894

Schedule C-EZ, Net Profit From Business

A taxpayer qualifies to file Schedule C-EZ (instead of Schedule C) if:

- Had business expenses of \$5,000 or less, did not claim depreciation, or the business use of home deduction.
- Did not have a net loss from the business.
- Uses cash method of accounting and did not have an inventory at any time during the year.
- Had only one business as either a sole proprietor, qualified joint venture, or statutory employee.
- Had no employees during the year.
- Do not have prior year unallowed passive activity losses from the business.

Hobby Loss Rules (page 5-19)

- Presumed not a hobby (loss limits do not apply) if profit in three out of five years (two out of seven years for breeding, training, showing, or racing horses).
- Hobby losses limited to hobby income for taxpayers who itemize in the following order:
 - 1) Deduct certain personal expenses (home mortgage interest, taxes, casualty loss) in full on the normal line on Schedule A. If any remaining hobby income, go to category 2.
 - 2) Deduct operating expenses that do not result in an adjustment to basis of property (advertising, insurance premiums, wages) as miscellaneous itemized deductions subject to 2% AGI limit. If any remaining hobby income, go to category 3.
 - 3) Deduct expenses that reduce basis of property (depreciation) as miscellaneous itemized deductions subject to 2% AGI limit.

Farmers — Estimated Tax

For calendar year taxpayers, only one estimated payment is required if at least two-thirds of gross income for 2014 or 2015 is from farming or fishing. The due date of the estimated payment for tax year 2015 is January 15, 2016, and the required payment is two-thirds of the tax liability for 2015, or 100% of the tax shown on the 2014 return. Due dates for the first three installments do not apply.

Exception: No estimated payment is required if the 2015 tax return is filed and the balance due paid by March 1, 2016.

Features of Sole Proprietorships*

Organization and Ownership	<ul style="list-style-type: none"> • One individual carrying on an unincorporated trade or business. • A qualified joint venture whose only members are spouses may elect not to be taxed as a partnership and file as two sole proprietorships. An LLC may not make this election. See <i>Spousal business</i>, page 5-6. • Easiest business to organize with minimal legal restrictions. • The entity does not exist apart from the owner. Business starts and ends based on engaging in and ending engagement in business. • The owner has complete freedom over business decisions and is entitled to 100% of the profits. The owner is limited by his or her own ability to raise capital and obtain financing. Outside investors cannot be part owners. • Transfer of ownership consists of selling the business assets. • A single-member LLC is taxed as a sole proprietorship unless an election is made to be taxed as a corporation.
Taxation of Profits and Losses	<ul style="list-style-type: none"> • The owner is self-employed and pays SE tax on net profits. See <i>Self-Employment Tax</i>, page 5-23. • Net profits are subject to income tax in the year earned and cannot be deferred by retaining profits. • Losses offset other income in year incurred, such as W-2 wages, interest, dividends, and capital gains. <p>Exception: Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules.</p>
Accounting and Recordkeeping	<ul style="list-style-type: none"> • Accounting is less involved than partnerships and corporations. Double-entry bookkeeping is not required as no balance sheet is needed when filing Schedule C, <i>Profit or Loss From Business</i>, or Schedule F, <i>Profit or Loss From Farming</i>. • Cannot file as a fiscal year business unless owner files Form 1040 under the fiscal year rules.
Fringe Benefits	<p>Excludable fringe benefits are generally not allowed for owner.</p> <p>Exceptions: Health insurance, if spouse is an employee of the sole proprietorship, and the owner is covered as a family member of the employee-spouse. Also eligible for dependent care assistance fringe benefits (Tab 13), de minimis fringe benefits (Tab 13), and working condition fringe benefits (Tab 13).</p>
Liability	<p>Owner is personally liable for all debts and lawsuits against the business.</p> <p>Exception: If organized as an LLC under state law, liability is usually limited to owner's investment and his or her own malpractice.</p>

* Includes single-member LLCs and spousal businesses.

Note: For information on other types of business entities as compared to sole proprietorships, see *Business Entity Comparison Chart*, Tab 31, *Small Business Edition*.

Self-Employment Tax Situations Chart

This list is not intended to be all-inclusive.

Type of Worker/Income	SE Tax Requirements
Employee	No SE tax, subject to FICA withholding.
Hobby income	Not subject to SE tax. ¹ See page 5-19 for information on hobbies.
Partners and LLC members	Guaranteed payments and a general partner's distributive share of income are subject to SE tax. A limited partner's distributive share is not subject to SE tax [IRC §1402(a)(13)]. See <i>Court Case</i> below. ² Distributive shares to LLC members who are active in the production of the LLC's earnings are subject to SE tax. (CCA 201436049)
Partnership losses	A self-employment loss reported on Schedule K-1 to a partner cannot be used to offset other self-employment income unless the partner has basis in the loss. See <i>Basis</i> , Tab 20, <i>Deluxe Edition/Small Business Edition</i> .
Deceased partner	If a general partner dies during the year, earnings from self-employment include the distributive share of partnership profits through the end of the month in which the partner died.
Retired partner	Lifelong periodic payments are not subject to SE tax if the partner had no other interest in the partnership and did not perform services for the partnership during the year.
S corporation shareholder	Distributive share of earnings are not subject to SE tax. Wages paid for services performed are subject to FICA.
Share crop farming	Producing crops or livestock on someone else's land for a share of the crops or livestock is subject to SE tax, as is the landlord's income if he or she materially participates in the farm activity.
Department of Agriculture	Payments for participating in a land diversion program are subject to SE tax. <i>Exception:</i> See <i>Conservation Reserve Program</i> , page 5-25.
Community property states	State laws that say income is earned one-half by each spouse do not apply to SE tax. The spouse who actually earns the income is subject to SE tax.
Covenant not-to-compete	Not subject to SE tax. (<i>Milligan</i> , 9th Cir., 1994)
Insurance agent (self-employed)	Subject to SE tax on regular, renewal, and deferred commissions, if earned prior to retirement. <i>Exception:</i> Covenant not-to-compete.
Rental real estate	Not subject to SE tax unless substantial services are provided, such as a hotel or tourist camp.
Newspaper and magazine sales	Under age 18, exempt from SE tax. Age 18 or older, subject to SE tax.
Notary public	Exempt from SE tax. Enter "Exempt-Notary" on SE tax line of Form 1040.
Interest on accounts receivable	Subject to SE tax if received in the course of trade or business.
Net operating loss	Carryovers from other years do not reduce current year earnings for SE tax calculation purposes.
Fishing vessel crew members	Subject to SE tax if compensation based on share of catch and average crew size is less than 10. Crews of 10 or more are considered employees.
Corporate director fees	Subject to SE tax.
Estate fiduciary fees	Not subject to SE tax unless taxpayer is a professional fiduciary or an active participant in the estate's trade or business.
Depreciation recapture	Not subject to SE tax unless due to the business use of Section 179 or 280F property falling to 50% or less.
Church employees (not a minister or religious order member)	Must pay SE tax on wages exceeding \$108.28 (unless minister or member of religious order) if employer has a certificate in effect electing an exemption from employee Social Security and Medicare taxes.
Ministers and members of religious order	Pay SE tax on salaries and other income for services performed as an ordained, commissioned, or licensed minister, member of a religious order, or a Christian Science practitioner. Housing allowance income may be subject to SE tax. See <i>Parsonage Allowance</i> , Tab 14. <i>Exceptions:</i> <ul style="list-style-type: none"> • A minister or Christian Science practitioner can apply for exemption from SE tax by filing Form 4361, <i>Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners</i>. • A member of a recognized religious group can file for an exemption from SE tax if he or she is conscientiously opposed to accepting Social Security or Medicare benefits, by filing Form 4029, <i>Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits</i>. • Payment for services performed by a member of a religious order who has taken a vow of poverty is exempt from SE tax. [IRC §1402(c)]
U.S. citizen employed by foreign government	Subject to SE tax only if the services are performed in the United States, Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the U.S. Virgin Islands.
Foreign earned income	U.S. citizens living and working outside the U.S. are subject to SE tax on SE earnings, unless the U.S. has a Social Security exemption agreement with the foreign country. The foreign earned income exclusion for income tax purposes does not apply to SE tax. See <i>Foreign Income</i> , Tab 14.
State and local government employees	Certain fee basis government employees not covered under a Social Security agreement may be subject to SE tax.

¹ **Court Case:** The courts have ruled that an activity subject to SE tax must be regular and continuous. A taxpayer was not liable for SE tax for doing a one-time window installation job where he had never performed that kind of service before, nor did he ever again at any time thereafter. (*Batok*, T.C. Memo 1992-727)

² **Court Case:** Three partners in an LLP each held 1% of their interest as a general partner, and 32% of their interest as a limited liability partner (LLP). The court ruled the partners were liable for SE tax on their entire share of partnership income. The court said Congress intended IRC section 1402(a)(13) to apply to investors who were not actively participating in the partnership. (*Renkemeyer*, 136 T.C. No. 137)

Principal Business or Professional Activity Codes

These codes for the Principal Business or Professional Activity classify sole proprietorships by the type of activity they are engaged in to facilitate the administration of the IRC. These six-digit codes are based on the North American Industry Classification System (NAICS).

Select the category that best describes the primary business activity (for example, Real Estate). Then select the activity that best identifies the principal source of sales or receipts (for example, real estate agent). Now find the six-digit code assigned to this activity (for example, 531210, the code for offices of real estate agents and brokers) and enter it on line B, Schedule C.

Note: If principal source of income is from farming activities, file Schedule F, and enter code on line B, Schedule F.

Accommodation, Food Services, & Drinking Places

Accommodation

- 721310 Rooming & boarding houses
- 721210 RV (recreational vehicle) parks & recreational camps
- 721100 Traveler accommodation (including hotels, motels, & bed & breakfast inns)

Food Services & Drinking Places

- 722514 Cafeterias & buffets
- 722410 Drinking places (alcoholic beverages)
- 722511 Full-service restaurants
- 722513 Limited-service restaurants
- 722515 Snack & non-alcoholic beverage bars
- 722300 Special food services (including food service contractors & caterers)

Administrative & Support and Waste Management & Remediation Services

Administrative & Support Services

- 561430 Business service centers (including private mail centers & copy shops)
- 561740 Carpet & upholstery cleaning services
- 561440 Collection agencies
- 561450 Credit bureaus
- 561410 Document preparation services
- 561300 Employment services
- 561710 Exterminating & pest control services
- 561210 Facilities support (management) services
- 561600 Investigation & security services
- 561720 Janitorial services
- 561730 Landscaping services
- 561110 Office administrative services
- 561420 Telephone call centers (including telephone answering services & telemarketing bureaus)
- 561500 Travel arrangement & reservation services
- 561490 Other business support services (including repossession services, court reporting, & stenotype services)
- 561790 Other services to buildings & dwellings
- 561900 Other support services (including packaging & labeling services, & convention & trade show organizers)

Waste Management & Remediation Services

- 562000 Waste management & remediation services

Agriculture, Forestry, Fishing, & Hunting

Crop Production

- 111100 Oilseed & grain farming
- 111210 Vegetable & melon farming
- 111300 Fruit & tree nut farming
- 111400 Greenhouse, nursery, & floriculture production
- 111900 Other crop farming

Animal Production

- 112111 Beef cattle ranching & farming
- 112112 Cattle feedlots
- 112120 Dairy cattle & milk production
- 112210 Hog & pig farming
- 112300 Poultry & egg production
- 112400 Sheep & goat farming
- 112510 Aquaculture
- 112900 Other animal production (including breeding of cats & dogs)

Forestry & Logging

- 113000 Forestry & logging (including forest nurseries & timber tracts)
- 113110 Timber tract operations
- 113210 Forest nurseries & gathering of forest products
- 113310 Logging

Fishing, Hunting, & Trapping

- 114110 Fishing
- 114210 Hunting & trapping

Support Activities for Agriculture & Forestry

- 115110 Support activities for crop productions (including cotton ginning, soil preparation, planting, & cultivating)
- 115210 Support activities for animal production (including farriers)
- 115310 Support activities for forestry

Arts, Entertainment, & Recreation

Amusement, Gambling, & Recreation Industries

- 713100 Amusement parks & arcades
- 713200 Gambling industries
- 713900 Other amusement & recreation services (including golf courses, skiing facilities, marinas, fitness centers, bowling centers, skating rinks, miniature golf courses)

Museums, Historical Sites, & Similar Institutions

- 712100 Museums, historical sites, & similar institutions

Performing Arts, Spectator Sports, & Related Industries

- 711410 Agents & managers for artists, athletes, entertainers, & other public figures
- 711510 Independent artists, writers, & performers
- 711100 Performing arts companies
- 711300 Promoters of performing arts, sports, & similar events
- 711210 Spectator sports (including professional sports clubs & racetrack operations)

Construction of Buildings

- 236200 Nonresidential building construction
- 236100 Residential building construction

Heavy and Civil Engineering Construction

- 237310 Highway, street, & bridge construction
- 237210 Land subdivision
- 237100 Utility system construction
- 237990 Other heavy & civil engineering construction

Specialty Trade Contractors

- 238310 Drywall & insulation contractors
- 238210 Electrical contractors
- 238350 Finish carpentry contractors
- 238330 Flooring contractor
- 238130 Framing carpentry contractors
- 238150 Glass & glazing contractors
- 238140 Masonry contractors
- 238320 Painting & wall covering contractors
- 238220 Plumbing, heating & air-conditioning contractors
- 238110 Poured concrete foundation & structure contractors
- 238160 Roofing contractors
- 238170 Siding contractors
- 238910 Site preparation contractors
- 238120 Structural steel & precast concrete construction contractors
- 238340 Tile & terrazzo contractors
- 238290 Other building equipment contractors
- 238390 Other building finishing contractors
- 238190 Other foundation, structure, & building exterior contractors
- 238990 All other specialty trade contractors

Educational Services

- 611000 Educational services (including schools, colleges, & universities)

Finance & Insurance

Credit Intermediation & Related Activities

- 522100 Depository credit intermediation (including commercial banking, savings institutions, & credit unions)
- 522200 Nondepository credit intermediation (including sales financing & consumer lending)
- 522300 Activities related to credit intermediation (including loan brokers)

Insurance Agents, Brokers, & Related Activities

- 524210 Insurance agencies & brokerages

- 524290 Other insurance related activities

Securities, Commodity Contracts, & Other Financial Investments & Related Activities

- 523140 Commodity contracts brokers
- 523130 Commodity contracts dealers
- 523110 Investment bankers & securities dealers
- 523210 Securities & commodity exchanges
- 523120 Securities brokers
- 523900 Other financial investment activities (including investment advice)

Health Care & Social Assistance

Ambulatory Health Care Services

- 621610 Home health care services
- 621510 Medical & diagnostic laboratories
- 621310 Offices of chiropractors
- 621210 Offices of dentists
- 621330 Offices of mental health practitioners (except physicians)
- 621320 Offices of optometrists
- 621340 Offices of physical, occupational & speech therapists, & audiologists
- 621111 Offices of physicians (except mental health specialists)
- 621112 Offices of physicians, mental health specialists
- 621391 Offices of podiatrists
- 621399 Offices of all other miscellaneous health practitioners
- 621400 Outpatient care centers
- 621900 Other ambulatory health care services (including ambulance services, blood, & organ banks)

Hospitals

- 622000 Hospitals

Nursing & Residential Care Facilities

- 623000 Nursing & residential care facilities

Social Assistance

- 624410 Child day care services
- 624200 Community food & housing, & emergency & other relief services
- 624100 Individual & family services
- 624310 Vocational rehabilitation services

Information

- 511000 Publishing industries (except Internet)

Broadcasting (except Internet) & Telecommunications

- 515000 Broadcasting (except Internet)
- 517000 Telecommunications & Internet service providers

Data Processing Services

- 518210 Data processing, hosting, & related services
- 519100 Other information services (including news syndicates & libraries, Internet publishing & broadcasting)

Motion Picture & Sound Recording

- 512100 Motion picture & video industries (except video rental)
- 512200 Sound recording industries

Principal Business or Professional Activity Codes continued

Manufacturing

315000 Apparel mfg.
 312000 Beverage & tobacco product mfg.
 334000 Computer & electronic product mfg.
 335000 Electrical equipment, appliance, & component mfg.
 332000 Fabricated metal product mfg.
 337000 Furniture & related product mfg.
 333000 Machinery mfg.
 339110 Medical equipment & supplies mfg.
 322000 Paper mfg.
 324100 Petroleum & coal products mfg.
 326000 Plastics & rubber products mfg.
 331000 Primary metal mfg.
 323100 Printing & related support activities
 313000 Textile mills
 314000 Textile product mills
 336000 Transportation equipment mfg.
 321000 Wood product mfg.
 339900 Other miscellaneous mfg.

Chemical Manufacturing

325100 Basic chemical mfg.
 325500 Paint, coating, & adhesive mfg.
 325300 Pesticide, fertilizer, & other agricultural chemical mfg.
 325410 Pharmaceutical & medicine mfg.
 325200 Resin, synthetic rubber, & artificial & synthetic fibers & filaments mfg.
 325600 Soap, cleaning compound, & toilet preparation mfg.
 325900 Other chemical product & preparation mfg.

Food Manufacturing

311110 Animal food mfg.
 311800 Bakeries, tortilla, & dry pasta mfg.
 311500 Dairy product mfg.
 311400 Fruit & vegetable preserving & speciality food mfg.
 311200 Grain & oilseed milling
 311610 Animal slaughtering & processing
 311710 Seafood product preparation & packaging
 311300 Sugar & confectionery product mfg.
 311900 Other food mfg. (including coffee, tea, flavorings, & seasonings)

Leather & Allied Product Manufacturing

316210 Footwear mfg. (including leather, rubber, & plastics)
 316110 Leather & hide tanning & finishing
 316990 Other leather & allied product mfg.

Nonmetallic Mineral Product Manufacturing

327300 Cement & concrete product mfg.
 327100 Clay product & refractory mfg.
 327210 Glass & glass product mfg.
 327400 Lime & gypsum product mfg.
 327900 Other nonmetallic mineral product mfg.

Mining

212110 Coal mining
 212200 Metal ore mining
 212300 Nonmetallic mineral mining & quarrying
 211110 Oil & gas extraction
 213110 Support activities for mining

Other Services

Personal & Laundry Services

812111 Barber shops
 812112 Beauty salons
 812220 Cemeteries & crematories
 812310 Coin-operated laundries & drycleaners
 812320 Drycleaning & laundry services (except coin-operated) (including laundry & drycleaning dropoff & pickup sites)
 812210 Funeral homes & funeral services
 812330 Linen & uniform supply
 812113 Nail salons
 812930 Parking lots & garages
 812910 Pet care (except veterinary) services
 812920 Photofinishing
 812190 Other personal care services (including diet & weight reducing centers)
 812990 All other personal services

Repair & Maintenance

811120 Automotive body, paint, interior, & glass repair
 811110 Automotive mechanical & electrical repair & maintenance
 811190 Other automotive repair & maintenance (including oil change & lubrication shops & car washes)
 811310 Commercial & industrial machinery & equipment (except automotive & electronic) repair & maintenance
 811210 Electronic & precision equipment repair & maintenance
 811430 Footwear & leather goods repair
 811410 Home & garden equipment & appliance repair & maintenance
 811420 Reupholstery & furniture repair
 811490 Other personal & household goods repair & maintenance

Professional, Scientific, & Technical Services

541100 Legal services
 541211 Offices of certified public accountants
 541214 Payroll services
 541213 Tax preparation services
 541219 Other accounting services

Architectural, Engineering, & Related Services

541310 Architectural services
 541350 Building inspection services
 541340 Drafting services
 541330 Engineering services
 541360 Geophysical surveying & mapping services
 541320 Landscape architecture services

541370 Surveying & mapping (except geophysical) services
 541380 Testing laboratories

Computer Systems Design & Related Services

541510 Computer systems design & related services

Specialized Design Services

541400 Specialized design services (including interior, industrial, graphic, & fashion design)

Other Professional, Scientific, & Technical Services

541800 Advertising & related services
 541600 Management, scientific, & technical consulting services
 541910 Market research & public opinion polling
 541920 Photographic services
 541700 Scientific research & development services
 541930 Translation & interpretation services
 541940 Veterinary services
 541990 All other professional, scientific, & technical services

Real Estate & Rental & Leasing

Real Estate

531100 Lessors of real estate (including miniwarehouses & self-storage units)
 531210 Offices of real estate agents & brokers
 531320 Offices of real estate appraisers
 531310 Real estate property managers
 531390 Other activities related to real estate

Rental & Leasing Services

532100 Automotive equipment rental & leasing
 532400 Commercial & industrial machinery & equipment rental & leasing
 532210 Consumer electronics & appliances rental
 532220 Formal wear & costume rental
 532310 General rental centers
 532230 Video tape & disc rental
 532290 Other consumer goods rental

Religious, Grantmaking, Civic, Professional, & Similar Organizations

813000 Religious, grantmaking, civic, professional, & similar organizations

Retail Trade

Building Material & Garden Equipment & Supplies Dealers

444130 Hardware stores
 444110 Home centers
 444200 Lawn & garden equipment & supplies stores
 444120 Paint & wallpaper stores
 444190 Other building materials dealers

Clothing & Accessories Stores

448130 Children's & infants' clothing stores
 448150 Clothing accessories stores
 448140 Family clothing stores
 448310 Jewelry stores
 448320 Luggage & leather goods stores

448110 Men's clothing stores
 448210 Shoe stores
 448120 Women's clothing stores
 448190 Other clothing stores

Electronic & Appliance Stores

443142 Electronics stores (including audio, video, computer, & camera stores)
 443141 Household appliance stores

Food & Beverage Stores

445310 Beer, wine, & liquor stores
 445220 Fish & seafood markets
 445230 Fruit & vegetable markets
 445100 Grocery stores (including supermarkets & convenience stores without gas)
 445210 Meat markets
 445290 Other specialty food stores

Furniture & Home Furnishing Stores

442110 Furniture stores
 442200 Home furnishings stores

Gasoline Stations

447100 Gasoline stations (including convenience stores with gas)

General Merchandise Stores

452000 General merchandise stores

Health & Personal Care Stores

446120 Cosmetics, beauty supplies, & perfume stores
 446130 Optical goods stores
 446110 Pharmacies & drug stores
 446190 Other health & personal care stores

Motor Vehicle & Parts Dealers

441300 Automotive parts, accessories, & tire stores
 441222 Boat dealers
 441228 Motorcycle, ATV, & all other motor vehicle dealers
 441110 New car dealers
 441210 Recreational vehicle dealers (including motor home & travel trailer dealers)
 441120 Used car dealers

Sporting Goods, Hobby, Book, & Music Stores

451211 Book stores
 451120 Hobby, toy, & game stores
 451140 Musical instrument & supplies stores
 451212 News dealers & newsstands
 451130 Sewing, needlework, & piece goods stores
 451110 Sporting goods stores

Miscellaneous Store Retailers

453920 Art dealers
 453110 Florists
 453220 Gift, novelty, & souvenir stores
 453930 Manufactured (mobile) home dealers
 453210 Office supplies & stationery stores
 453910 Pet & pet supplies stores
 453310 Used merchandise stores
 453990 All other miscellaneous store retailers (including tobacco, candle, & trophy shops)

Nonstore Retailers

454112 Electronic auctions
 454111 Electronic shopping
 454310 Fuel dealers (including heating oil & liquefied petroleum)
 454113 Mail-order houses
 454210 Vending machine operators

continued on next page

Principal Business or Professional Activity Codes continued

454390	Other direct selling establishments (including door-to-door retailing, frozen food plan providers, party plan merchandisers, & coffee-break service providers)	423940	Jewelry, watch, precious stone, & precious metals
		423300	Lumber & other construction materials
		423800	Machinery, equipment, & supplies
		423500	Metal & mineral (except petroleum)
		423100	Motor vehicle & motor vehicle parts & supplies
		423400	Professional & commercial equipment & supplies
		423930	Recyclable materials
		423910	Sporting & recreational goods & supplies
		423920	Toy & hobby goods & supplies
		423990	Other miscellaneous durable goods
			Merchant Wholesalers, Nondurable Goods
		424300	Apparel, piece goods, & notions
		424800	Beer, wine, & distilled alcoholic beverage
		424920	Books, periodicals, & newspapers
		424600	Chemical & allied products
		424210	Drugs & druggists' sundries
		424500	Farm product raw materials
		424910	Farm supplies
		424930	Flower, nursery stock, & florists' supplies
		424400	Grocery & related products
		424950	Paint, varnish, & supplies
		424100	Paper & paper products
		424700	Petroleum & petroleum products
		424940	Tobacco & tobacco products
		424990	Other miscellaneous nondurable goods
			Wholesale Electronic Markets and Agents & Brokers
		425110	Business to business electronic markets
		425120	Wholesale trade agents & brokers
			Unclassified establishments (unable to classify)
		999999	

Transportation & Warehousing

481000	Air transportation
485510	Charter bus industry
484110	General freight trucking, local
484120	General freight trucking, long distance
485210	Interurban & rural bus transportation
486000	Pipeline transportation
482110	Rail transportation
487000	Scenic & sightseeing transportation
485410	School & employee bus transportation
484200	Specialized freight trucking (including household moving vans)
485300	Taxi & limousine service
485110	Urban transit systems
483000	Water transportation
485990	Other transit & ground passenger transportation
488000	Support activities for transportation (including motor vehicle towing)

Couriers & Messengers

492000	Couriers & messengers
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Warehousing & Storage Facilities

493100	Warehousing & storage (except leases of miniwarehouses & self-storage units)
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Utilities

221000	Utilities
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Wholesale Trade

Merchant Wholesalers, Durable Goods

423200	Furniture & home furnishing
423700	Hardware, & plumbing & heating equipment & supplies
423600	Household appliances & electrical & electronic goods

Schedule C— Profit or Loss From Business

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- IRS Pub. 334, *Tax Guide for Small Business*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 555, *Community Property*
- IRS Pub. 583, *Starting a Business and Keeping Records*
- IRC §61(a)(2), IRC §162, IRC §1402

Related Topics

- Business Deductions, Tab 8
- Meals, Entertainment, Travel, and Lodging, Tab 8
- Inventory/Cost of Goods Sold, Tab 8
- Start-Up/Organization Costs, Tab 8
- Depreciation, Tab 9



Schedule C Filing Requirements

- Use Schedule C, *Profit or Loss From Business*, to report income and deductions from a business or profession operated as a sole proprietor. An activity is a business if the primary purpose is for income or profit, and the taxpayer is involved in the activity with continuity and regularity. See *Hobby Loss Rules*, page 5-19, for activities not engaged in for profit.
- Use Schedule C to report wages and expenses of a statutory employee. See *Statutory employee income*, page 5-8.
- Use separate Schedules C to report income and deductions of certain qualified joint ventures. See *Spousal business*, below.
- Use Schedule C to report certain income shown on Form 1099-MISC, *Miscellaneous Income*. See *Erroneous Treatment of Employees as Independent Contractors—Form 1099-MISC Received*, page 5-22.
- If a taxpayer owns and operates more than one sole proprietorship, file a separate Schedule C for each business activity. Combining separate activities on one Schedule C could result in negligence penalties. (Rev. Rul. 81-90)
- If a taxpayer receives income as both a self-employed individual and an employee in the same line of work, and expenses cannot be specifically identified as either for self-employment or as an employee, expenses must be allocated between Schedule C and Form 2106, *Employee Business Expenses*.

Schedule C or Partnership

If two or more individuals engage in a business together with the intent to share profits, the activity is a partnership, not a sole proprietorship. Partnerships file Form 1065, *U.S. Return of Partnership Income*, unless they elect to be taxed as a corporation by filing Form 8832, *Entity Classification Election*. See Tab 20, *Deluxe Edition/Small Business Edition*, for partnership reporting rules.

Spousal business—qualified joint venture. A qualified joint venture whose only members are spouses may elect not to be treated as a partnership for federal tax purposes. A joint venture is qualified if:

- The only members of the joint venture are the spouses,
- Both spouses materially participate in the trade or business,
- A joint return is filed for the tax year, and
- Both spouses elect to have the provision apply.

Electing to file as a qualified joint venture. The election is made by dividing all items of income, gain, loss, deduction, and credit between the spouses in accordance with their respective interests in the venture. Each spouse then completes a separate Schedule C (Schedule F for farm business ventures) and Schedule SE (Form 1040), *Self-Employment Tax*, based on this allocation.

Termination of partnership. If the spouses filed a Form 1065 for the year prior to the election, the partnership terminates at the end of the year immediately preceding the year the election takes effect.



Community property laws. Spouses who wholly own an unincorporated business as community property under the community property laws of a state, foreign country, or U.S. possession can treat the business either as a sole proprietorship or a partnership. Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. See *Community Property*, Tab 14.

Spousal LLC. An unincorporated business organized as an LLC that is wholly owned by both spouses is not eligible to be a qualified joint venture and should file as a partnership. However, an LLC wholly owned by both spouses as community property may be treated as a disregarded entity or a partnership. (Rev. Proc. 2002-69)

Spouses with rentals. Spouses with rental real estate activity can make the election to be treated as a qualified joint venture and not be subject to SE tax on profits, assuming the rental activity is not otherwise subject to SE tax. (Ltr. Rul. 200816030)

Single-member LLC. A single-member LLC is generally disregarded and not treated as an entity separate from its owner for federal income tax purposes.

Disregarded entity. A single-member LLC owned by an individual files Schedule C (or Schedule E, *Supplemental Income and Loss*, or Schedule F, *Profit or Loss From Farming*), as applicable.

Corporate election. A single-member LLC can elect to be taxed as a corporation. See *Check the Box rules*, Tab 18, *Deluxe Edition/Small Business Edition*.

Schedule C Recordkeeping and Substantiation Rules

Business records must be available at all times for inspection by the IRS. Business records are used to prove the source of receipts, as well as support deductible expenses and credits. There is no specific kind of recordkeeping required for sole proprietorships. Any system that clearly shows income and expenses is acceptable. See Tab 8 for information on accounting methods.

Travel and entertainment. Special recordkeeping rules apply to travel and entertainment expenses. See *Substantiating Meals, Entertainment, Travel, and Lodging*, Tab 8.

Payroll. Special recordkeeping rules apply to employment tax records. See *Payroll Recordkeeping*, Tab 23, *Deluxe Edition/Small Business Edition*.

Business bank account. A business should have a bank account that is used for depositing business income and paying business expenses.

- Business account activity may be tracked using a manual check register, a ledger, a spreadsheet, accounting software, etc.
- Deposit records should identify the source of the funds and whether deposits are business income, personal funds, or loans.
- Records of checks, electronic transfers, point-of-service transactions, and other withdrawals should identify the payee, business purpose, and other information that helps document the business expense.
- Avoid using the business account to pay personal expenses.
- Business profits can be withdrawn by writing a check to the business owner or by electronic transfer to the business owner's personal account. Outright cash withdrawals should be carefully documented.
- An IRS auditor may request a copy of electronic accounting files. See *Computerized records*, next column.

Court Case: Cohan, a theatrical manager and producer, entertained actors, employees, and drama critics. He also incurred travel expenses for business. He kept no records. He estimated that he had spent \$11,000 during the first six months of 1921 (over \$146,000 in 2015 dollars). The government disallowed all deductions on the grounds that it was impossible to tell how much he had in fact spent.

The court ruled in favor of Cohan and his use of estimates to substantiate his deductions. The court noted that he had to have incurred expenses and said: "Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can...to allow nothing at all appears to us inconsistent with saying that something was spent." This decision is referred to as the "Cohan Rule." (*Cohan*, 2nd Cir., March 3, 1930)



Court Case: In contrast to the preceding court case, the IRS disallowed all deductions claimed on three separate Schedules C, and the Tax Court agreed. The taxpayer claimed that a house fire had destroyed documents that would have substantiated his deductions, but he failed to reconstruct his records in any meaningful manner. Therefore, the Court could not apply the Cohan rule in allowing estimates of the deductible amounts. (*Roumi*, T.C. Memo 2012-2)

How long should records be kept? Records must be kept at least until the statute of limitations for a tax return has expired. See *Statutes of Limitations*, Tab 15. Following are some general guidelines.



If the taxpayer:	Then the period is:
Owes additional tax.	Three years.
Omits reportable income in excess of 25% of gross income that should have been reported on the return.	Six years.
Files a fraudulent return.	Unlimited.
Does not file a return.	Unlimited.
Files a claim for credit or refund after the original return has been filed.	Later of three years, or two years after tax was paid.
Files a claim for loss from worthless securities or a bad debt deduction.	Seven years.

Employment tax records. Employment tax records should be kept for at least four years after the date the tax becomes due or is paid, whichever is later.

Asset records. Asset records include acquisition cost, date, and any other information affecting basis. See *Basis and Holding Period Rules* chart, Tab 6. Asset records are used to calculate depreciation, amortization, and depletion deductions, and basis for gain or loss upon sale or other disposition. Asset records should be kept until the period of limitations expires for the year in which the asset is disposed of in a taxable disposition.

Computerized records. Business books and records maintained on a computer must provide enough detail to identify underlying source documents and substantiate entries on tax and information returns. (Rev. Proc. 98-25)

Planning Tips

Form W-9, Request for Taxpayer Identification Number and Certification. Have independent contractors fill out and return Form W-9 before any services are provided. A written agreement should also be signed that states he or she is an independent contractor. The independent contractor should bill the sole proprietor for work performed. See *Independent Contractor vs. Employee*, page 5-21.

Retirement. Defer tax through retirement plan contributions, such as SEPs, SIMPLEs, defined benefit, defined contribution, and solo 401(k) plans. Unlike employees, sole proprietors generally have greater freedom of choice in choosing plans and greater access to withdrawing funds without having to first separate from service. See Tab 13 for retirement plans.

Hire children as bona-fide employees. A child under age 18 working for a parent-owned unincorporated business is exempt from FICA. Income tax is also reduced by shifting income to the child's lower tax rate. See *Family Businesses—Employing Family Members*, page 5-19.

Use health savings accounts (HSAs). HSAs can greatly reduce the cost of health care and save through IRA-type savings, amounts contributed to the plan that are not spent on health care. See *Health Savings Accounts (HSAs)*, Tab 13, for details.

Charitable contributions. Turn Schedule A charitable contributions into Schedule C advertising costs by donating money to a charity in exchange for advertising.

Business travel. Convert nondeductible vacation travel into business travel by planning vacations around business trips. See *Meals, Entertainment, Travel, and Lodging*, Tab 8, for travel and entertainment expenses.

Start-up costs. Convert capitalized start-up costs into current operating deductions by planning for an earliest possible start date. See *Start-Up/Organization Costs*, Tab 8.



Schedule C Line-by-Line

Schedule C heading information:

Principal business or profession (line A). Describe the business or professional activity and the type of product or service that provided the principal source of income for the business. If the taxpayer owns more than one business, complete a separate Schedule C for each business.

Principal Business Activity Code (line B). See the *Principal Business Activity Codes* chart, page 5-4.

Employer Identification Number (EIN) (line D). See *Employer Identification Number (EIN)*, page 5-1, on how to obtain an EIN.

No EIN. If there is no EIN, leave line D blank.

Sole proprietor. A sole proprietor is not required to have an EIN unless he or she has a qualified retirement plan, is a payer of gambling winnings, or is required to file employment or excise tax returns. However, a sole proprietor may obtain an EIN to use instead of his or her own Social Security number when opening a business bank account or issuing Form 1099-MISC to subcontractors or vendors.

Single-member LLC. By default, a single-member LLC owned by an individual is treated as a disregarded entity and follows the same EIN rules as other sole proprietors, except for employment tax returns. State law may require a single-member LLC to obtain an EIN, which may be listed on line D. This same EIN can be used instead of the member's Social Security number for banking and other reporting purposes, but not for employment tax returns.

Single-member LLC with employees. A single-member LLC is not a disregarded entity for employment tax purposes. (Reg. §301.7701-2)

- The LLC must obtain a separate EIN for use when filing employment tax returns.
- Do not use the employment-purpose EIN for information returns or list it on line D. Leave line D blank if the employment-purpose EIN is the only EIN the single-member LLC has.

Accounting method (line F). The cash method, accrual method, or any other method permitted by the Internal Revenue Code may be used. See *Accounting Periods and Methods*, Tab 8.

Material participation (line G). If the sole proprietor does not materially participate in the business, losses may be limited under the passive activity loss rules. See *Material Participation*, page 7-11.

Form(s) 1099 (line I and line J). A sole proprietor is required to file Form 1099-MISC, *Miscellaneous Income*, for any payments totaling \$600 or more to independent contractors and other non-employees for services performed for the business. See *Independent Contractor vs. Employee*, page 5-21.

Form 1099-MISC is also used to report direct sales of at least \$5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

Exceptions: The following payments are not required to be reported on Form 1099-MISC, although they may be taxable to the recipient.

- Payments to corporations (including an LLC treated as a corporation).
- Payments for merchandise, telegrams, telephone, freight, storage, and similar items.
- Payments of rent to real estate agents.
- Wages and allowances paid to employees (report on Form W-2).
- Payments to a tax-exempt organization including tax-exempt trusts, the United States, a state, the District of Columbia, a U.S. possession, or a foreign government.

For more information, see *Form 1099-MISC*, Tab 23, *Deluxe Edition/Small Business Edition*.

Schedule C, Part I—Income

Gross income includes income from whatever source derived, unless specifically listed in the IRC as being exempt.

Gross receipts or sales (line 1). Gross income includable on line 1 is gross receipts from a trade or business. If the total amounts reported in box 7, Form 1099-MISC, exceeds the total reported on Schedule C, attach a statement explaining the difference.

Example: Terry is a cash basis tailor. She offers her services to various wedding dress and tuxedo rental stores. She bills each store once a month for her labor. One store mailed her December payment on December 30, 2015, which she received on January 4, 2016. The store included the December payment on her 1099-MISC for 2015, which made her 1099-MISC income greater than the total includable on her 2015 Schedule C. Terry must attach a statement to her return explaining this difference.

Statutory employee income. If the taxpayer received a Form W-2 with box 13 "statutory employee" checked, the amount from box 1 of the Form W-2 is reported on line 1, Schedule C. Enter related statutory expenses on the appropriate lines of Schedule C and enter net profit or allowable loss on line 12, Form 1040.

- Do not carry net statutory income to Schedule SE. Social Security and Medicare tax should have been withheld and reported on the Form W-2.
- If a statutory employee also has self-employment income from another activity, the taxpayer must file a separate Schedule C for each activity. See *Statutory non-employee*, page 5-21.

Statutory employees are defined in IRC section 3121(d)(3) as:


- Agent-drivers or commission-drivers distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services.
- Full-time life insurance salesmen.
- Home workers making items according to specifications of the employer with materials or goods furnished to the worker by the employer. The finished products are then required to be returned to the employer.
- Full-time traveling or city sales people selling for one principal employer (except for sideline sales activities on behalf of some other person).



Substantially all the services must be performed personally by the statutory employee for the employer. The statutory employee cannot have a substantial investment in facilities used in connection with performing the services (other than for transportation). The services cannot be in the nature of a single transaction. There must be a continuing relationship with the employer.

Barter income. Barter is the exchange of goods or services without the payment of money. For example, a plumber may do repair work for a dentist in exchange for dental services. Barter may occur on an informal basis between individuals or businesses, or when a third party, such as a barter exchange organization, may be involved. When barter occurs in the course of a trade or business, the following rules apply.

- The fair market value of goods and services received must be included in business income in the year of receipt and is subject to self-employment tax.
- Associated expenses are deductible as business expenses.
- Bartering income is subject to 1099 reporting requirements. See *Form 1099-MISC*, Tab 23, *Deluxe Edition/Small Business Edition*.
- Barter exchanges report trades on Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*. A sole proprietor includes barter exchange income on Schedule C if it occurs in connection with the sole proprietorship.

 **Author's Comment:** Omission of barter income is a target in an IRS audit. Tax preparers should question their clients about bartering transactions and make sure all income has been reported.

Returns and allowances (line 2). Report sales returns and allowances as a positive number on line 2. A sales return is a cash or credit refund given to a customer who returned defective, damaged, or unwanted products. A sales allowance is a reduction in the selling price of products, such as a discount.

Cost of goods sold (line 4). Enter the cost of goods sold as calculated in Part III, Cost of Goods Sold, Schedule C. See *Schedule C, Part III—Cost of Goods Sold*, page 5-11.

Other income (line 6). The following income should be entered on line 6.

- Finance reserve income.
- Scrap sales.
- Bad debts recovered.
- Interest on notes and accounts receivable.
- State gasoline or fuel tax refunds.
- Credit for federal tax paid on fuels claimed on the 2014 return.
- Any amount of credit for biofuel claimed on line 2, Form 6478, *Biofuel Producer Credit*.
- Any amount of credit for biodiesel and renewable diesel fuels claimed on line 8, Form 8864, *Biodiesel and Renewable Diesel Fuels Credit*.
- Prizes and awards related to business.
- Taxable amount from Form 1099-PATR, *Taxable Distributions Received From Cooperatives*, allocated to the business.
- Recapture of excess depreciation, including Section 179 from Part IV, Form 4797, *Sales of Business Property*, when business use of listed property falls to 50% or less.
- Inclusion amount on leased listed property (other than a vehicle) when business use drops to 50% or less.
- Other kinds of miscellaneous business income.



Schedule C, Part II—Expenses

The Internal Revenue Code does not provide a complete list of expenses that are deductible for businesses. Instead, IRC section 162(a) states that a deductible business expense is any expense that is both ordinary and necessary.

Deductible Business Expense Factors

OrdinaryCommon and accepted in a particular industry.
NecessaryHelpful and appropriate for a particular trade or business, even if not indispensable.

See *Business Deductions*, Tab 8, for more information about business expenses.

Current deduction or capital expense. If real or tangible property is produced or acquired for resale, certain expenses attributable to the property must be included in inventory costs or capitalized. See *Uniform Capitalization Rules*, Tab 8.

Expenses not allowed on Schedule C:

- **Charitable contributions.** Report qualified charitable contributions by a sole proprietor as itemized deductions on Schedule A, Form 1040.

- **Penalties and fines.** Penalties, fines, and other costs for breaking the law are not deductible. However, penalties paid for late performance or nonperformance of a contract are generally deductible.
- **Political contributions.** Direct or indirect contributions or gifts to political parties or candidates are not deductible.
- **Lobbying expenses.** Lobbying expenses are generally nondeductible. Lobbying expenses are described in IRC section 162(e).

Advertising (line 8). Advertising expenses directly related to a taxpayer's business activities are deductible. Deductible expenses include the cost of goodwill advertising to keep the business's name in the public, such as the costs for sponsoring local activities and causes.

Car and truck expenses (line 9). See *Schedule C, Part IV—Information on Vehicle*, page 5-12, for details. See *Business Autos*, page 10-3, for information on deducting the business use of a vehicle.

Standard mileage rate. The business standard mileage rate for 2015 is 57.5¢ per mile. See *Standard Mileage Rate per Mile* chart, page 10-1, for prior-year rates.

Commissions and fees (line 10). Commissions and fees are paid for services conducted by nonemployees. For example, paying an independent sales representative a commission or a finder's fee paid to someone outside the business. A commission paid to an employee is not reported here and is instead included in wages reported on Form W-2.

Contract labor (line 11). Contract labor is work performed for a business by non-employees, such as independent contractors. See *Independent Contractor vs. Employee*, page 5-21. For wages paid to employees, see *Wages (line 26)*, page 5-11.

Information returns. If an independent contractor is paid \$600 or more, the payer must issue a 1099-MISC. See *Form 1099-MISC*, Tab 23, *Deluxe Edition/Small Business Edition*.

Depletion (line 12). Depletion is the using up of natural resources by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows an owner to account for the reduction of a product's reserve. To compute the depletion deduction, see *Depletion*, Tab 9.

Depreciation and Section 179 expense deduction (line 13). Depreciation is the annual deduction allowed to recover the cost or other basis of business or investment property having a useful life of more than one year. See *Depreciation*, Tab 9.

Employee benefit programs (line 14). Include contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan. Examples of employee benefit programs include accident and health plans, group-term life insurance, and dependent care assistance programs. Do not include on any contributions made on behalf of the sole proprietor (see dependent care assistance program and self-employed health insurance deduction, below, for exceptions). See *Employee Fringe Benefits*, Tab 13.

Dependent care assistance program. Contributions made on behalf of employees to a dependent care assistance program are deductible employee benefits. If contributions were made on behalf of the sole proprietor to a dependent care assistance program, complete Parts I and III, Form 2441, *Child and Dependent Care Expenses*, to figure the deductible contribution.

Self-employed health insurance deduction. Health insurance paid on behalf of the sole proprietor as a self-employed taxpayer is deductible as an adjustment to income on line 29, Form 1040. Deductible amounts include health insurance premiums paid for the self-employed taxpayer, spouse, dependents, and a child under age 27, if any of the following apply.

- The taxpayer was self-employed and had a net profit for the year (including self-employment earnings from a partnership).
- The taxpayer used one of the optional methods to figure net earnings from self-employment on Schedule SE.
- The taxpayer received wages from an S corporation in which the taxpayer was a more than 2% shareholder. Health insurance benefits paid for the taxpayer are shown in box 1 and box 14, Form W-2.

The adjustment on line 29, Form 1040 is limited to the smaller of:

- Eligible health insurance premiums, or
- Net profit and any other earned income* from the business under which the insurance plan is established, reduced by:
 - The deduction on line 27, Form 1040, for a portion of SE tax. See *Self-Employment Tax*, page 5-23, and
 - The deduction on line 28, Form 1040, for any self-employed SEP, SIMPLE, or qualified plan contribution. See *Retirement and Employee Benefits*, Tab 13.



* Earned income for a more than 2% S corporation shareholder is Medicare wages (box 5, Form W-2) from that corporation.

For purposes of the net profit limit, the taxpayer cannot combine Schedule C profits from multiple businesses for one health insurance plan. (Ltr. Rul. 200524001)

Did You Know? All Medicare Parts are eligible for the self-employed health insurance deduction. Taxpayers can amend open years to claim omitted Medicare premium deductions. (CCA 201228037)

Example: Joe owns Joe's Auto Repair, a sole proprietorship that had net profits of \$1,200. In connection with this business, he purchased health insurance under his own name at a cost of \$2,000. Joe owns a second sole proprietorship that had net profits of \$1,000. Joe had no deduction for retirement plans, and his self-employment deduction was \$155, \$85 which is attributable to Joe's Auto Repair. Joe's self-employed health insurance deduction is limited to \$1,115 (\$1,200 minus \$85). The remaining \$885 health insurance premiums may be deducted as a medical expense on Schedule A.

Do not include any amount paid for any month or part of month in which the taxpayer was eligible to participate in a subsidized health plan maintained by the taxpayer's employer or spouse's employer.

Example: Jennifer was eligible to participate in a plan partially subsidized by her employer from January 1 through April 2. On April 3, she was covered under a plan established by her new self-employment business. She cannot use amounts paid for health insurance coverage for January through the end of April to figure the deduction.

Premium tax credit. No deduction is allowed for the portion of premiums for a qualified health plan equal to the amount of the premium tax credit. [IRC§280C(g)]

Health insurance in the name of the individual. To qualify for the self-employed insurance deduction the insurance plan must be established, or considered to be established, under the business. [IRC §162(1)(2)(A)]

- For self-employed individuals filing Schedule C (or Schedule F), a policy can be either in the name of the business or the individual. (Ltr. Rul. 200524001)
- For partners, a policy can be either in the name of the partnership or the partner. If the policy is in the name of the partner and the partner pays the premium, the partnership must reimburse the partner and report the premium amounts on Schedule K-1, Form 1065, as guaranteed payments.
- For more than 2% shareholders, a policy can be either in the name of the S corporation or the shareholder. If the policy is in the shareholders name and the shareholder pays the premiums,

the S corporation must reimburse the shareholder and report the premium amounts on Form W-2 as wages. (Notice 2008-1)

See *Employee Fringe Benefits*, Tab 13.

Employee-spouse health insurance. A deduction on line 14, Schedule C, for 100% of the cost of providing health coverage for a sole proprietor and an employee-spouse and family may be claimed by following this procedure.

- The sole proprietor hires his or her spouse as a bona fide employee of the business.
- The sole proprietor provides family accident and health coverage for the employee-spouse, either through a self-insured medical expense reimbursement plan under IRC section 105(b), or by purchasing an accident and health insurance policy under IRC section 106(a). The cost of health coverage and medical expense reimbursements are excluded from the employee-spouse's gross income. (Rev. Rul. 71-588)
- The sole proprietor is then covered by the plan as a member of the employee-spouse's family.
- Deductible expenses include reimbursed medical expenses for health insurance premiums and other costs not reimbursed by insurance.

Court Case: The IRS contended a husband was not a bona fide employee of his wife's day care business. The court ruled in favor of the taxpayer. He had a contract to work for the day care, his wife had the right to control his activities, she set the amount of compensation he received, and she had a right to terminate his employment. The taxpayer also submitted written records of his work schedule and showed that the work performed was integral to the day care's operation. Payments were made on account of the employer-employee relationship, not on account of the family relationship. (*Speltz*, T.C. Summary 2006-25)

- If the spouse is an independent contractor rather than an employee of the sole proprietor, then the cost of accident and health insurance benefits are not excluded from gross income by the spouse under IRC section 106(a).
- The accident and health policy should be purchased in the name of the employee-spouse to exclude the benefit from gross income. If the insurance is purchased in the name of the self-employed person, then a deduction for the cost of insurance claimed on Schedule C may be disallowed. The advantage of taking the deduction on Schedule C is that it also reduces the amount subject to SE tax.



Court Case: Although the taxpayer and his spouse had a bona fide employment agreement, a deduction on Schedule F for health insurance premiums and medical expenses was not allowed under the provision for employee-spouse health insurance. The taxpayer failed to prove that the expenses for health coverage were incurred and paid by his spouse. The employer-spouse was the primary insured under the policy, and it was established that he incurred and paid the expenses in question, not his employee-spouse. The court determined that the amounts were not paid under an employee benefit program and were therefore not deductible. (*Albers*, T.C. Memo 2007-144)

Court Case: In contrast to *Albers*, the court ruled a farming taxpayer, whose wife was a bona fide employee, could reimburse her for medical expenses through a medical reimbursement plan set up for his employees, even though one of the reimbursements made was for a joint health insurance plan in the taxpayer's name. The IRS contended the wife could only be reimbursed for medical costs and insurance in her name. The Tax Court concluded that since the employee-wife had paid nearly all the premiums from an account in her name, the deductions were allowable. (*Frahm*, T.C. Memo 2007-351)

Insurance (other than health) (line 15). Insurance premiums paid for a trade or business are deductible. Deduct amounts paid for employee accident and health insurance on line 14, Schedule C. See *Insurance*, Tab 8.

Interest (line 16). Deduct interest paid on debt used in connection with the business, including business portion of vehicle loans (in addition to standard mileage rate deduction). See *Interest Tracing Rules*, Tab 4, for applicable rules.

Do not include any of the following on line 16.

- Interest claimed on Form 8829, *Expenses for Business Use of Your Home*. See *Business Use of Home*, page 5-12.
- Interest paid or assessed on income tax or underpayment penalties, even if tax is owed in connection with the business.
- Interest required to be added to basis under IRC section 263A uniform capitalization rules. See *UNICAP*, Tab 8.

Legal and professional services (line 17). Fees charged by accountants and attorneys, that are ordinary and necessary expenses directly related to operating the business, and fees for tax advice and for preparation of tax forms related to the business, are deductible on line 17.

Office expense (line 18). Office expenses include office décor items, janitorial services, lawn maintenance, postage, and general office supplies such as paper, pens, pencils, staplers, printer toner, ink, etc.

Note: Office expenses for furniture and fixtures, rent, utilities, and renovations are deducted on other lines.

Pension and profit-sharing plans (line 19). Amounts contributed to a pension, profit-sharing, or annuity plan for the benefit of the employees are reported on line 19. Any amounts contributed on behalf of the self-employed taxpayer should be deducted on line 28, Form 1040, not Schedule C. See *Retirement and Employee Benefits*, Tab 13.

Rent or lease (line 20). Use line 20a for vehicle, machinery, or equipment rentals or leases. Use line 20b for other property rentals, such as office space in a building. See *Rent or lease*, Tab 8.

Repairs and maintenance (line 21). Deduct the cost of incidental repairs and maintenance that do not add to the property's value or appreciably prolong its life. See *Repairs and Improvements*, page 7-6.

Supplies (line 22). Do not include materials and supplies that must be accounted for as inventory. See *Schedule C, Part III—Cost of Goods Sold*, next column. Supplies are deductible to the extent they were actually consumed and used in the business during the year.



Exception: The cost of incidental supplies on hand for which no inventories or records of use are kept are deductible in the year purchased. See *Materials and supplies*, Tab 8.

Taxes and licenses (line 23). Deduct the following taxes and licenses on line 23.

- State and local sales tax imposed on the business as the seller of goods or services. Sales tax imposed on the business and collected from customers must be reported in gross receipts or sales on line 1, Schedule C. If local law imposes sales tax on the buyer rather than the seller, the seller neither deducts taxes paid nor includes taxes collected in income.
- Real estate and personal property taxes on business assets.
- Licenses and regulatory fees for the business paid each year to a state or local government. Some licenses, such as liquor licenses, may have to be amortized. See IRS Pub. 535, *Business Expenses*, for details.
- Payroll taxes, such as the employer's share of FICA, FUTA, and state unemployment taxes. The employee's share of withheld FICA is deducted on line 26 as wages. Reduce the deduction on

line 23 by any amounts shown on Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*.

- Federal highway use tax.
- Contributions to state unemployment insurance fund or disability benefit fund if considered taxes under state law.

Do not deduct any of the following on line 23.

- Federal income tax, including the taxpayer's SE tax. However, a portion of SE tax is deductible on line 27, Form 1040.
- Estate and gift tax.
- Taxes assessed to pay for improvements, such as paving and sewers. Add these taxes to the property's basis.
- Taxes on the taxpayer's home or personal use property. **Exception:** See *Business Use of Home*, page 5-12, for real estate taxes deductible on the business use of a home.
- State and local sales taxes on property purchased for use in the business. Add these taxes to the cost of the property.
- State and local sales taxes imposed on the buyer that the business is required to collect and pay over to the state or local government. Do not include the tax collected in gross income. However, if the state or local government allows the business to retain any part of the sales tax collected, report that amount as other income on line 6, Schedule C.
- Other taxes and license fees not related to the business.

Travel, meals, and entertainment (line 24). Deduct expenses for lodging and transportation connected with overnight travel for business and business meal and entertainment expenses. See *Meals, Entertainment, Travel, and Lodging*, Tab 8.



Utilities (line 25). Deduct only utility expenses for the business. See *Business Use of Home*, page 5-12, and *Residential telephone line*, Tab 4.

Wages (line 26). Include total gross salaries and wages paid to employees of the business (which includes withheld taxes), minus any employment tax credits being claimed. Do not include:

- Salaries and wages deducted elsewhere, such as wages included in cost of goods sold.
- Taxable fringe benefits paid to employees (such as personal use of a car) that are applicable to depreciation or to other expenses deducted elsewhere.
- Payments to independent contractors (deduct on line 11 instead).
- Any amounts paid to or taken as draw by the sole proprietor.

See Form W-2 and Form W-3, payroll tax return filing rules, and other labor law issues, Tab 23, *Deluxe Edition/Small Business Edition*. See *Employee Fringe Benefits*, Tab 13.

Business use of home (line 30). Calculate the deduction for business use of the home using Form 8829, *Expenses for Business Use of Your Home*, or using the simplified method. See *Business Use of Home*, page 5-12.

Net profit or loss (line 31). Enter net profit on line 12, Form 1040. If a loss, answer the at-risk question for line 32. If the taxpayer did not materially participate in the operation of the business, see *Passive Activity Losses*, page 7-9.

At-risk question (line 32). If line 31 is a loss, and the taxpayer has amounts in the business for which the taxpayer is not at risk the loss may be limited. See *At-Risk Rules*, page 7-14. Otherwise, if all investment is at risk, the loss is entered as a negative number on line 12, Form 1040.

Schedule C, Part III—Cost of Goods Sold

If the production, purchase, or sale of merchandise is an income producing factor, the business must take inventories into account at the beginning and end of the tax year. This is true whether the cash or the accrual method of accounting is allowed. See *Inventory/*

Cost of Goods Sold, Tab 8, for information on calculating the cost of goods sold deduction and inventory valuation methods. See *Accounting Periods and Methods*, Tab 8, to determine whether a business with inventory can use the cash method of accounting.

Did You Know? If the cash method of accounting is allowed, inventory items must still be reported on Part III, Schedule C, rather than as materials and supplies on line 22. The cost of inventory items under the cash method of accounting is deductible in the later of:

- The year the inventory is sold, or
- The year the inventory is paid for.

Inventory at beginning of year. Enter the amount from line 41, 2014 Schedule C. If there is a change in the method of accounting beginning with 2015, refigure the 2014 closing inventory using the new method of accounting and enter the result on line 35. See Form 3115, *Application for Change in Accounting Method*, instructions for information on the IRC section 481(a) adjustment.

Purchases less cost of items withdrawn for personal use. Include the cost of merchandise purchased for resale during 2015. If inventory is taken for personal use, subtract the cost of personal use items from total purchases for the year.

Cost of labor. The cost of labor is added to inventory in manufacturing and construction type activities. Retailers and wholesalers do not add labor to inventory unless the uniform capitalization rules apply. See *Uniform Capitalization Rules (UNICAP)*, Tab 8.

Materials and supplies. If producing a product to sell in a manufacturing or construction activity, include the cost of raw materials and supplies.

Other costs. If the uniform capitalization rules apply, certain costs may be added to inventory. See *Uniform Capitalization Rules (UNICAP)*, Tab 8.

Inventory at end of year. If the cash method of accounting is used, and inventory items are accounted for in the same manner as materials and supplies that are not incidental, enter the cost of inventory from line 40 that was not sold during the year. Otherwise, see *Inventory Valuation Methods*, Tab 8.

Schedule C, Part IV—Information on Vehicle

If a deduction is taken for any car and truck expenses, complete one of the following.

- Part IV of Schedule C if:
 - The standard mileage rate is claimed, the vehicle is leased, or the vehicle is fully depreciated, and
 - Form 4562, *Depreciation and Amortization*, is not required for any other reason. If more than one vehicle is used for business, attach a separate schedule with the information requested in Part IV, Schedule C, for each additional vehicle.
- Part V, Form 4562 if claiming depreciation on the vehicle or Form 4562 is required for any other reason.

See *Business Autos*, page 10-3, for information on deducting the business use of a vehicle.

Standard mileage rate. The business standard mileage rate for 2015 is 57.5¢ per mile. See *Standard Mileage Rate Per Mile* chart, page 10-1, for prior-year rates.



Schedule C, Part V—Other Expenses

Include all ordinary and necessary business expenses not deducted elsewhere on Schedule C. List the type and amount of each expense separately. Other expenses include the following.

- Amortization from Form 4562. See *Amortization*, page 8-1, for a list of things that can be amortized.
- Deductible at-risk losses from previous years that were suspended under the at-risk rules. See *At-Risk Rules*, page 7-14.

- Debts and partial debts from sales or services that were included in income and are definitely known to be worthless. See *Bad debts*, Tab 8.
- Up to \$5,000 of certain business start-up costs if the business began in 2015. The \$5,000 limit is reduced by the amount total start-up costs exceed \$50,000. Remaining start-up costs can be amortized over a 180-month period beginning with the month business began. See *Start-Up/Organization Costs*, Tab 8.
- Costs of making commercial buildings more efficient.
- Up to \$15,000 of costs paid to remove barriers to individuals with disabilities and the elderly.
- Up to \$10,000 of certain forestation and reforestation costs. The remaining costs may be amortized. See IRS Pub. 535, *Business Expenses*.

Business Use of Home

Cross References

- Form 8829, *Expenses for Business Use of Your Home*
- IRS Pub. 587, *Business Use of Your Home*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*

Related Topics

- Real Estate Taxes, Tab 4
- Home Mortgage Interest, Tab 4
- Sales of Business Property (Form 4797), Tab 6
- Business Use or Rental of Home—Application of Exclusion Rules, Tab 6
- Depreciation, Tab 9



Business Use of Home Summary Chart

Tests for Self-Employed	Exceptions
1) Exclusive use test. Page 5-13.	– Inventory or product sample storage. – Day care facilities.
2) Regular use test. Page 5-13.	– None.
3) Trade or business use test. Page 5-13.	– Some rental activities. See <i>Mixed-Use Property—Vacation Homes (IRC §280A)</i> , page 7-7.
4) Principal place of business test. (Includes administrative and management activities.) Page 5-13.	– Meeting patients, clients, or customers in home office. – Separate free-standing structure.

- Employee business use of home additional tests (must meet both, no exceptions), page 5-14:
 - Convenience of employer test, and
 - No renting to employer rule.
- Business use of home depreciation is 39-year nonresidential real property.

Qualification Rules—Business Use of Home

Generally, a taxpayer cannot deduct items related to his or her home, such as mortgage interest and real estate taxes, as business expenses. However, a taxpayer may be able to deduct expenses related to the business part of the home if specific requirements are met. (IRC §280A)

Requirements to qualify for a deduction. To take a business deduction, a taxpayer must use part of his or her home under one of the following situations.

- An area in the home is exclusively and regularly used as the taxpayer's principal place of business.
- An area in the home is exclusively and regularly used as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.

- A separate structure which is not attached to the home is used in connection with a trade or business.
- An area in the home is used on a regular basis for storage of inventory or product samples.
- The home is used for a rental activity. See *Mixed-Use Property—Vacation Homes (IRC §280A)*, page 7-7.
- The home is used as a day care facility.

Additional tests for employees. In addition to meeting one of the tests, above, an employee must meet both of the following.

- The business use of a home must be for the convenience of the employer, and
- The employee cannot rent any part of the home to the employer and use the rented portion to perform services as an employee for that employer.



1) Exclusive Use Test

The exclusive use test is met if a specific area of the home is used only for business. The area can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition. This test is not met if the taxpayer uses the area both for business and for personal purposes, such as a den used for business during the day and TV viewing during the evening.

Exceptions: The exclusive use test is not required for:

- An area used on a regular basis for storage of inventory or product samples.
- A home used as a day care facility.

Storage of inventory or product samples—exception to exclusive use test. A taxpayer using part of a home for business to store inventory or product samples is not required to meet the exclusive use test. However, the taxpayer must meet all the following tests.

- The taxpayer is in the business of selling products at wholesale or retail.
- The inventory or product samples are kept in the home for use in the business.
- The taxpayer's home is the only fixed location of the business.
- The storage space is used on a regular basis.
- The storage space is a separately identifiable space suitable for storage.



Example: Peter is in the business of selling office supplies at wholesale to retail office supply stores. His home is the only fixed location for his business. He regularly uses storage shelves in his garage and basement for storage of inventory and product samples. The garage is also used to park the family cars, and the basement is also used as a recreation area for the family. The portions of the home used for storage space qualify for the business use of home deduction, even though these areas are not exclusively used for business.

Day care facilities—exception to exclusive use test. The exclusive use test is not required if the home is used in a day care business. To qualify, both of the following requirements must be met.

- The taxpayer must be in the trade or business of providing day care for children, persons age 65 or older, or persons who are physically or mentally unable to care for themselves.
- The taxpayer must have applied for, been granted, or be exempt from having, a license or other approval as a day care center under state law. If the application was rejected, or the license or other authorization was revoked, the taxpayer does not meet this test.

2) Regular Use Test

The regular use test means a taxpayer must use a specific area of the home for business on a regular basis. Incidental or occasional

business use is not regular use. All facts and circumstances are considered in determining whether the business use is regular.

Court Case: A taxpayer was in the floor covering business and spent one hour in his home office each morning contacting customers, builders, and suppliers. In the evening, he spent a few more hours in his home office preparing various paperwork and returning calls. The court was satisfied that one hour in the morning and a few hours in the evening met the regular use test. (*Cole*, T.C. Memo 1999-207)

3) Trade or Business Use Test

To satisfy the trade or business use test, a taxpayer must use part of the home in connection with a trade or business. If the use is for a profit-seeking activity that is not a trade or business, the business use of home deduction is not allowed.

Example: Kathy uses her den exclusively and regularly to read financial periodicals and reports, clip bond coupons, and to carry out similar activities related to her investments. She does not invest as a broker or dealer. Her activities are not part of a trade or business and, therefore, she cannot claim a deduction for the business use of her home.

Court Case: A taxpayer was a hospital employee. He also owned six rental units held for the production of income. The IRS denied the office-in-home deduction for the rental activity as it was not a trade or business. The court allowed the deduction and noted the personal efforts of the taxpayer to manage six units in seeking new tenants, supplying furnishings, cleaning, and otherwise preparing the units for new tenants. These activities were sufficiently systematic and continuous to place the taxpayer in the business of real estate rental. (*Curphey*, 73 T.C. No. 766)

4) Principal Place of Business Test

A trade or business can have more than one location. To qualify for a business use of home deduction, the home must be the principal place of business for that trade or business. To make this determination, the following are considered.

- The relative importance of the activities performed at each place where business is conducted, and
- The amount of time spent at each place where business is conducted.

A home office qualifies under this test if:

- The home office is used exclusively and regularly for administrative or management activities of the trade or business, and
- There is no other fixed location where substantial administrative or management activities are conducted.

Administrative or management activities. Examples include billing customers, clients, or patients, keeping books and records, ordering supplies, setting up appointments, and forwarding orders or writing reports.

Administrative or management activities performed at other locations. The following activities will not disqualify a home office from being a principal place of business.

- Someone other than the taxpayer does administrative or management activities at locations other than the taxpayer's home office. For example, another company does the taxpayer's book-keeping from its place of business.
- Administrative or management activities are conducted at places that are not fixed locations, such as a car or hotel room.
- The taxpayer occasionally conducts minimal administrative or management activities at a fixed location outside the home office.
- The taxpayer conducts substantial non-administrative or non-management business activities at a fixed location outside the home office. For example, the taxpayer meets with or provides

services to customers, clients, or patients at a fixed location outside the home.

- The taxpayer has suitable space to conduct administrative or management activities outside the home, but instead, chooses to use his or her home office for those activities.

Example: Mark is a self-employed plumber. Most of his working hours are spent at customers' homes and offices installing and repairing plumbing. He uses an office in his home regularly and exclusively for administrative activities, such as calling customers, ordering supplies, and customer billings. He writes up estimates for customers on their premises. He does not perform any substantial management activities at any other fixed location. He hires Susan as an independent contractor to perform bookkeeping and tax preparation services at her place of business. Mark's home office qualifies as his principal place of business for deducting expenses for the business use of his home.

More than one trade or business. The same home office can be used as the principal place of business for two or more separate business activities. The principal place of business test is determined separately for each activity.

Author's Comment: The fact that more than one business is using the home office does not disqualify the home office under the exclusive use test for another trade or business. In multiple business-use situations, the exclusive use test is applied by combining all trades or businesses using the same home office. The exclusive use test fails if one of the business activities using the home office fails under one of the other tests.

Court Case: A taxpayer performed two activities out of his home office, a teaching activity and a writing activity. Because the writing activity was ruled to be a hobby, a depreciation deduction on the home office for the teaching activity was not allowed. (*Clark*, T.C. Memo 1989-598)

Meeting patients, clients, or customers—exception to principal place of business test. The principal place of business test is not required if a taxpayer meets patients, clients, or customers in his or her home. The regular and exclusive use test must still be met. This exception applies only if the taxpayer meets both of the following tests.

- The taxpayer physically meets with patients, clients, or customers in the home, and
- Customer use of the home is substantial and integral to the conduct of the taxpayer's business.

Examples of taxpayers who may meet this exception include doctors, dentists, attorneys, and other professionals who maintain offices in their home. Using a home for occasional meetings and telephone calls will not qualify for this exception.

Example: Louise is a self-employed attorney. She works three days a week in her city office and two days a week in her home office used only for business. She regularly meets clients in her home office. Even though her principal place of business is her city office, her home office qualifies for a business deduction because she meets clients there in the normal course of her business.

Separate structure—exception to principal place of business test. The principal place of business test is not required if the area in the home used for business is a separate, free-standing structure, such as a studio, garage, or barn. The area must still meet the regular and exclusive use tests.

Example: Gloria operates a floral shop in town. She grows the plants for her shop in a greenhouse behind her home. She uses the greenhouse exclusively and regularly in her business. Because it is a separate structure, she can deduct the expenses for the business use of her greenhouse even though it is not her principal place of business.



Employee Business Use of Home

If the taxpayer is using a home office as an employee, the following additional requirements must be met.

- The home office must be for the convenience of the employer.
- The employee must be able to itemize deductions on Schedule A.
- The employee is not renting the home office to the employer.

Convenience of employer. This term does not necessarily mean that the employer requires the employee to have a home office.

- The employer must either provide no facilities or inadequate facilities for the employee to perform services for the employer.
- Use that is merely appropriate and helpful to the employer's business does not satisfy the convenience of the employer requirement.

Example: Amy teaches first grade. The school provides a small office where she can perform required tasks, such as preparing lesson plans, grading papers and tests, and meeting with students and parents. Amy prefers to do grading and lesson preparation in a home office used regularly and exclusively for these purposes. The use of Amy's home office does not meet the convenience of the employer test. Her employer provides her with office space and does not require her to work at home.

Home office deduction for employees. Employees deduct business use of home expenses on Schedule A, subject to limitations. See *Reporting Expenses for Business Use of the Home*, page 5-17.

Court Case: The taxpayers were professional musicians employed by the Metropolitan Opera Association, Inc. The nature of the taxpayers' business required that they spend many hours per week practicing. The employer did not provide space for the musicians to practice. Neither did the employer request nor require that they practice in their own homes. The court concluded that the requirement to practice was enough to meet the convenience of employer test. (*Drucker*, 2nd Cir., August 19, 1983)

Calculation Methods for Business Use of Home

To calculate the business use of home deduction, a taxpayer may elect each tax year to use either the simplified method or the regular method by using the chosen method on a timely filed tax return. Once a method is chosen for a tax year, it cannot be changed.

Business Use of Home Methods

	<i>Simplified Method</i>	<i>Regular Method</i>
Regular/exclusive use tests	Same rules.	Same rules.
Maximum square footage allowed for business.	300 square feet.	No maximum.
Expenses allowed	\$5 per square foot.	Actual expenses determined and records maintained.
Depreciation deduction.	No.	Yes.
Depreciation recapture on sale of home.	No.	Yes.
Deduction cannot exceed gross income limitation.	Same rules.	Same rules.
Carryover of expenses in excess of gross income limitation.	No.	Yes.*
Home-related itemized deductions (i.e. mortgage interest and real estate taxes).	Claimed in full on Schedule A.	Allocated between Schedule A and business schedule.

* Loss carryover from use of regular method in prior year may not be claimed in a year the simplified method is used. The loss is carried over until the next year the regular method is used again.

Simplified Method

Taxpayers can elect to use a simplified method when calculating the business use of home deduction, which has the following provisions.



- A standard deduction of \$5 per square foot of home used for business (maximum allowable area of 300 square feet). See *Allowable area*, below, for certain limitations.
- Deduction limited to business income. The deduction cannot be greater than business net income shown on line 29, Schedule C. No business use of home deduction is allowed if there is a business loss.
- No carryover allowed. (Any carryover from previously using regular method is carried over until next year regular method used again)
- Allowable home-related itemized deductions, such as mortgage interest and real estate taxes, are claimed in full on Schedule A.
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.
- If more than one business qualifies for the business use of home deduction, the election applies to all qualified business uses of home.
- If the taxpayer moved during the year, elect the simplified method for only one home. The regular method must be used for any other home.

Note: The simplified method reduces recordkeeping and substantiation but does not change the criteria for claiming a deduction.

Allowable area. The allowable area is the smaller of actual square footage of the business-use area of the home or 300 square feet. The allowable area may be smaller if the taxpayer conducted the business as a qualified joint venture with his or her spouse, the area used by the business was shared with another person's qualified business use, the taxpayer used the home for the business for only part of the year, or the area used by the business changed during the year. To compute a smaller allowable area, see the *Area Adjustment Worksheet (for simplified method)*, *Tools for Tax Pros*, www.thetaxbook.com/tools.

Area used by a qualified joint venture. In a qualified joint venture, the taxpayer and spouse compute the deduction separately. Split the actual area used in conducting business between the taxpayer and spouse in the same manner as other tax attributes are split.

Shared use. A taxpayer who shares a home with someone else who also qualifies for a business use of home deduction may not include the same square footage to compute the deduction as the other person. The shared space must be allocated in a reasonable manner.

More than one qualified business use. A taxpayer that conducts more than one qualifying business is limited to a maximum of 300 square feet for all businesses. Allocate actual square footage used (up to 300 feet) among the qualified businesses in a reasonable manner. The taxpayer must use the same method for all qualified business uses of the same home for a particular year. However, if a taxpayer has a qualified business use of home and a rental use of the same home, the simplified method cannot be used for the rental use.

Part-year use or area changes. If qualified business use is for a portion of the year (for example, a seasonal business, a business that begins during the year, or the taxpayer moves during the year) or the taxpayer changes the square footage of business use, the deduction is limited to the average monthly allowable square footage. Compute the average by adding the amount of allowable square feet used in each month and dividing the sum by 12. Do not take more than 300 square feet into account for any

month. If qualified business use was less than 15 days in a month, the taxpayer must use zero for that month.

Example: On July 20, Georgia began using 420 square feet of her home for qualified business use and continued using that space until the end of the year. Her average monthly allowable square footage is 125 square feet, which is computed using 300 square feet for each month August through December divided by 12 ($1,500 \div 12 = 125$). Her deduction is limited to \$625 ($125 \times \5) using the simplified method.

Example: From January 1 through July 16, Jack used 300 square feet of his home for qualified business use. On July 17, Jack moved to a new home and immediately began using 200 square feet for the same qualified business use. Jack elects the simplified method for the first home and must use the regular method for the second home. His average monthly allowable square footage is 175 square feet, computed using 300 square feet for January through July divided by 12 ($2,100 \div 12 = 175$). Using the simplified method, his deduction for the first home is limited to \$875 ($175 \times \5).

Daycare use simplified method. If a taxpayer does not use the area of the home exclusively for daycare, the prescribed rate (\$5 per square foot) must be reduced before computing the business use of home deduction using the simplified method. The \$5 rate is multiplied by a fraction, the numerator is the number of hours that the space was used during the year for daycare and the denominator is the total number of hours during the year the space was available for all uses. To compute the reduced rate, see *Daycare Facility Worksheet (for simplified method)*, *Tools for Tax Pros*, www.thetaxbook.com/tools.

Note: A taxpayer that uses at least 300 square feet for daycare regularly and exclusively during the year does not reduce the rate and is allowed the maximum deduction (\$1,500) when electing the simplified method.

Regular Method

A taxpayer that does not elect the simplified method calculates the business use of home deduction using actual expenses by dividing home operating expenses between personal (indirect) and business use (direct), determining the business-use percentage of the home, and applying the deduction limitation.

Deductible business use of home expenses. Some expenses are deductible on Schedule A, whether or not a taxpayer uses his or her home for business. Others are deductible on Form 8829, *Expenses for Business Use of Your Home*, or Schedule A, only if the home is used for business. See *Reporting Expenses for Business Use of the Home*, page 5-17.

Deductible Regardless	Deductible Only If for Business
<ul style="list-style-type: none"> • Real estate taxes. • Mortgage interest. • Casualty losses. • Qualified mortgage insurance premiums.* 	<ul style="list-style-type: none"> • Homeowner's insurance. • Rent. • Repairs and maintenance. • Security system. • Utilities and services. • Depreciation (deductible after applying deduction limitation to above expenses).



* ~~The provision allowing a deduction for mortgage insurance premiums expired on December 31, 2014. At the time this publication went to print, the provision had not been extended. See *What's New*, Tab 1, for any new information about extension of this provision.~~

The deduction for mortgage insurance premiums has been extended through 2016.

Types of Business-Use-of-Home Expenses			
Expense	Description	Examples	Deductibility
Direct	Expenses only for business part of home.	Painting or repairs only in the area used for business.	Full
Indirect	Expenses for keeping up and running the entire home.	Insurance, utilities, and general repairs.	Percentage of home used for business.
Unrelated	Expenses only for parts of home not used for business.	Lawn care or painting a room not used for business.	Not deductible.

Telephone. Basic local telephone service for the first line into the home is not deductible, even if used for business. Additional charges for business long distance or a second line used for business are deductible.

- Cell phone expenses may be deductible. See *Cell phones*, Tab 8.
- Telephone costs are deducted on Schedule C (or Schedules E or F or Form 2106, as applicable), not as part of business use of the home.



Depreciation. A qualified home office is considered 39-year nonresidential real property. Depreciation is calculated by multiplying the basis in the home by the business use percentage, multiplied by the applicable percentage from the depreciation tables in Tab 9. For purposes of home office depreciation, the basis in the home is the smaller of:

- The FMV of the home minus the FMV of land on the date the home was first used for business, or
- The home's cost plus permanent improvements minus casualty losses minus the cost of land on the date the home was first used for business. See *Determining Basis in a Residence*, Tab 6.

Home improvements. The tax treatment of permanent improvements made to a home used for business depends on timing.

<i>If Improvements Are Made:</i>	<i>Then the Cost of Improvements is:</i>
Before using the.....	Added to home's basis and depreciated home for business as part of the entire home's adjusted basis.
After use of the home.....	Depreciated as a separate asset, but only if for business has begun improvements affect the business-use area.

Example: Rita put a new roof on her home in 2002 and replaced her furnace in 2015. She first used her home for business in 2006. The cost of the roof is added to the home basis, and the business portion is depreciated over 39 years, starting in 2006. The business portion of the furnace cost is depreciated as a separate asset over 39 years, starting in 2015.

Determining business-use percentage. Home expenses are multiplied by the business-use percentage to determine the deductible portion of the expense.

Business-use percentage. Any reasonable method may be used to determine the business-use percentage. The following are two common methods.

- Divide square footage of area used for business by total square footage of home.
- If all rooms are about the same size, divide the number of rooms used for business by total number of rooms in home.

Part-year use. Do not include home expenses in the business use equation for any period during the year where the home was not used for business.

Day care facility. The business-use percentage of an area exclusively used for business in a day care facility is calculated under the business-use percentage method, above. For the portion of the home regularly used, but not exclusively used for the day care business, multiply that portion by the business-use percentage of time.

Example: Jane uses her 1,600 square foot basement for day care. The total area of her home is 3,200 square feet. Her day care uses the basement an average of 12 hours per day, five days a week, 50 weeks per year. The basement is used by her family at night and on weekends. The business-use percentage of her home is calculated as follows: $1,600 \div 3,200 = 50\%$. $12 \times 5 \times 50 = 3,000$ day care hours per year. $24 \times 365 = 8,760$ total hours per year. $3,000 \div 8,760 = 34.25\%$ day care time percentage. Any direct expenses, such as repainting the basement, are multiplied by 34.25% to determine the deductible business portion of the expense. Any indirect expenses, such as utilities, are multiplied by 17.13% ($50\% \times 34.25\% = 17.13\%$) to determine the deductible business portion of the expense.

Did You Know? In many cases, the basement and garage may be included in the total square footage of a day care provider's home when calculating the business-use percentage. In addition to regularly used rooms, the business-use area can include:

- Entryways, halls, food preparation areas, and bathrooms.
- Basement with laundry or tool rooms, storage or furnace area, etc.
- Garage where business car is parked or where household tools, trash cans, or stored day care items are kept.

Calculating time spent on day care. The provider should keep a log of time spent conducting the day care business, including:

- Dates and hours each person was in the provider's care, and
- Additional time spent organizing, preparing meals, and cleaning up. (*Neilson*, 94 T.C. No. 1)

Example: Beth cares for children 10 hours per day. Since she spends an hour in the morning preparing meals and craft projects for the children, and another hour in the evening cleaning up, she may count 12 hours as time spent on day care. Her guest room is used two hours each day for naps, although it is available for diaper changing and other activities during the full 12-hour business period. Beth treats the guest room as used 12 hours per day.



Deduction limitation. The business use of the home deduction is limited to net income from the business as follows.

- 1) Determine net business income.
 - Gross business income minus all business expenses except the deductions for $\frac{1}{2}$ SE tax and business use of home, plus
 - Any net gain derived from the business use of the home that is reportable on Schedule D or Form 4797.
- 2) Deduct the business portion of real estate taxes, mortgage interest, and casualty losses from net business income. Note that these items are deductible as a business expense even if the business has a loss. If the result is:
 - Zero or less, stop. Carry any remaining expenses for business use of the home forward to the next year.
 - More than zero, continue.
- 3) Deduct all business expenses relating to use of the home (other than real estate taxes, mortgage interest, casualty losses, and depreciation), but no more than the amount remaining from step 2). If the result is:
 - Zero, stop. Carry forward excess expenses, including business portion of depreciation on the home.
 - More than zero, continue.
- 4) Deduct the business portion of depreciation on the home, but no more than the amount remaining from step 3). Carry excess depreciation forward to the next year.

More than one business location. A taxpayer may conduct business in the home and in another location on a regular basis (see *Meeting patients, clients, or customers*, page 5-14). For purposes of the business use of home deduction limitation, income must be allocated between the locations. All relevant facts and circumstances are considered in making the income allocation,

including time spent at each location, business investment at each location, etc.

Example: A tax professional has an office in the home where he meets with 40% of his clients and prepares their taxes. He also has an office in another location outside his home where he meets 60% of his clients and prepares their taxes. His tax preparation activity from both locations is reported on one Schedule C. Assuming his home office qualifies for a deduction under all other rules, he uses 40% of his net income for purposes of the home office deduction limitation rules.

Carryover of unallowed expenses. Deductions not allowed due to the net income limitation are carried over to the following year when using the regular method. They are added to current expenses from each category and subject to the deduction limit for that year for that category, whether or not the taxpayer lives in the same home during that year. If the simplified option is used, any carryover from a previous year is not allowed, and the taxpayer continues to carry over the disallowed amount to the next year the regular method is used again.

Reporting Expenses for Business Use of the Home

Sole proprietors and statutory employees. Report the business use of the home deduction on line 30, Schedule C, Form 1040, regardless of the method used. See *Statutory employee income*, page 5-8.

Simplified method. The simplified method deduction is calculated on a worksheet. See *Simplified Method Worksheet, Tools for Tax Pros*, www.thetaxbook.com/tools.

Regular method—Form 8829, Expenses for Business Use of the Home. The regular method deduction is calculated on Form 8829 and is attached to the tax return.

Farmers, partners, and employees. Do not use Form 8829. Instead, use the worksheet in IRS Pub. 587, *Business Use of Your Home*, to apply gross income limitations and determine deductible amounts. Business use of home expenses that are suspended due to income limitations can be carried forward, just as they are for sole proprietors.

Note: The worksheet in IRS Pub. 587 is not a required attachment. The same results can be obtained by using Form 8829 as a worksheet with minor line adjustments.

Farmers. Report deductible business use of home expenses as Other Expenses on line 32, Schedule F, Form 1040.

Partners. Report deductible business use of home expenses as unreimbursed partnership expenses on line 27, Schedule E, Form 1040. See *Unreimbursed Partnership Expenses*, Tab 20, *Deluxe Edition/Small Business Edition*.

Employees (other than statutory employees). Report business use of the home expenses as itemized deductions on Schedule A as follows.

- Report real estate taxes, mortgage interest, and casualty losses in full on Schedule A as if no business use deduction were being taken.
- Report deductible amounts of other expenses, such as insurance, utilities, repairs, and depreciation, as miscellaneous itemized deductions on line 21, Schedule A, subject to the 2% AGI limitation.
- If Form 2106, *Employee Business Expenses*, is required, report the other expenses on line 4, Form 2106. These amounts will be carried to line 21, Schedule A. See *Job Expenses*, Tab 4.
- Deductions not allowed due to the 2% AGI limitation cannot be carried forward and are lost.



Rental of home office to employer. The deduction for business use of a home is limited if a taxpayer performs services as an employee in a part of his or her home rented to the employer. [IRC §280A(c)(6)]

- Report rental income on Schedule E, Form 1040.
- Deduct real estate taxes, mortgage interest, and casualty losses for the rented part on Schedule A, Form 1040, subject to any limitations.
- The business portions of other home expenses, such as insurance, utilities, repairs, and depreciation, are not deductible.

Example: Cathi is an employee of her S corporation which she runs from her home office. The S corporation deducts the rent it pays Cathi for use of the office. Cathi must report the rental income on Schedule E, but she cannot deduct any expenses on the business portion of her home other than mortgage interest, real estate taxes, and casualty losses.

Sole Proprietorships

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- IRS Pub. 334, *Tax Guide for Small Business*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 587, *Business Use of Your Home*
- IRC §162, *Trade or business expenses*



Related Topics

- Business Deductions, Tab 8
- Limited Liability Companies (LLCs), Tab 20, *Deluxe Edition/Small Business Edition*

A sole proprietorship does not legally exist separate from the individual. Liabilities of the business are the taxpayer's liabilities. A sole proprietor risks his or her personal assets, as well as business assets in the venture.

Exception: A sole proprietorship with LLC status receives limited liability protection under state law. For federal tax purposes, a single-member LLC is generally disregarded and taxed as a sole proprietorship unless it elects to be taxed as a corporation.

See *Hobby Loss Rules*, page 5-19, for characteristics of for-profit trades or businesses.

Day Care Providers—Deducting Meals

Meals and entertainment provided to day care recipients are deductible in full as an operating expense not subject to the 50% limitation rules. Do not deduct the cost of food consumed by the day care provider, the provider's own children, or family members.

Standard Meal and Snack Rates for 2015

	Continental U.S.	Alaska	Hawaii
Breakfast.....	\$1.31	\$2.09	\$1.53
Lunch and dinner (each)	\$2.47	\$4.00	\$2.88
Snacks (each/up to three).....	\$0.73	\$1.19	\$0.86

See *Standard Meal and Snack Rates* chart, page 5-1, for prior years and 2016 amounts.

Food Program Reimbursements. The U.S. Department of Agriculture provides reimbursements through the Child and Adult Care Food Program (CACFP), administered by USDA grants to the states.

- CACFP, or other food program reimbursements reported on Form 1099, should be shown as "Other Income" in the income section of Schedule C. Deduct the cost of the food as an expense. If no 1099 has been issued, the food expense deduction may be reduced by the amount of any reimbursement received.

- Food program reimbursements for the day care provider's own children are not income to the provider and should be clearly identified as such when reducing the amount reported as income.

Computing the deduction for meals and snacks. A family day care provider may deduct actual food costs or may use the *Standard Meal and Snack Rates* table, page 5-17, to compute the deduction for food provided to eligible children. Only one method of computing food costs may be used in a tax year, but the method may be changed from year to year.

- For purposes of the standard rates, a family day care provider is an individual in the business of providing day care who:
 - Provides nonmedical childcare in the home of the provider,
 - Does not receive a transfer of legal custody, and
 - Generally provides childcare less than 24 hours each day.
- For purposes of the standard rates, eligible children are minor children receiving care in the home of the provider, not to include any of the following.
 - Children who are full- or part-time residents of the home in which the care is provided.
 - Children whose parents or guardians are residents of that home.
 - Children who receive day care for personal reasons of the provider, such as caring for a relative as a favor.
- The standard meal and snack rates may be used for a maximum of one breakfast, one lunch, one dinner, and three snacks per eligible child per day. If using this method, the family day care provider must keep records, including the name of each child, dates and hours of attendance, and type and quantity of each meal or snack served.
- The standard meal and snack rates include beverages but not the cost of non-food supplies such as food storage containers, paper products, or utensils. Deduct these costs separately.
- If the actual expense method is used instead of the standard meal and snack rates, separate records with receipts must be kept for the day care food and for nondeductible family food costs.



Authors, Artists, and Musicians

Unique tax issues may apply to taxpayers involved in the creative or performing arts, such as authors, artists, photographers, musicians, etc.

Uniform Capitalization (UNICAP) Rules. Under the UNICAP rules of IRC section 263A, a taxpayer may have to capitalize certain indirect costs of producing a product or performing a service. One of the exceptions to the UNICAP rules is in the case of a self-employed freelance author, photographer, or artist. Expenses normally capitalized under UNICAP are deductible as current expenses. See *Uniform Capitalization Rules (UNICAP)*, Tab 8.

Qualified performing artists (QPAs). Employees who meet the QPA definition can deduct business expenses as an adjustment to income on line 24, Form 1040, rather than as itemized deductions subject to the 2% AGI limitation [IRC §62(a)(2)(B)]. See *Qualified performing artists*, Tab 8, for details and requirements for claiming deductions.

Royalties. Royalties may be received for the performance of personal services or for the ownership of an intangible asset. Royalties are taxable as ordinary income and are generally reported on Schedule C or Schedule E (Part I). For information about royalties from oil, gas, or mineral properties, see *Schedule E*, page 7-4.

- When the producer or creator of a musical composition, literary work, or work of art receives royalty income in connection with a copyright on that product, the royalty arises from the performance of services and is reported on Schedule C as self-employment income and is subject to self-employment tax.

- Royalty income received by someone who purchases the copyright of a musical composition or literary work as an investment is reported on Schedule E and is not subject to self-employment tax.
- Payments for the right to use a person's image or likeness are not income from services, even if described as royalties.

Court Case: The taxpayer, a professional golfer, received endorsement fees from various sponsors. Each endorsement agreement included the sponsor's right to use the taxpayer's name and likeness in advertising its products, and some of the agreements included additional requirements to play a specified number of rounds or tournaments while using sponsor products. The taxpayer allocated the endorsement income as part royalty and part personal service income. The Tax Court agreed, stating that the courts had repeatedly characterized payments for the right to use a person's name and likeness as royalties because the person has an ownership interest in the right. The sponsors had paid for both the services provided and the right to use the taxpayer's name and likeness, so allocation of income was appropriate for this taxpayer. (*Goosen*, 136 T.C No. 27)

Example: Paul was lead singer for the Zagnuts in 1979 and wrote their one hit wonder entitled "Wholly Bholly." He has been receiving royalties ever since, even though he has not performed as a professional musician for 25 years. Paul must report his royalty income as self-employment income because he is receiving the income as a result of past personal services performed.

Sale of musical compositions. A taxpayer may elect to treat the sale or exchange of a musical composition or copyright in musical works as a capital asset if the taxpayer's personal efforts created the property, or the taxpayer acquired the property through circumstances (i.e. gift) entitling the taxpayer to the basis of the person who created the property. (Reg. §1.1221-3)

- The election must be made separately for each affected asset.
- The election is made by reporting the sale or exchange on Form 8949, *Sales and Dispositions of Capital Assets*, on or before the due date of the return (including extensions).
- The election may be automatically revoked by filing an amended return within six months of the return's original due date, excluding extensions, and treating the sale or exchange of the asset as the sale or exchange of property that is not a capital asset.
- The taxpayer may also obtain permission to revoke the election by requesting a letter ruling.

Foster Care Business

Foster care payments received that do not qualify for the IRC section 131 exclusion or are not reimbursements from a charitable organization, are considered earnings from self-employment. See *Foster Care Payments*, Tab 3.

Ordinary and necessary expenses incurred that are not reimbursed by any organization are deductible as business expenses. However, if a taxpayer receives both taxable income and excludable foster care payments, expenses allocable to the excludable payments are not deductible. Also, for taxpayers in the foster care business, unreimbursed expenses are not considered support for dependency purposes.

Kids in Business—Paper Routes, Babysitting, and Lawn Mowing

The following are some industry exceptions to the SE, FICA, and FUTA tax rules.

Paper route. A child under age 18 delivering newspapers to customers is exempt from SE tax, FICA, and FUTA. [IRC §1402(c)(2)(A) and IRC §3121(b)(14)]



Domestic services performed by a child. Domestic services include activities such as babysitting, cleaning, and lawn mowing.

- A child under age 21 performing domestic services for a parent is exempt from employment taxes on those services. [IRC §3121(b)(3)(B)]
- A child under age 18 performing domestic services in a private home of the employer is exempt from employment taxes if the domestic services are not the principal occupation of the child. [IRC §3121(b)(21)]
- Domestic services are not considered to be the principal occupation of a child who is a student.

Student employment. A student of any age working for a school, college, or university is exempt from FICA and FUTA if the student regularly attends classes and performs services as an employee of such school, college, or university. [IRC §3121(b)(10)]

Working for parent-owned unincorporated business. Children under age 18 working for parent-owned unincorporated businesses are exempt from FICA and FUTA. Children under age 21 working for parent-owned unincorporated businesses are exempt from FUTA.

Author's Comment: Although a child performing domestic services under the control and direction of the homeowner is exempt from employment taxes, the same child could also be considered an independent contractor. If the child is performing domestic services for a number of homeowners, perhaps providing his or her own supplies, then the activity could be a trade or business, subject to SE tax.

Example: Cal, age 16, earns \$1,560 mowing lawns for three of his neighbors during his summer break from high school. He does not advertise or conduct the activity as a business. The homeowners provide equipment and gas and tell him when to work. Cal is considered a domestic employee of each of the neighbors who employ him. His income is not subject to FICA or FUTA, and his domestic employers are not required to withhold employment taxes from his wages. Since Cal's earnings are below the standard deduction for dependent children, he is not required to file a tax return.

Example: Kurt, age 17, works three days per week during the summer mowing lawns for various customers in the area. Kurt owns his own lawn mowing equipment, purchases his own gas and supplies, and distributes fliers advertising his services to the public. Homeowners expect certain standards to be met, but do not have substantial control over whom Kurt sends to mow the lawn or what time of day the lawns are to be mowed. Kurt nets \$1,560 during the summer of 2015 before going back to school as a full-time student. Kurt is self-employed, and although he owes no income tax on his earnings, he must file a 2015 tax return to pay \$220 in self-employment tax.

Family Businesses—Employing Family Members

Family businesses organized as sole proprietorships offer several tax planning opportunities.

- A child employed by a parent is exempt from FICA until age 18 and FUTA until age 21. These exemptions do not apply when a child is employed by a parent-owned corporation.
- A child employed by a parent for domestic work is exempt from both FICA and FUTA until age 21.
- A parent employed by a child is exempt from FUTA.
- A spouse employed by a spouse is exempt from FUTA.
- A child employed by a parent shifts income from the parent's higher tax bracket to the child's lower tax bracket.
- A child employed by a parent could provide opportunities for the parent to utilize the education tax credits that may be lost due to AGI phaseouts. See *Education Benefits Comparison Chart*, page 12-2.
- A spouse employed by a spouse can be covered under an employee health insurance plan that allows the sole proprietor to

deduct health costs against SE taxable income. See *Employee-spouse health insurance*, page 5-10.

- When family members are employees of the sole proprietor, travel expenses may be deductible for family member employees when mixing business with vacation travel. The cost of travel for a non-employee family member is not deductible, even when the sole purpose of the trip is for business.

See *Special Rules for Various Types of Employment*, Tab 23, *Deluxe Edition/Small Business Edition*, for a payroll tax chart.

Children employed by unincorporated parent-owned business. For the above rules to apply, the child must be a bona-fide employee of the parent-owned business. This means the child must actually render legitimate services as an employee of the business, the child must actually be paid for those services, and the payment must be reasonable in relation to the services rendered.

Example: Dan owns a lawn care service and employs his 16-year-old daughter, Cassie, to help. She operates mowing equipment and provides other legitimate services as an employee. In 2015, she earned \$11,800 during her summer vacation helping her dad in his business. Assume Dan is in a combined 30% federal and state income tax bracket. The \$11,800 in wages paid to Cassie reduces Dan's 2015 tax liability by \$3,540, and his 2015 SE tax by \$1,667, for a total tax savings of \$5,207. Cassie's wages are not subject to FICA or FUTA. If she contributes \$5,500 to an IRA, she will have zero income tax in 2015.

Cassie's 2015 wages	\$ 11,800
2015 IRA contribution	(5,500)
2015 standard deduction	(6,300)
Cassie's 2015 taxable income.....	\$ 0

If Cassie were to contribute to a SIMPLE plan instead of an IRA, Dan could shift up to \$19,364 to his daughter tax free in 2015 and save himself \$8,545 in combined 2015 income and SE tax.

Cassie's 2015 wages	\$ 18,800
2015 maximum SIMPLE elective deferral.....	(12,500)

Employer's 3% match is \$564, tax free to Cassie, deducted by Dan.

2015 standard deduction	(6,300)
Cassie's 2015 taxable income.....	\$ 0

Court Case: The taxpayers employed their minor daughters in a dog breeding business. The daughters were each paid a fixed amount, representing what the taxpayers stated they could afford to pay them; not based on hours worked or a wage rate. The girls were not paid, but amounts were credited for them to draw against for personal expenses. They performed duties like cleaning, taking out the garbage, and lawn mowing. The court agreed with the IRS and ruled against the taxpayers stating the children were not bona fide employees. The court cited the lack of Forms W-2, payments unrelated to dates and hours actually worked, failure to maintain adequate records of employment, and compensation for services in the nature of family chores, as reasons for the ruling. (*Alexander*, T.C. Summary 2006-127)

Hobby Loss Rules

Cross References

- Form 5213, *Election to Postpone Determination as to Whether the Presumption Applies That an Activity is Engaged in for Profit*
- IRS Pub. 535, *Business Expenses*
- IRC §183, *Activities not engaged in for profit*
- Reg. §1.183-1, *Activities not engaged in for profit*



Related Topics

- Miscellaneous Itemized Deductions, Tab 4

Hobby or Business?

If a business or investment activity is not conducted as a for-profit business, IRC section 183 limits deductions to the amount of income from the activity. This rule applies to individuals, partnerships, estates, trusts, and S corporations (but not to other corporations).

If an activity is considered a for-profit business, deductions can exceed income, allowing the resulting loss to offset other income.

Relevant factors. In determining whether an activity is a hobby or a business, all facts and circumstances are taken into account. No single factor alone is decisive. The following questions, though not all inclusive, can help in determining if the activity is a business.

- Does the taxpayer carry on the activity in a businesslike manner, including the maintenance of complete and accurate books and records?
- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity for his or her livelihood?
- Are any losses due to circumstances beyond the taxpayer's control?
- Are losses normal in the start-up phase of this type of business?
- Has the taxpayer adapted methods of operation in an attempt to improve profitability?
- Does the taxpayer (or taxpayer's advisors) have the knowledge or expertise needed to carry on the activity as a successful business?
- Has the taxpayer made a profit at similar activities in the past?
- Does the activity make a profit in some years?
- Does the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?
- How significant is the element of personal pleasure or recreation in the activity?



See Regulation section 1.183-2(b) for more discussion and examples.

Author's Comment: Regulation section 1.183-2(b) lists the element of personal pleasure or recreation as a factor in making the hobby vs. business determination, but that factor has been omitted from IRS Pub. 535, *Business Expenses*, and from various help pages on the IRS website. It seems that the IRS acknowledges that taxpayers can take genuine pleasure in a for-profit business activity.

Presumption of profit. IRC section 183(d) states that if an activity is profitable in three of the last five tax years, including the current year, the presumption is it is carried on for profit, and the hobby loss limitations do not apply. If the activity consists primarily of breeding, training, showing, or racing horses, the IRS will presume it is carried on for profit if a profit is produced in at least two of the last seven tax years, including the current year.

Court Case: A married couple ran a horse breeding and boarding activity in which they kept and cared for as many as 60 horses. The husband worked outside the home full-time while the wife worked full-time on the horse breeding and boarding activity. The husband also worked mornings, evenings, and weekends on the horse breeding and boarding activity. From 1992 through 2002, the taxpayers reported over \$400,000 in losses. The court ruled the activity was not a hobby. Although recordkeeping was poor, it was adequate. Although the couple was self-taught, they accumulated many years of experience. They also had a legitimate, although unrealized, long-term goal of profiting from a self-perpetuating herd of purebred horses that would increase in value over time. (*Helnick*, T.C. Memo 2009-220)

Reporting Hobby Income and Expenses

Occasional profits from hobby activities are not subject to self-employment tax, and losses from hobby activities cannot be used to offset other income. Do not use Schedule C or Schedule F to report income and expense from a hobby. Use the following procedures instead.

Hobby income. Gross income for the purposes of the hobby loss rules equals gross receipts minus the cost of goods sold deduction. Hobby income may include capital gain, rent, and other income.

- Report capital gain from the sale of hobby assets on Form 8949, *Sales and Dispositions of Capital Assets*. Losses from such sales are nondeductible personal losses.
- Report all other hobby income, less cost of goods sold, on line 21, Form 1040. Identify the amount as "activity not engaged in for profit." Any consistent method for determining cost of goods sold is permitted if it follows generally accepted accounting methods. [Reg. §1.183-1(e)]

Hobby expenses. Expenses related to hobby income are reported as itemized deductions on Schedule A in the following order.

Category 1. Deduct in full on Schedule A on the usual lines, even if the expenses exceed gross hobby income.

- Expenses deductible as personal expenses, as well as for business activities.
- *Examples:* Hobby portions of home mortgage interest, real estate tax, and casualty loss.

Category 2. Deduct as miscellaneous itemized deductions subject to the 2% AGI limitation, but only to the extent that gross hobby income exceeds Category 1 deductions.

- Hobby expenses that do not result in adjustment to the basis of property.
- *Examples:* Wages, advertising, insurance, utilities, interest (other than home mortgage interest).

Category 3. Deduct as miscellaneous itemized deduction subject to the 2% AGI limitation, but only to the extent that gross hobby income exceeds total Category 1 and Category 2 deductions.

- Hobby expenses that decrease the basis of property.
- *Examples:* Amortization, depreciation, portion of casualty loss not deductible in Category 1.

Hobby Loss Example

The following example illustrates the mechanics of reporting hobby income and expenses.

Example: Laura goes into business selling jewelry in a multi-level marketing organization. She uses an area of her home regularly and exclusively to do paperwork, plan demonstrations, and store inventory. Product demonstrations usually take place in customer homes. Laura does not need the income and really does not care about making a profit.



Laura's sales activity is a hobby. Her intent is not to make a profit, but to cover her costs and get discounts on jewelry for herself and her friends. She reports gross receipts minus the cost of goods sold on line 21, Form 1040. Other related costs are allocated to the proper category and deducted as itemized deductions on Laura's Schedule A.

For 2015, assume Laura incurs the following income and expenses.

Gross receipts (includes box 3 plus box 7, Form 1099-MISC) ...	\$ 6,900	
Cost of goods sold deduction:		
Opening inventory	\$ 300	
Plus purchase of supplies and materials	7,500	
Minus personal use items and gifts	(3,900)	
Minus ending inventory	(200)	(3,700)
Gross income (reported on line 21, Form 1040)	\$ 3,200	

Category 1 deductions:		
Real estate taxes (Schedule A).....	\$	700
Home mortgage interest (Schedule A).....	800	(1,500)
Remaining income limit for Category 2.....		\$1,700
Category 2 deductions (miscellaneous expense, 2% AGI limitation):		
Incentives and prizes paid to "downline"	\$	700
Insurance	185	
Repairs	40	
Standard mileage deduction (1,000 miles)	575	
Training meeting expense	100	(1,600)
Remaining income limit for Category 3.....	\$	100
Category 3 deductions (miscellaneous expense, 2% AGI limitation):		
Depreciation on demonstration equipment.....	\$	100
Depreciation of start-up kit.....	\$	300

Since Category 3 expenses exceed the income limit, the depreciation on the two assets must be allocated as follows:

$(\$100 \div \$400) \times \$100 = \25 depreciation allowed on demo equipment
 $(\$300 \div \$400) \times \$100 = \75 depreciation allowed on the start-up kit

If 2% of Laura's AGI is too high, it is possible that Laura will receive no tax benefit at all from her Category 2 and Category 3 expenses.

Author's Comment: Most hobbies would not qualify for a home office deduction under the exclusive use test. Thus, there would be no Category 1 deduction for real estate taxes and mortgage interest, and in many cases, no Category 2 deduction for auto expenses.

Election to Postpone Determination of Hobby or Business Status

A taxpayer can elect to postpone an IRS determination as to whether the activity is a hobby or a business by filing Form 5213, *Election to Postpone Determination as to Whether the Presumption Applies That an Activity is Engaged in for Profit*. The form should be filed within three years after the due date for the tax return of the year in which the taxpayer first engaged in the activity.

Independent Contractor vs. Employee

Cross References

- Form 8919, *Uncollected Social Security and Medicare Tax on Wages*
- Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*
- Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*
- IRS Pub. 15, (Circular E), *Employer's Tax Guide*
- IRS Pub. 15-A, *Employer's Supplemental Tax Guide*
- IRC §3121(d), IRC §3402(d), IRC §3508, IRC §3509
- Rev. Proc. 78-35
- Rev. Rul. 87-41



Related Topics

- Payroll and Labor Laws, Tab 23, *Deluxe Edition/Small Business Edition*
- Form 1099-MISC, Tab 23, *Deluxe Edition/Small Business Edition*

Worker Classifications

A worker performing services for a business falls under one of the following classifications.

- An independent contractor.
- A common-law employee.
- A statutory employee.
- A statutory non-employee.

An employer must generally withhold federal income taxes, withhold and pay over Social Security and Medicare taxes (FICA), and pay federal unemployment tax (FUTA) on wages paid to an employee. An employer does not generally have to withhold or pay over any federal taxes on payments to independent contractors.

Penalties and interest. When the IRS determines that a worker is actually an employee rather than an independent contractor, the employer is subject to penalties for failure to withhold and remit income, FICA and FUTA taxes, interest on the underpaid amounts, and penalties for failure to file information returns.

Independent contractor. An independent contractor is a self-employed worker who is generally responsible for paying his or her own income and FICA taxes through estimated tax payments. The business hiring the worker issues a 1099-MISC, *Miscellaneous Income*, for payments of \$600 or more, but generally is not responsible for withholding income tax or FICA.

Common-law employee. A worker treated as an employee under common factors that indicate employee status (Rev. Rul. 87-41). The business hiring the employee issues Form W-2 for wages paid and is responsible for withholding income tax and FICA. The employer is also liable for FUTA and various state employment taxes. The employee may also be eligible for fringe benefits offered by the employer.

Corporate officer. Any officer of a corporation providing services for his or her corporation in exchange for compensation is an employee of the corporation. [IRC §3121(d)(1)]

Corporate director. A director of a corporation in his or her capacity as such is not an employee of the corporation. Director fees are reported on box 7, Form 1099-MISC, and are subject to self-employment tax. [Reg. §31.3121(d)-1(b)]

Statutory employee. A worker may qualify as an independent contractor under common-law rules, but is treated as an employee under the IRC [IRC §3121(d)(3)]. See *Statutory employee income*, page 5-8, for a list of workers classified as statutory employees and for rules on how to report their income and expenses.

Statutory non-employee. A statutory non-employee is a worker who could be considered a common-law employee, but is treated as self-employed under the Internal Revenue Code. (IRC §3508)

There are three categories of statutory non-employees.

- **Direct seller.** A direct seller is an individual who sells consumer products outside of a permanent retail store, sells consumer products for resale outside of a permanent retail store, or delivers or distributes newspapers or shopping news.
- **Licensed real estate agent.** This category includes individuals engaged in appraisal activities for real estate sales if income is based on sales or other output.
- **Companion sitter.** A companion sitter is an individual who provides personal attendance, companionship, or household care services to children or individuals who are handicapped or elderly, and who is not an employee of a companion sitting placement service.

To be considered statutory non-employees, direct sellers and licensed real estate agents must meet two additional requirements.

- Substantially all payments for services performed are directly related to sales or other output, rather than hours worked, and
- Services are performed under a written contract stating that they will not be treated as employees for federal tax purposes.

Court Case: A taxpayer worked from home, providing auditing services for an insurance company. Although he had signed an employment contract and received a W-2, he considered himself to be an independent contractor and reported his income and expenses on Schedule C. The IRS rejected this treatment of W-2 wages as Schedule C income and the Tax Court agreed. The court determined that the taxpayer was a common-law employee and not an independent contractor or statutory

employee. His income was reportable as wages and his business expenses were deductible only as miscellaneous deductions on Schedule A, subject to the 2% AGI limitation. (*Feaster*, T.C. Memo 2010-157)

Factors Used to Determine Independent Contractor vs. Common-Law Employee Status

Except for specific types of statutory and non-statutory employees, the general rules for classifying workers as independent contractors or common-law employees center on who has the right to control the details of how services are to be performed.

Revenue Ruling 87-41 lists 20 factors used to make this determination. IRS Pub. 15-A, *Employer's Supplemental Tax Guide*, groups these factors into three categories.

- 1) Behavioral control.
- 2) Financial control.
- 3) Type of relationship between the parties.



Behavioral control. The following are factors that indicate a business has the right to direct and control a worker's behavior.

- **Instructions that the business gives to the worker.** Employers generally control when, where, and how work is to be done, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, what work must be performed by a specified individual, and what order or sequence to follow.
- **Training that the business gives to the worker.** Employees may be trained to perform a service in a particular manner. Independent contractors generally use their own methods.

Financial control. Factors that indicate a business has the right to control the business aspects of a worker's job include:

- **Extent of the worker's unreimbursed business expenses.** Independent contractors are more likely to incur expenses that are not reimbursed, such as fixed overhead costs that he or she incurs regardless of whether work is currently being performed.
- **Extent of the worker's investment.** Independent contractors often have significant investment in facilities used to perform services for someone else, such as maintaining a separate office or other business location.
- **Extent to which the worker makes his or her services available to the public.** Independent contractors are generally free to offer their services to other businesses or consumers. They often advertise and maintain a visible business location.
- **Method of payment for services performed.** Employees generally are guaranteed a regular wage and work for an hourly fee or a salary. Independent contractors are generally paid a flat fee for a specific job. Exceptions apply to some professions, such as accountants and lawyers who charge hourly fees for their services.
- **Extent to which the worker can make a profit.** Independent contractors can make a profit or a loss.

Type of relationship. The following are factors that indicate the type of relationship.

- **Written contracts.** Written contracts can describe the relationship and intent between the worker and the business hiring the worker.
- **Employee-type benefits provided to worker.** Employers often provide fringe benefits to employees, such as health insurance, pensions, and vacation pay.
- **Permanency of the relationship.** Employer-employee relationships generally continue indefinitely.
- **Extent services performed by the worker are a key aspect of the business hiring the worker.** A worker who is key to the success of a business is more likely to be controlled by the business, which indicates employee status. For example, an accounting firm hires an accountant to provide accounting

services for clients. It is more likely that the accounting firm will present the accountant's work as its own and would have the right to control or direct that work.

Safe Harbor Rules for Businesses

Section 530 of the Revenue Act of 1978 provides safe harbor rules that allow a business to continue treating a worker as an independent contractor, even if the worker would otherwise be considered an employee under the common-law rules (Rev. Proc. 78-35). Three requirements must be met.

- 1) **Reasonable basis.** A reasonable basis exists for not treating workers as employees if:
 - The business relied on judicial precedent or published ruling, or
 - A prior IRS employment audit of the business did not reclassify similarly treated workers as employees, or
 - A significant segment of businesses in the same industry treats similar workers as independent contractors, or
 - The business relied on any other reasonable basis, such as the advice of a lawyer or accountant familiar with the business.
- 2) **Substantive consistency.** For all periods beginning after 1977, the business and any predecessor business must have treated the worker and any similar workers as independent contractors.
- 3) **Reporting consistency.** All required federal tax returns, including Forms 1099-MISC, must have been filed consistent with the treatment of the worker as an independent contractor.



Author's Comment: According to the IRS Office of Chief Counsel, the reasonable basis standard is most clearly met if the taxpayer can demonstrate actual reliance on the relevant authority prior to making the initial decision of whether workers will be treated as employees or independent contractors. (PMTA 2011-15)

Court Case: A taxpayer treated workers hired to perform masonry services as independent contractors, a typical practice in the construction trades. The tax court determined that the workers were really employees. Section 530 relief was denied because the taxpayer failed to timely file and issue Forms 1099-MISC to the workers. The taxpayer was liable for payroll taxes, penalty, and interest for the years in question. (*Atlantic Coast Masonry, Inc.*, T.C. Memo 2012-233)

Erroneous Treatment of Employees as Independent Contractors—Form 1099-MISC Received

A taxpayer does not necessarily have to have a business for payments to be reported on Form 1099-MISC, *Miscellaneous Income*. A worker may have performed services as a nonemployee, even without realizing it, because the payer has determined that an employer-employee relationship did not exist.

A worker who receives Form 1099-MISC instead of Form W-2 has two options:

- 1) File Schedule C (or Schedule C-EZ, if applicable) to report the income and any expenses, and Schedule SE to pay the self-employment tax on the earnings, or
- 2) File Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. The IRS will then decide if the worker should have been treated as an employee, subject to income and FICA tax withholding.

Form 8919, Uncollected Social Security and Medicare Tax on Wages. The worker may choose to report the income as wages on his or her tax return before receiving the SS-8 determination. Submit Form 8919 with the tax return and check box G under the Reason Codes. Pay the employee share of FICA taxes and deduct

unreimbursed employee business expenses on Schedule A, subject to the 2% AGI limitation.

Note: If the IRS determines that the worker who filed Form 8919 is really an independent contractor, then the personal return must be amended. If the IRS agrees that the worker is really an employee, the employer will be liable for employment taxes.

IRC Section 3509 Relief for Employers

Under IRC section 3509, employers who do not qualify for IRC section 530 relief may be able to use reduced tax rates and correct the tax treatment of misclassified employees. Reduced rates apply only to the employee portion of FICA taxes and to federal income tax that should have been withheld. Requirements and procedures for obtaining IRC section 3509 relief are explained in Chapter 2 of IRS Pub. 15, *Employer's Tax Guide*.

IRC Section 3402(d) Relief for Employers

IRC section 3402(d) provides relief of employer liability for federal income tax not withheld from a payee, using the following procedure.

- Obtain Form 4669, *Statement of Payments Received*, from each payee, attesting that income tax has been paid on the compensation.
- Using Form 4670, *Request for Relief from Payment of Income Tax Withholding*, as a cover sheet, submit all Forms 4669 for the tax year.
- The employer will be assessed applicable penalties and interest.

Voluntary Classification Settlement Program

The Voluntary Classification Settlement Program (VCSP) permits eligible taxpayers to reclassify workers as employees for future tax periods and obtain relief similar to that available under IRC section 3509. See *IRC Section 3509 Relief for Employers*, above.

VCSP eligibility requirements. All of the following must be met.

- The taxpayer is presently treating the workers as nonemployees and has consistently done so in the past.
- All required Forms 1099 have been filed for the workers for the previous three tax years.
- The taxpayer is not currently under employment tax audit by the IRS or currently under audit concerning the classification of workers by the Department of Labor or by a state government agency.
- The taxpayer is in compliance with the results of any previous worker classification audit by the IRS or Department of Labor.

Form 8952. The taxpayer must file Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*, at least 60 days prior to the date the workers are to be treated as employees.

The IRS is not obligated to accept the taxpayer's application to participate in the VCSP.

Self-Employment Tax

Cross References

- Schedule SE (Form 1040), *Self-Employment Tax*
- IRC §1401, IRC §1402

Related Topics

- Ministers, Tab 14
- Payroll and Labor Laws, Tab 23, *Deluxe Edition/Small Business Edition*
- Self-Employment Tax—Sale of Business, Tab 27, *Small Business Edition*



Who Pays Self-Employment Tax

Taxpayers pay SE tax when net earnings from self-employment are \$400 or more. A taxpayer is self-employed if he or she carries on a trade or business as a sole proprietor (including farmers) or as a general partner in a partnership. A trade or business generally is an activity carried on for a livelihood or in good faith to make a profit. Facts and circumstances determine whether or not an activity is a trade or business. A taxpayer does not actually have to make a profit to be a trade or business. See *Self-Employment Tax Situations Chart*, page 5-3, for a list of specific activities with brief descriptions of whether income earned is subject to SE tax. The list is not all inclusive.

Self-Employment Tax

Self-employment tax is comprised of Social Security and Medicare tax assessed on taxpayers who work for themselves and is paid separately from income tax. Self-employment tax is equivalent to FICA taxes withheld from the pay of most wage earners. For more information on Social Security credits and coverage, see *Social Security*, Tab 22, *Deluxe Edition/Small Business Edition*.

Author's Comment: Not reporting all self-employment income, or incorrectly reporting self-employment income for the wrong spouse may cause lower Social Security benefits at retirement.

Self-employment (SE) tax rate. For 2015, the SE tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Schedule SE (Form 1040), Self-Employment Tax. A taxpayer must pay self-employment tax and file Schedule SE if net profit from self-employment is \$434 or more, unless an optional method is chosen. See *Self-Employment Tax Optional Methods*, page 5-24.

Percentage of income subject to self-employment tax. Multiply net profit by 92.35% (.9235) to get net earnings subject to SE tax.

- If net earnings are \$118,500 or less, multiply the amount by 15.3% (.153), which results in total self-employment tax.
- If net earnings are more than \$118,500, multiply the amount by 2.9% (.029) and add \$14,694 to the result for total self-employment tax.

Enter total self-employment tax amount on line 57, Form 1040.

Maximum earnings subject to self-employment tax. Only the first \$118,500 (2015) of net earnings from self-employment is subject to the 12.4% Social Security part of self-employment tax. All net earnings from self-employment are subject to the 2.9% Medicare part of self-employment tax.

More than one business. If a taxpayer has earnings from more than one business, combine the net profit (or loss) from each to determine total earnings subject to self-employment tax. A loss from one business reduces profit from another business.

Deduction for one-half self-employment tax. A taxpayer can deduct one-half of the total self-employment tax amount as an adjustment to income on line 27, Form 1040.

Additional Medicare tax. A 0.9% additional Medicare Tax applies to self-employment income over \$200,000 (Single, QW, HOH), \$250,000 (MFJ), or \$125,000 (MFS). Use Form 8959, *Additional Medicare Tax*, to compute the additional tax amount. For more information, see *Additional Medicare Tax*, Tab 3.

Claim all deductions. The Self-Employment Contributions Act of 1954 requires every taxpayer to claim all allowable deductions, including depreciation, in computing net earnings from self-employment for SE tax purposes. Penalties apply for making a false statement or representation in connection with any matter arising under the act. (Rev. Rul. 56-407)

Self-Employment Tax Optional Methods

Taxpayers with a loss or small amount of income may use one or both optional methods to compute SE tax. Using an optional method gives credit toward Social Security and may increase certain tax credits.

Nonfarm optional method. Qualifications include:

- Self-employed on a regular basis (net earnings from self-employment were \$400 or more in at least two of the previous three tax years).
- Net nonfarm profits were less than \$5,284 (2015), and less than 72.189% of gross nonfarm income.
- Used nonfarm optional method less than five years. There is a five-year lifetime limit. The years do not have to be consecutive.

Farm optional method. Qualifications include:

- Gross farm income was \$7,320 (2015) or less, or
- Net farm profits were less than \$5,284 (2015).

Use Part II, Schedule SE, to elect and compute an optional method.

Note: Do not combine farm and nonfarm earnings to compute net earnings under either method when using both optional methods.

Schedule F— Profit or Loss From Farming

Cross References

- Schedule F (Form 1040), *Profit or Loss From Farming*
- Schedule J (Form 1040), *Income Averaging for Farmers and Fishermen*
- Form 4835, *Farm Rental Income and Expenses*
- Form T (Timber), *Forest Activities Schedule*
- IRS Pub. 225, *Farmer's Tax Guide*

Related Topics

- Rental Real Estate, page 7-5
- Farm Rentals, page 7-9
- Passive Activity Losses, page 7-9
- Business Deductions, Tab 8
- Depreciation, Tab 9



Where to Report Sales of Farm Products

Item Sold	Schedule F, Profit or Loss From Farming	Form 4797, Sales of Business Property
Farm products raised for sale.	X	
Farm products bought for resale.	X	
Farm assets not held primarily for sale, such as livestock, held for draft, breeding, sport, or dairy purposes (bought or raised). See <i>Reporting Farming Activities</i> , below.		X

Reporting Farming Activities

Where?	SE Tax?	Description of Activity
Schedule F	Yes	Income received from operating, managing, or cultivating a farm for profit, either as owner or tenant, or for caring for someone else's crops or livestock. Farm rental income received by landowner or sublessor who materially participates in a sharecrop arrangement. Most agricultural payments. See <i>Agricultural Program Payments</i> , page 5-25. Sale of farm products raised on the farm for sale or purchased for resale.

Where?	SE Tax?	Description of Activity
Form 4835	No	Farm rental income received in a sharecrop arrangement in which the taxpayer did not materially participate. Report income in the year crops are converted into money or equivalent regardless of accounting method.
Schedule E	No	Cash rent received from a tenant who uses the taxpayer's land, based on a flat charge.
Schedule C	Yes	Income from contract harvesting of a commodity raised by someone else. Rental income received by a self-employed taxpayer in the business of renting farm equipment to farmers.
Line 21, Form 1040	No	Personal property rental income received by a taxpayer who is not in the business of renting. Report related expenses on line 36, Form 1040, labeled "PPR."
Form 4797	Maybe *	Sale of farm products not held primarily for sale (such as draft, breeding, dairy, or sport livestock), whether purchased or raised. Sale of farm equipment, buildings, or other depreciable property.

* The portion of depreciation that must be recaptured as ordinary income is not subject to SE tax, unless due to Section 179 or 280F property falling below 50% business use.

Farming Activities

A taxpayer is in the business of farming if he or she cultivates, operates, or manages a farm for profit, either as owner or tenant. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

Farm Inventory Accounting

Farmers generally must use the accrual method for inventory. See *Exceptions to the Accrual Method Rule for Inventory*, Tab 8. Farm inventory includes all items held for sale or for use as feed, seed, etc., whether purchased or raised, that are unsold at the end of the year. See *Inventory/Cost of Goods Sold*, Tab 8.

Farm Product Inventory	Yes	No
Eggs under incubation in a hatchery operation and accrual method of accounting is used.	X	
Harvested and purchased farm products held for sale or held for feed or seed, such as grain, hay, silage, cotton, tobacco, concentrates, etc.	X	
Supplies acquired for sale or that become a physical part of items held for sale.	X	
Incidental supplies and supplies that do not become part of items held for sale. ¹		X
Livestock held primarily for sale or purchased for resale.	X	
Fur-bearing animals such as mink, chinchillas, foxes, etc., held by a farmer who is in the business of breeding and raising them.	X	
Animals held for draft, breeding, dairy, or sport. ²		X
Raised livestock held for draft, breeding, dairy, or sport purposes and unit-livestock-price method is used. ³	X	
Growing crops with a pre-productive period of two years or less.		X
Growing crops when UNICAP rules apply. ⁴	X	

¹ Deduct as farm expense in the year used or consumed.

² These are business assets of the farm, subject to depreciation.

³ See *Unit-livestock-price method*, page 5-25.

⁴ See *Uniform Capitalization Rules for Farmers*, page 5-28.

Valuation methods. Farm inventory can be valued under methods available to other businesses (cost, lower of cost or

market, etc.). Farmers also have two additional methods unique to farming.

- **Farm-price method.** Entire inventory (except livestock) is valued at its market price less the direct cost of disposition.
- **Unit-livestock-price method.** Livestock is grouped and classified according to type and age, and then a standard unit price for each animal within a class or group is used to determine the value of inventory.

Crop Method of Accounting

If crops are planted and harvested in different tax years, a farmer can elect the crop method of accounting to deduct the entire cost of production, including expenses for seed and young plants, in the year income is realized from the crop. IRS approval is required, even for the first tax return. File Form 3115, *Application for Change in Accounting Method*, to obtain IRS approval. This method is not allowed for timber or when UNICAP rules apply.

Agricultural Program Payments

Most agricultural program payments are taxable. Taxable amounts reported on Schedule F are also subject to SE tax.

Commodity Credit Corporation (CCC) loans. Loan proceeds are generally not included in income. But if a farmer pledges a portion of crop production to secure a CCC loan, the proceeds can be treated as a sale of crops. The amount reported as income is added to the basis of the commodity. IRS approval is not required to adopt this method and the farmer generally must report all CCC loans in later years in the same way.

A taxpayer can use cash to repay a CCC loan, purchase CCC certificates for use in repayment of the loan, or deliver the pledged collateral as full payment for the loan at maturity. See IRS Notice 2007-63 for information about treatment of market gain associated with the repayment of CCC loans.

Conservation Reserve Program (CRP). Under the CRP, the government pays owners or operators with highly erodible or other specified cropland to convert its usage to a less intensive use.

Court Case: A non-farmer reported CRP income as rental income. The Tax Court agreed with the IRS' decision to treat the income as farm income subject to SE tax. The Circuit Court reversed the Tax Court decision, ruling the CRP payments to a non-farmer are considered rental income. (*Morehouse*, 8th Cir., October 10, 2014)

Social Security recipients. CRP payments made to taxpayers who are receiving Social Security retirement or disability benefits are exempt from self-employment tax. [IRC §1402(a)(1)]

Crop insurance and crop disaster payments. Insurance proceeds (including government disaster payments) received due to damaged crops are taxable in the year received. This includes payments for the inability to plant crops because of drought, flood, or any other natural disaster. The taxpayer can elect to postpone reporting income until the following year if:

- Cash method of accounting is used,
- Insurance proceeds are received in the same year the crops were damaged, and
- Under normal business practice, the taxpayer would have included income from the damaged crops in any tax year following the year the damage occurred.

To elect to postpone income, check the appropriate box in Part I, Schedule F, and attach a statement to the return with the following information.

- A statement that the taxpayer is postponing income under IRC section 451(d).
- Description of the specific crops damaged.



- A statement that under normal conditions, income from the damaged crops would have been included in income in a tax year following the year the crops were damaged.
- The cause of damage and date(s) it occurred.
- Total payments received from insurance with an itemization for each specific crop, and dates payments were received.
- Name of insurance carrier(s).

Feed assistance and payments. The government provides benefits to qualifying livestock producers when a natural disaster causes a livestock emergency. Benefits may be in the form of partial reimbursement of the cost of feed, certain transportation expenses, and donations of, or sale at, below market price of feed owned by the CCC. Include the following in taxable income.

- The market value of donated feed.
- The difference between the market value of feed and the reduced price of feed purchased by the taxpayer.
- Any cost reimbursements received.

These benefits are taxable in the year received. They cannot be postponed under the crop insurance or weather-related sale of livestock rules. A corresponding deduction for the cost of feed, is allowed.

Cost-sharing exclusion (improvements). An exclusion from income is allowed for payments received under a federal or state cost-sharing conservation, reclamation, and restoration program. The exclusion applies if all of the following tests are met.

- Payment was for a capital expense. Payments for expenses that are currently deductible do not count.
- The improvement does not substantially increase annual income from the property. An increase in income is substantial if it is more than the greater of 10% of average annual income prior to receiving the improvement, or \$2.50 times the number of affected acres.
- The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

See IRS Pub. 225, *Farmer's Tax Guide*, for a list of qualifying programs and the calculation of the excludable amount.



Patronage Dividends From Cooperatives

When a farmer buys supplies from a cooperative, the cooperative may later refund a portion of the purchase price in the form of a patronage dividend. The refund generally represents the excess net earnings of the cooperative. Patronage dividends are reported on Form 1099-PATR, *Taxable Distributions Received From Cooperatives*.

Tax reporting. Report the total amount received on Part I, Schedule F, and allocate the dividends by source as follows.

- Attributable to deductible farm expenses Taxable
- Attributable to personal expenses Nontaxable
- Attributable to the purchase of capital assets..... Reduce asset basis

Qualified written notice of allocation. Include the stated dollar value in income in the year received. The amount included in income that exceeds money received becomes the basis in the notice. A written notice of allocation is qualified if at least 20% of the patronage dividend is paid in money or by qualified check and either of the following conditions is met.

- Notice is redeemable in cash for at least 90 days after it is issued.
- Taxpayer agreed to include the stated dollar value in income in the year received by either signing a written agreement, getting membership in the cooperative, or by endorsing and cashing a qualified check that was paid as part of the same patronage dividend.

continued on next page

Any loss on redemption is deductible on Part II, Schedule F.

Nonqualified notice of allocation. Do not include the stated dollar value in income when received. The basis in the notice is zero. Tax is paid on any amount received from its sale in the year of disposition.

Per-Unit Retain Certificate From Cooperatives

A per-unit retain allocation is an amount paid to patrons for products sold for them that is fixed without regard to the net earnings of the cooperative. Per-unit retain certificates generally receive the same tax treatment as patronage dividends.

Farm Debt Cancellation

When farm debt is cancelled or forgiven, the amount forgiven may be includable in taxable income on line 10, Schedule F.

Qualified farm debt exclusion. Farmers can exclude from income a cancelled debt that is qualified farm debt owed to a qualified person. The exclusion applies only if the farmer was insolvent when the debt was cancelled and only to the extent the cancelled debt is more than the amount by which the farmer was insolvent. Qualified farm debt must meet both of the following requirements:

- Debt was incurred directly in operating a farming business, and
- At least 50% of total gross receipts for the previous three tax years preceding the year of debt cancellation were from farming business.

Qualified person. A qualified person is actively and regularly engaged in the business of lending money, including any federal, state, or local government, or any of their agencies or subdivisions, and the USDA. A qualified person does not include any of the following individuals:

- A person related to the farmer.
- A person from whom the farmer acquired the property (or a person related to this person).
- A person who receives a fee from the farmer's investment in the property (or a person related to this person).

Reduction of tax attributes. A farmer must use special rules to reduce the basis of property for excluded cancelled qualified farm debt. Under these rules, qualified property is reduced in the following order:

- 1) Depreciable qualified property.
- 2) Land that is qualified property and used or held for use in farming business.
- 3) Other qualified property.

Qualified property. Qualified property is any property used or held for use in a trade or business or for the production of income.

Form 982, Reduction of Tax Attributes Due to Discharge or Indebtedness. Form 982 is used to reduce tax attributes for above items.

See *Foreclosures, Repossessions, and Cancellation of Debt*, Tab 14, for information on debt cancellation, other exclusions, and bankruptcy.

Net Operating Losses on Farms

If a farmer's deductible loss from operating a farm is more than the farmer's other income for the year, a net operating loss (NOL) may exist. See *Net Operating Loss (NOL)*, Tab 8.

5-year farming loss carryback period. The carryback period for a farming loss is five years instead of the usual two years.

- Only the farming loss portion of the NOL is carried back five years.
- The farmer can make an irrevocable election to treat a farming loss as if it were not a farming loss. If the election is made, the loss is subject to the usual 2-year carryback period.

Farming loss. A farming loss is the smaller of:

- The amount that would be the NOL for the tax year if only income and deductions attributable to farming business are considered.
- The NOL for the tax year.



Excess Farm Loss Limitation

Farm losses of all taxpayers (except C corporations) are limited in years the farmer received certain government subsidies. The excess farm loss for a year is the greater of:

- \$300,000 (\$150,000 if MFS), or
- The taxpayer's total net farm income from the prior five tax years.

Farming losses from casualty losses or losses by reason of disease or drought are disregarded. Also, the excess farm loss limitation is applied before the passive activity loss rules are applied.

Excess farm loss is carried forward to the next year and treated as a deduction.

Income Averaging for Farmers and Fishermen

If farm income is high in the current year and low in any of three prior (base) years, a farmer may qualify to calculate a lower tax by income averaging on Schedule J (Form 1040), *Income Averaging for Farmers and Fishermen*. When electing to use Schedule J, the taxpayer:

- Need not have been in the farming business in any of the base years.
- May have a different filing status than in the base years.
- Need not have been required to file a tax return in any of the base years, although base year income amounts are needed for Schedule J.
- Does not use income averaging for AMT calculations.
- Does not recalculate AMT or Kiddie Tax for any of the base years.
- Must combine income, gains, losses, and deductions from farming and fishing businesses if the taxpayer is engaged in both activities.



Fishing business. IRS regulations define a fishing business as:

- Catching, taking, or harvesting activities that result in the killing of fish or the bringing of live fish on board a vessel, support operations at sea, but not processing of fish, or
- Lessors of fishing boats when payment is based on share of catch, or
- Crewmembers when compensation is based on a share of the catch.

Elected farm income (EFI). The taxpayer first calculates total income, gains, losses, and deductions attributable to farming and fishing, including wages or compensation received as a shareholder in an S corporation engaged in a farming or fishing business, certain Exxon Valdez litigation proceeds, and deduction for deposits into a Merchant Marine Capital Construction Fund (CCF). EFI is the portion of this total that the taxpayer chooses to be taxed at base year rates on Schedule J. A lower tax may result if the taxpayer uses less than the total amount available. EFI cannot exceed taxable income, and the capital gain portion of EFI cannot exceed the lesser of total net capital gain or net capital gain attributable to farming or fishing. See Regulation section 1.1301-1 for more information and examples.

Prepaid Farm Supplies

Prepaid farm supplies include feed, seed, fertilizer, and similar farm supplies that are not used or consumed as of the end of the tax year. If the cash method of accounting is used to report income and expenses, a deduction for prepaid farm supplies may

be limited to 50% of the total other deductible farm expenses for the year (all Schedule F deductions except prepaid farm supplies).

Example: Ken bought \$5,500 worth of fertilizer in 2015 that will not be used until 2016. His other deductible farm expenses in 2015 total \$10,000. Ken's deduction for prepaid farm supplies in 2015 cannot be more than \$5,000 (50% of \$10,000). The \$500 excess is deductible in 2016 when the fertilizer is used.

Exceptions: The limit on deducting prepaid farm supplies does not apply for farmers if either of the following is true.

- Prepaid farm supplies are more than 50% of other deductible farm expenses because of a change in business operations caused by unusual circumstances.
- Total prepaid farm supplies expense for the preceding three tax years is less than 50% of total other deductible farm expenses for those three tax years.

Prepaid livestock feed. Cash method farmers cannot deduct in the year paid the cost of feed that livestock will consume in a later year unless all the following three tests are met.

- 1) The payment is for the purchase of feed rather than a deposit,
- 2) The prepayment has a business purpose and is not merely for tax avoidance, and
- 3) Deducting the prepayment does not result in a material distortion of income.

If all three tests are met, the deduction for prepaid livestock feed is still subject to the 50% rule discussed above.



Real Estate Taxes on Farm Land

Taxes on the portion of the farm used as the taxpayer's personal residence should be deducted as itemized deductions on Schedule A rather than as business deductions on Schedule F.

Did You Know? According to IRS Pub. 225, the business and non-business portion of property taxes can be determined based on the assessed valuation. For example, a 160 acre farm may have a personal residence sitting on a two-acre parcel of land. 98.75% of the total land area is used for farming. However, the assessed valuation of the property may only show 50% allocated to the land and farm buildings, while the other 50% is allocated to the house. This may seem less advantageous for deduction purposes, but when the property is eventually sold, only 50% of the total sale price would be allocated to the business, while the other 50% could qualify for the IRC section 121 home sale exclusion of a personal residence.

Farm Truck and Car Expenses

Farmers can calculate the deduction for the business use of vehicles under either the standard mileage rate method or actual expense method. See *Business Autos*, page 10-3.

Business use percentage for farm vehicles. Farmers can claim 75% of the use of a car or light truck as business use without any records if the vehicle is used during most of the normal business day directly in connection with the farming business.

Fuel and road use excise tax. Owners, tenants, or operators of a farm may be eligible to claim a credit or refund of excise taxes on fuel used for farming purposes in carrying on a trade or business of farming on a farm in the United States.

Claim the credit on Form 4136, *Credit for Federal Tax Paid on Fuels*, filed annually with the individual or business tax return. Claim refunds on Form 8849, *Claim for Refund of Excise Taxes*, filed quarterly. No credit or refund is allowed for any personal, household, or non-fuel use, except in some circumstances for undyed diesel fuel or undyed kerosene.¹ Credits and refunds are summarized in the next column.

Fuel Used on Farm for Farming Purposes	Credit	Refund
Gasoline	Yes	No
Aviation gasoline	Yes	No
Kerosene used in aviation	Yes	Yes
Undyed diesel fuel and undyed kerosene	Yes ²	Yes ²
Other fuels, including liquified hydrogen ³	Yes ²	Yes ²
Off-Highway Business Use Fuel	Credit	Refund
Gasoline	Yes	Yes
Undyed diesel fuel and undyed kerosene	Yes ¹	Yes ¹
Other fuels, including liquified hydrogen ³	Yes	Yes

¹ Applies to undyed kerosene not sold from a blocked pump, or for blending with undyed diesel for household heating, lighting, or cooking.

² Credit or refund by the farmer only, even if purchased by someone else and used on the farm for farming purposes.

³ The credit for liquefied hydrogen expired on September 30, 2014.

Did You Know? No credit or refund is allowed for any dyed diesel fuel or dyed kerosene, which are usually purchased tax free. If these fuels are used for taxable purposes, Form 2290, *Heavy Highway Vehicle Use Tax Return*, must be filed to pay excise tax and avoid penalties.

Depreciation for Farm Property

Farm property such as machinery, equipment, livestock, or structures with a useful life of more than a year must generally be depreciated. See Tab 9, *Depreciation*, for general depreciation rules, the Section 179 deduction, and the special depreciation allowance.

Farming Asset Recovery Periods

Assets:	GDS Life	Method	Sec. 179
Agricultural and horticultural single purpose structures	10 yrs	150% DB	Yes
Autos	5 yrs	150% DB	Yes
Cattle (dairy or breeding)	5 yrs	150% DB	Yes
Cotton ginning assets	7 yrs	150% DB	Yes
Drainage facilities	15 yrs	150% DB	Yes
Farm buildings (other than single purpose structures)	20 yrs	150% DB	No
Farm machinery and equipment	7 yrs	150% DB	Yes
Fences (agricultural)	7 yrs	150% DB	Yes
Fruit or nut trees and vines	10 yrs	SL	Yes
Goats and sheep (breeding)	5 yrs	150% DB	Yes
Grain bin	7 yrs	150% DB	Yes
Hogs (breeding)	3 yrs	150% DB	Yes
Horses, breeding and working, up to age 12 when placed in service	7 yrs	150% DB	Yes
Horses, breeding and working, over age 12 when placed in service	3 yrs	150% DB	Yes
Horses, racing, over age 2	3 yrs	150% DB	Yes
Horses, racing, age 2 or younger	3 yrs 7 yrs*	150% DB	Yes
Nonresidential real property, placed in service after May 12, 1993	39 yrs	SL	No
Residential rental property	27.5 yrs	SL	No
Trucks (less than 13,000 lbs)	5 yrs	150% DB	Yes
Water wells	15 yrs	150% DB	No

See Tab 9 for other depreciation recovery periods and methods.

* ~~The provision allowing race horses two years of age or younger to be depreciated over three years expired on December 31, 2014. At the time this~~

Race horses treated as 3-year property has been extended through 2016.

Depreciation method. Most farm property must generally be depreciated under GDS using the 150% declining balance (DB) method. However, a farmer must use ADS for property for which

an election not to apply the UNICAP rules to certain farming costs is in effect.

Livestock. Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory account. Livestock a farmer raises usually has no depreciable basis because the costs of raising them are deducted and not added to their basis. However, for immature livestock, depreciation begins when the livestock reaches the age of maturity (when the livestock can be worked, milked, or bred), and the basis is their initial cost.

Fruit or nut trees and vines. An orchard, grove, or vineyard acquired before the trees or vines have reached the income-producing stage, and have a pre-productive-period of more than two years, the pre-productive-period costs must be capitalized under the UNICAP rules (unless the farmer elects not to use the rules). Depreciation begins when the trees and vines reach the income-producing stage (bear fruit, nuts, or grapes in quantities sufficient to commercially warrant harvesting).

Business Use of the Home

A farmer may be able to deduct certain expenses for business use of the home, subject to limitations. The simplified method is also available. Allowable expenses are computed on the worksheet in IRS Pub. 587, *Business Use of Your Home*. Deduct on line 32, Schedule F (Form 1040). See *Business Use of Home*, page 5-12.

Soil and Water Conservation Expenses

A taxpayer in the business of farming can choose to deduct certain expenses for:

- Soil or water conservation,
- Prevention of erosion of land used in farming, or
- Endangered species recovery.

Otherwise, these expenses are capital expenses that must be added to the basis of the land. The deduction is limited to 25% of gross income from farming. Unused amounts can be carried over.

Uniform Capitalization Rules for Farmers

Uniform capitalization (UNICAP) rules require businesses to capitalize certain costs if the business produces property or acquires it for resale. A farmer produces property by raising or growing any agricultural or horticultural commodity, including plants and animals. However, UNICAP rules for farmers do not apply to the following property.

- Any animal.
- Any plant with a preproductive period of two years or less.
- Costs of replanting certain plants lost or damaged due to casualty.

The first two exceptions do not apply to farm corporations, partnerships, or tax shelters that are required to use the accrual method of accounting. See *Uniform Capitalization Rules (UNICAP)*, Tab 8.

Timber Sales by Farmers

The tax treatment of timber sold by farmers depends on whether the timber is held as an investment or is a product of the farm.

- Standing timber held as an investment is a capital gain asset. Report gains or losses from a sale on Schedule D.
- Timber held, purchased, or raised primarily for sale to customers is an ordinary income asset. Report sales proceeds on Schedule F, line 1 (purchased timber) or line 2 (raised timber).
- IRC section 631(a) permits the election to treat cut timber as a sale or exchange, resulting in a basis adjustment when an actual sale or exchange occurs.

- IRC section 631(b) permits an election to treat outright sales of timber as capital gain. The payment date may be treated as the date of sale, even if cutting or disposition of the timber has not yet occurred.

Form T, Forest Activities Schedule I. Attach Form T to the tax return if electing to treat cut timber as sale or exchange, making an outright sale of timber, or claiming cost depletion. Form T is not required if the taxpayer only has an occasional sale of timber. See instructions for Form T.

Timber basis. Timber basis is recovered through depletion, which occurs when standing timber (including Christmas trees) is cut. Cost depletion is the only method permitted for timber. It is claimed as a deduction on Schedule F in the year of sale or other disposition of cut timber, or in the year the farmer elects to treat cutting as a sale or exchange. See *Depletion*, Tab 6.

Postponing Gain on Weather-Related Sales of Livestock

If more than the normal amount of livestock, including poultry, is sold because of a drought, flood, or other weather-related condition, gain from the additional animals can be postponed until the following year. All the following must be true.

- Principal trade or business is farming,
- Cash method of accounting is used,
- Under usual business practices, the taxpayer would not have sold the additional animals this year except for the weather-related condition, and
- The weather-related condition caused an area to be designated as eligible for federal assistance.

How to postpone gain. To postpone gain, attach a statement to the tax return for the year of sale which includes the following information.

- A statement that the taxpayer is postponing gain under IRC section 451(e).
- Evidence of the weather-related conditions that forced the early sale and date the area was eligible for federal assistance.
- Explanation of the relationship between the area affected by the weather-related condition and the resulting early sale of livestock.
- Number of animals sold in each of the three preceding years.
- Number of animals the taxpayer would have sold under normal weather conditions.
- Total number of animals sold and the number sold due to the weather-related conditions.
- Computation of income to be postponed.

Involuntary conversion rules for livestock. Gain on livestock sold under the weather-related sales rules discussed, above, can be postponed under the involuntary conversion rules if replacement property is purchased within the replacement period. See *Involuntary Conversions*, Tab 14.

- If it is not practical to invest sales proceeds in other livestock, the proceeds can be used to purchase other property used in farming (but not real property) and still qualify for postponement of gain.
- The replacement period is extended from the usual two years to four years if weather-related conditions occur in an area eligible for federal assistance. (Notice 2006-82 and Notice 2008-86)
- The IRS may further extend the four-year replacement period if the weather-related conditions that caused the area to be eligible for federal assistance continue beyond three years. (Notice 2012-62)



~ End ~