J.K. LASSER'S®

A Wiley Brand

SMALL BUSINESS TAXES 2017

Over 250,000 copies sold!

Your Complete Guide to a Better Bottom Line

BARBARA WELTMAN

"The Guru of Small Business Taxes"—*The Wall Street Journal*

J.K. LASSER'S™

SMALL BUSINESS TAXES 2017

Your Complete Guide to a Better Bottom Line

Barbara Weltman

WILEY

Cover design: Wiley

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

ISBN 978-1-119-24905-4 (paper)
ISBN 978-1-119-24918-4 (ePDF)
ISBN 978-1-119-24913-9 (ePub)

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

This book is dedicated with love to my understanding husband, Malcolm Katt.

Contents

Preface

According to a 2015 report from the National Small Business Association (NSBA), 85% of small businesses use paid tax preparers to file their returns. So why do you need to read up on taxes? The answer is simple: You, not your accountant or other financial adviser and not software, run the business, so you can't rely on someone else to make decisions critical to your activities. NSBA found that 67% of small businesses say that federal taxes have a significant or moderate impact on the day-to-day operation of their businesses. You need to be informed about tax-saving opportunities that continually arise so you can strategically plan to take advantage of them. Being knowledgeable about tax matters also saves you money; the more you know, the better able you are to ask your accountant key tax and financial questions that can advance your business, as well as to meet your tax responsibilities.

This is a great time to be a small business. Not only is small business a major force in our economy but it also is the benefactor of numerous tax rules that make it easier to write off expenses and minimize the taxes you owe. This edition of the book has been revised to include all of the new rules taking effect for 2016 returns. Your business needs to use every tax-saving opportunity to survive and thrive at this time. The book also provides information about future changes scheduled to take effect in order to give you an overall view of business tax planning. Most importantly, it addresses the many tax questions I have received from readers as well as visitors to my website, www.barbaraweltman.com.

This book focuses primarily on federal income taxes. Businesses may be required to pay and report many other taxes, including state income taxes, employment taxes, sales and use taxes, and excise taxes. Some information about these taxes is included in this book to alert you to your possible obligations so that you can then obtain further assistance if necessary. However, the book takes a holistic approach to taxes, showing you where applicable the ramifications that tax decisions can have on your business activities and your bottom line. Statistics, resources, and other materials are provided to help you better run your business by making good tax decisions and implementing sound business practices.

Whether or not you use a paid tax professional to prepare your tax return, expect to devote considerable time to taxes as part of running your business. The NSBA report found that one in 3 owners spent in excess of 80 hours (2 full work weeks) on making tax-related calculations, filing forms, meeting with accountants, and other tax-related chores each year. Also be prepared to spend money not only on your tax payments but also on administrative costs (e.g., accountants' fees). Nearly half of small businesses spend more than $5,000 annually, and 27% spend more than $10,000 each year, according to the same report. In another report, the Small Business Association found that 66% of owners polled thought taxes—the administrative hassles and cost—threatened their viability.

It is important to stay alert to future tax changes. Uncertainty has been labeled an impediment to business growth. Pending or possible changes are noted in this book, including the expiration of nearly a dozen tax rules at the end of 2016 that can impact tax planning for 2017. Be sure to check on any final action before you take any steps that could be affected by these changes.

For a free supplement on tax developments affecting small businesses (available in February 2017), go to www.jklasser.com or www.barbaraweltman.com.

How to Use This Book

The purpose of this book is to make you acutely aware of how your actions in business can affect your bottom line from a tax perspective. The way you organize your business, the accounting method you select, and the types of payments you make all have an impact on when you report income and the extent to which you can take deductions. This book is not designed to make you a tax expert. It is strongly suggested that you consult with a tax adviser before making certain important decisions that will affect your ability to minimize your taxes (and Chapter 32 tells you how to work with a tax professional). I hope that the insight you gain from this book will allow you to ask your adviser key questions to benefit your business.

In Part 1, you will find topics of interest to all businesses. First, there is an overview of the various forms of business organization and an explanation of how these forms of organization affect reporting of income and claiming tax deductions. The most common forms of business organization include independent contractors, sole proprietors, and sole practitioners—individuals who work for themselves and do not have any partners. If self-employed individuals join with others to form a business, they become partners in a partnership. Sometimes businesses incorporate. A business can be incorporated with only one owner or with many owners. A corporation can be a regular corporation (*C corporation*), or it can be a small business corporation (*S corporation*). The difference between the C and S corporations is the way in which income of the business is taxed to the owner (which is explained in detail in Part 1). There is another form of business organization called a *limited liability company* (LLC). Limited liability companies with two or more owners generally are taxed like partnerships even though their owners enjoy protection from personal liability. The important thing to note is that each form of business organization will affect what deductions can be claimed and where to claim them. Part 1 also explains tax years and accounting methods that businesses can select.

Part 1 contains another topic of general interest to all businesses. It covers important recordkeeping requirements and suggestions to help you audit-proof your return to the extent possible and protect your deductions and tax credits. In the course of business you may incur certain expenses, but unless you have specific proof of those expenses, you may not be able to claim a deduction or credit. Learn how to keep the necessary records to back up your write-offs in the event your return is questioned by the IRS.

Part 2 details how to report various types of income your business may receive. In addition to fees and sales receipts—the bread-and-butter of your business—you may receive other types of ordinary income such as interest income, royalties, and rents. You may have capital gain transactions as well as sales of business assets. But you may also have losses—from operations or the sale of assets. Special rules govern the tax treatment of these losses. The first part of each chapter discusses the types of income to report and special rules that affect them. Then scan the second part of each chapter, which explains where on the tax return to report the income or claim the loss.

Part 3 focuses on specific deductions and tax credits. It provides you with guidance on the various types of deductions you can use to reduce your business income. Each type of deduction is explained in detail. Related tax credits are also explained in each deduction chapter. In the first part of each chapter, you will learn what the deduction is all about and any dollar limits or other special requirements that may apply. As with the income chapters, the second part of each deduction chapter explains where on the tax return you can claim the write-off. The answer depends on your form of business organization. You simply look for your form of business organization to learn where on the return to claim the deduction. The portion of the appropriate tax form or schedule is highlighted in certain instances. For your convenience, key tax forms for claiming these deductions have been included. While the forms and schedules are designed for the 2016 returns, they serve as an example for future years. Also, in Chapter 22, Miscellaneous Business Deductions, you will find checklists that serve as handy reference guides on all business deductions. The checklists are organized according to your status: self-employed, employee, or small corporation. You will also find a checklist of deductions that have not been allowed.

Part 4 contains planning ideas for your business. You will learn about strategies for deferring income, boosting deductions, starting up or winding down a business, running a sideline business, running multiple businesses, and avoiding audits. It also highlights the most common mistakes that business owners make in their returns. This information will help you avoid making the same mistakes and losing out on tax-saving opportunities. You will also find helpful information about electronic filing of business tax forms and how to use the Internet for tax assistance and planning purposes. And you will find information about other taxes on your business, including state income taxes, employment taxes, sales and use taxes, and excise taxes. Finally, you will see how to work with a tax professional and what to do if you are audited.

In Appendix A, you will see a listing of information returns you may be required to file with the IRS or other government agencies in conjunction with your tax obligations. These returns enable the federal government to crosscheck tax reporting and other financial information. Appendix B covers tax penalties that can apply if you fail to do something you were supposed to do, or if you do it wrong or do it late. Appendix C contains a checklist of tax-related corporate resolutions to help you keep your corporate minutes book up to date. Appendix D is a list of dollar limits and amounts in certain tax rules that are adjusted annually for inflation to help you plan ahead.

Several forms and schedules as well as excerpts from them have been included throughout the book to illustrate reporting rules. These forms are not to be used to file your return. (In many cases, the appropriate forms were not available when this book was published, and older or draft versions of the forms were included.) You can obtain the forms you need from the IRS's web site at www.irs.gov or where otherwise indicated.

Another way to stay abreast of tax and other small business developments that can affect your business throughout the year is by subscribing to *Barbara Weltman's Big Ideas for Small Business®*, a free online newsletter geared for small business owners and their professional advisers, and my "Small Business Idea of the Day®" (via e-mail) at www.barbaraweltman.com. For more information on the tax implications of your small business and any developments on the Alerts throughout the book, visit www.jklasser.com. Here you will also find a supplement to this book (available in February 2017), with updated information as it develops; the supplement is also posted on my site.

This book has been in print for more than 20 years and has tracked dramatic changes in tax law and business operations. For those who are using it for the first time, the book is a resource guide for handling taxes effectively as well as for making financial decisions and using business practices to increase your bottom line. For those who are perennial readers, you will see that while much in the book is unchanged, it has been updated and expanded to reflect new tax rules and additional comments on tax strategies and business practices. For tax practitioners, I recognize that there are no citations, and that there are some issues that are unsettled; I invite your comments on any areas in which you disagree with my presentation and for ways to make improvements in future editions (send comments to Barbara@barbaraweltman.com).

I would like to thank Sidney Kess, Esq. and CPA, for his valuable suggestions in the preparation of the original tax deduction book and Elliott Eiss, Esq., for his expertise and constant assistance with this and other projects.

Barbara Weltman
September 2016

Introduction

Small businesses are vital to the U.S. economy. They employ half of the country's private sector workforce and contribute more than half of the nation's gross national product. Historically, small businesses created 65% of all new jobs over the past 15 years.

For the 2013 tax year (the most recent year for statistics), there were more than 23.5 million sole proprietorships in the United States. More than one in 8 Form 1040 filers had a sole proprietorship that year. Another 7.5 million filers reported income from partnerships and S corporations. And the numbers of small businesses are growing.

Small businesses fall under the purview of the Internal Revenue Service's (IRS) Small Business and Self-Employed Division (SB/SE). This division services approximately 54 million tax filers, including 9 million small businesses (partnerships and corporations with assets of $10 million or less), more than 41 million of whom are full-time or partially self-employed, and about 7 million filers of employment, excise, and certain other returns. The SB/SE division accounts for about 40% of the total federal tax revenues collected. The goal of this IRS division is customer assistance to help small businesses comply with the tax laws.

Toward this end, the Small Business Administration (SBA) has teamed up with the IRS to provide small business owners with help on tax issues. The SBA provides tax information for start-ups at www.sba.gov and search "taxes."

There is also an IRS Tax Center devoted exclusively to small business and self-employed persons at www.irs.gov/Businesses/Small-Businesses-&-Self-Employed. Here you will find special information for your industry—agriculture, automotive, child care, construction, entertainment, gaming, manufacturing, real estate, restaurants, retailers, veterinarians, and even tax professionals are already covered, and additional industries are set to follow. You can see the hot tax issues for your industry, find special audit guides that explain what the IRS looks for in your industry when examining returns, and links to other tax information.

As a small business owner, you work, try to grow your business, and hope to make a profit. What you can keep from that profit depends in part on the income tax you pay. The income tax applies to your net income rather than to your gross income or gross receipts. You are not taxed on all the income you bring in by way of sales, fees, commissions, or other payments. Instead, you are essentially taxed on what you keep after paying off the expenses of providing the services or making the sales that are the crux of your business. Deductions for these expenses operate to fix the amount of income that will be subject to tax. So deductions, in effect, help to determine the tax you pay and the profits you keep. And tax credits, the number of which has been expanded in recent years, can offset your tax to reduce the amount you ultimately pay.

Special Rules for Small Businesses

Sometimes it pays to be small. The tax laws contain a number of special rules exclusively for small businesses. But what is a small business? The average size of a small business in the United States is one with fewer than 20 employees with annual revenue under $2 million. The SBA usually defines small business by the number of employees—size standards range from 500 employees to 1,500 employees, depending on the industry or the SBA program. The SBA also uses revenue for certain business size standards (e.g., average annual gross receipts for many nonmanufacturing industries). Size matters because only “small businesses” can qualify for SBA-guaranteed loans and for special consideration with federal contracting.

For tax purposes, however, the answer varies from rule to rule, as explained throughout the book. Sometimes it depends on your revenues, the number of employees, or total assets. In Table I.1 are more than 2 dozen definitions from the Internal Revenue Code on what constitutes a small business. You may be a small business for some tax rules but not for others.

Reporting Income

While taxes are figured on your bottom line—your income less certain expenses—you still must report your income on your tax return. Generally all of the income your business receives is taxable unless there is a specific tax rule that allows you to exclude the income permanently or defer it to a future time.

When you report income depends on your method of accounting. *How* and *where* you report income depends on the nature of the income and your type

TABLE I.1 Examples of Tax Definitions of Small Business

Tax Rule	Definition
Accrual method exception for small inventory-based businesses (Chapter 2)	Average annual gross receipts of no more than $10 million in the 3 prior years (or number of years in business if less)
Archer medical savings accounts (Chapter 19)	Fewer than 50 employees
Bad debts deducted on the nonaccrual-experience method (Chapter 11)	Average annual gross receipts for the 3 prior years of no more than $5 million
Building improvements safe harbor (Chapter 10)	Average annual gross receipts for the 3 prior years of no more than $10 million *and* building's unadjusted basis no greater than $1 million
Corporate alternative minimum tax (AMT) exemption for small C corporations (Chapter 22)	Average annual gross receipts of no more than $7 million ($5 million for the first 3-year period)
Disabled access credit (Chapter 10)	Gross receipts of no more than $1 million in the preceding year or no more than 30 full-time employees
Exemption from reporting health coverage on employees' W-2s	Fewer than 250 W-2s filed for the previous year
Employer mandate exemption from providing affordable health coverage	Fewer than 50 full-time/full-time equivalent employees
Employer wage differential credit for activated reservists (Chapter 7)	Fewer than 50 employees
First-year expensing election (Chapter 14)	Equipment purchases for 2016 of no more than $2.5 million
Independent contractor versus employee determination—shifting burden of proof to IRS (Chapter 7)	Net worth of business does not exceed $7 million
Late filing penalty for failure to file information return—cap (Appendix)	Average annual gross receipts of no more than $5 million for a 3-year period
Net operating loss carryback—3 years for a qualified small business (Chapter 4)	Average annual gross receipts of $5 million or less in the 3 prior years
Repair regulations—deduction under safe harbor for items up to $2,500 per item or invoice (Chapter 10)	No applicable financial statement (SEC filing; audited financial statement)
Repair regulations—safe harbor not to capitalize improvements to buildings (Chapter 10)	Average annual gross receipts under $10 million and building has unadjusted basis under $1 million
Reasonable compensation—shifting the burden of proof to the IRS (Chapter 7)	Net worth of business not in excess of $7 million
Research credit—offset to employer's Social Security taxes	Corporation or partnership with gross receipts of no more than $5 million for current year; other company with no gross receipts during the 5-year period ending with the current year
Retirement plan start-up credit (Chapter 16)	No more than 100 employees with compensation over $5,000 in the preceding year
Savings Incentive Match Plans for Employees (SIMPLE) plans (Chapter 16)	Self-employed or businesses with 100 or fewer employees who received at least $5,000 in compensation in the preceding year

(Continued)

TABLE I.1 *(Continued)*

Tax Rule	Definition
Section 1244 losses (Chapter 5)	Equity of no more than $1 million at the time stock is issued
Simple cafeteria plans (Chapter 7)	100 or fewer employees on business days during either of the 2 preceding years
Simplified change in accounting for repair safe harbors (Chapter 10)	Total assets less than $10 million *or* average annual gross receipts in 3 prior years less than $10 million
Small business/self-employed (SB/SE) division of IRS	Self-employed individuals, plus corporations and partnerships with assets under $10 million
Small employer health care credit (Chapter 19)	No more than 25 full-time equivalent employees
Small business stock—deferral or exclusion of gain on sale (Chapter 5)	Gross assets of no more than $50 million when the stock is issued and immediately after
UNICAP small reseller exception (Chapter 2)	Average annual gross receipts of no more than $10 million for a 3-year period
UNICAP simplified dollar value last-in, first-out (LIFO) method (Chapter 2)	Average annual gross receipts of no more than $5 million for a 3-year period

of business organization. Over the next several years, the declining tax rates for owners of pass-through entities—sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations—require greater sensitivity to the timing of business income.

The IRS reported a "tax gap" (the spread between revenues that should be collected and what actually is collected) of $450 billion a year and that $122 billion of this can be traced to entrepreneurs who underreport or don't report their income, or overstate their deductions. In order to close the tax gap, the IRS is stepping up its audit activities for self-employed individuals, and increased reporting to the IRS and other measures may be adopted.

Claiming Deductions

You pay tax only on your profits, not on what you take in (gross receipts). In order to arrive at your profits, you are allowed to subtract certain expenses from your income. These expenses are called "deductions."

The law says what you can and cannot deduct (see below). Within this framework, the nature and amount of the deductions you have often vary with the size of your business, the industry you are in, where you are based in the country, and other factors. The most common deductions for businesses include car and truck expenses, utilities, supplies, legal and professional services, insurance, depreciation, taxes, meals and entertainment, advertising, repairs, travel, rent for business property and equipment, and in some cases, a home office.

Are your deductions typical? The Government Accountability Office (formerly the General Accounting Office) in January 2004 compiled statistics on deductions claimed by sole proprietors for 2001 (no data more current is available). These numbers show the dollars spent on various types of deductions, the percentage of sole proprietors who claimed the deductions, and what percentage of total deductions each expense represented. For example, 25% of sole proprietors with business gross receipts under $25,000 claimed a deduction for advertising costs. This percentage rose to 65% when gross receipts exceeded $100,000. You can view these old statistics at www.gao.gov/new.items/d04304.pdf.

What Is the Legal Authority for Claiming Deductions?

Deductions are a legal way to reduce the amount of your business income subject to tax. But there is no constitutional right to tax deductions. Instead, deductions are a matter of legislative grace; if Congress chooses to allow a particular deduction, so be it. Therefore, deductions are carefully spelled out in the Internal Revenue Code (the Code).

The language of the Code in many instances is rather general. It may describe a category of deductions without getting into specifics. For example, the Code contains a general deduction for all *ordinary and necessary* business expenses, without explaining what constitutes these expenses. Over the years, the IRS and the courts have worked to flesh out what business expenses are ordinary and necessary. "Ordinary" means common or accepted in business and "necessary" means appropriate and helpful in developing and maintaining a business. Often the IRS and the courts reach different conclusions about whether an item meets this definition and is deductible, leaving the taxpayer in a somewhat difficult position. If the taxpayer uses a more favorable court position to claim a deduction, the IRS may very well attack the deduction in the event that the return is examined. This puts the taxpayer in the position of having to incur legal expenses to bring the matter to court. However, if the taxpayer simply follows the IRS approach, a good opportunity to reduce business income by means of a deduction will have been missed. Throughout this book, whenever unresolved questions remain about a particular deduction, both sides have been explained. The choice is up to you and your tax adviser.

Sometimes the Code is very specific about a deduction, such as an employer's right to deduct employment taxes. Still, even where the Code is specific and there is less need for clarification, disputes about applicability or terminology may still arise. Again, the IRS and the courts may differ on the proper conclusion. It will remain for you and your tax adviser to review the different authorities for the positions stated and to reach your own conclusions based on the strength of the different positions and the amount of tax savings at stake.

A word about authorities for the deductions discussed in this book: There are a number of sources for these write-offs in addition to the Internal Revenue Code. These sources include court decisions from the U.S. Tax Court, the U.S.

district courts and courts of appeal, the U.S. Court of Federal Claims, and the U.S. Supreme Court. There are also regulations issued by the Treasury Department to explain sections of the Internal Revenue Code. The IRS issues a number of pronouncements, including Revenue Rulings, Revenue Procedures, Notices, Announcements, and News Releases. The IRS also issues private letter rulings, determination letters, field service advice, and technical advice memoranda. While these private types of pronouncements cannot be cited as authority by a taxpayer other than the one for whom the pronouncement was made, they are important nonetheless. They serve as an indication of IRS thinking on a particular topic, and it is often the case that private letter rulings on topics of general interest later get restated in revenue rulings.

What Is a Tax Deduction Worth to You?

The answer depends on your tax bracket. The tax bracket is dependent on the way you organize your business. If you are self-employed and in the top tax bracket of 39.6% in 2016, then each $100 deduction will save you $39.60. Had you not claimed this deduction, you would have had to pay $39.60 of tax on that $100 of income that was offset by the deduction. If you have a personal service corporation, a special type of corporation for most professionals, the corporation pays tax at a flat rate of 35%. This means that the corporation is in the 35% tax bracket. Thus, each $100 deduction claimed saves $35 of tax on the corporation's income. Deductions are even more valuable if your business is in a state that imposes income tax. The impact of state income tax and special rules for state income taxes are not discussed in this book. However, you should explore the tax rules in your state and ascertain their impact on your business income.

When Do You Claim Deductions?

Like the timing of income, the timing of deductions—when to claim them—is determined by your tax year and method of accounting. Your form of business organization affects your choice of tax year and your accounting method.

Even when expenses are deductible, there may be limits on the timing of those deductions. Most common expenses are currently deductible in full. However, some expenses must be capitalized or amortized, or you must choose between current deductibility and capitalization. Capitalization generally means that costs can be written off ratably as amortized expenses or depreciated over a period of time. (Capitalized costs, such as for the purchase of machinery and equipment, are added to the balance sheet as company assets.) Amortized expenses include, for example, fees to incorporate a business and expenses to organize a new business. Certain capitalized costs may not be deductible at all, but are treated as an additional cost of an asset (*basis*).

Credits versus Deductions

Not all write-offs of business expenses are treated as deductions. Some can be claimed as tax credits. A tax credit is worth more than a deduction since it reduces your taxes dollar for dollar. Like deductions, tax credits are available only to the extent that Congress allows. In a couple of instances, you have a choice between treating certain expenses as a deduction or a credit. In most cases, however, tax credits can be claimed for certain expenses for which no tax deduction is provided. Business-related tax credits, as well as personal credits related to working or running a business, are included in this book.

Tax Responsibilities

As a small business owner, your obligations taxwise are broad. Not only do you have to pay income taxes and file income tax returns, but you also must manage payroll taxes if you have any employees. You may also have to collect and report on state and local sales taxes. Some businesses, such as farms, may have excise tax responsibilities. Finally, you may have to notify the IRS of certain activities on information returns.

It is very helpful to keep an eye on the tax calendar so you will not miss out on any payment or filing deadlines, which can result in interest and penalties. You might want to view the IRS's *Tax Calendar for Businesses and Self-Employed* (go to https://www.irs.gov/Businesses/Small-Businesses-%26-Self-Employed/IRS-Tax-Calendar-for-Businesses-and-Self-Employed). You can use IRS CalendarConnector to filter the calendar to view dates that apply to you (go to https://www.irs.gov/pub/irs-pdf/p1518a.pdf).

You can obtain most federal tax forms online at www.irs.gov. Nonscannable forms, which cannot be downloaded from the IRS, can be ordered by calling toll free at 800-829-4933 during normal business hours.

Organization

Business Organization

If you have a great idea for a product or a business and are eager to get started, do not let your enthusiasm be the reason you get off on the wrong foot. Take a while to consider how you will organize your business. The form of organization your business takes controls how income and deductions are reported to the government on a tax return. Sometimes you have a choice of the type of business organization; other times circumstances limit your choice. If you have not yet set up your business and do have a choice, this discussion will influence your decision on business organization. If you have already set up your business, you may want to consider changing to another form of organization.

According to the Tax Foundation, 94% of all businesses in the United States are organized as sole proprietorships, partnerships, limited liability companies (LLCs), or S corporations, all of which are "pass-through" entities. This means that the owners, rather than the businesses, pay tax on business income. Nearly 50% of the private sector workforce is employed by these pass-through entities.

The way in which you set up your business impacts the effective tax rate you pay on your profits (after factoring income taxes and employment taxes). Taxes, however, are only one factor in deciding what type of entity to use for your business.

As you organize your business, consider which type of entity to use after factoring in taxes (federal and state) and other consequences. Also consider whether to change from your current form of business entity to a new one and what it means from a tax perspective. Finally, be sure to obtain your business's federal tax identity number (or a new one when making certain entity changes).

For a further discussion on worker classification, see IRS Publication 15-A, *Employer's Supplemental Tax Guide*.

Sole Proprietorships

If you go into business for yourself and do not have any partners (with the exception of a spouse, as explained shortly), you are considered a *sole proprietor*, and your business is called a *sole proprietorship*. You may think that the term *proprietor* connotes a storekeeper. For purposes of tax treatment, however, proprietor means any unincorporated business owned entirely by one person. Thus, the category includes individuals in professional practice, such as doctors, lawyers, accountants, and architects. Those who are experts in an area, such as engineering, public relations, or computers, may set up their own consulting businesses and fall under the category of sole proprietor. The designation also applies to independent contractors. Other terms used for sole proprietors include freelancers, solopreneurs, and consultants. And it includes "dependent contractors": self-employed individuals who provide all (or substantially all) of their services for one company (often someone laid off from a corporate job who is then engaged to provide non-employee services for the same corporation). Further, it includes those working in the "gig economy" for such companies as Uber, Lyft, and TaskRabbit.

Sole proprietorships are the most common form of business. The IRS reports that one in 6 Form 1040s contains a Schedule C or C-EZ (the forms used by sole proprietorships). Most sideline businesses are run as sole proprietorships, and many start-ups commence in this business form.

There are no formalities required to become a sole proprietor; you simply conduct business. You may have to register your business with your city, town, or county government by filing a simple form stating that you are doing business as the "Quality Dry Cleaners" or some other business name other than your own (a fictitious business name, or FBN). This is sometimes referred to as a DBA, which stands for "doing business as."

From a legal standpoint, as a sole proprietor, you are personally liable for any debts your business incurs. For example, if you borrow money and default on a loan, the lender can look not only to your business equipment and other business property but also to your personal stocks, bonds, and other property. Some states may give your house homestead protection; state or federal law may protect your pensions and even Individual Retirement Accounts (IRAs). Your only protection for your personal assets is adequate insurance against accidents for your business and other liabilities and paying your debts in full.

Simplicity is the advantage to this form of business. This form of business is commonly used for sideline ventures, as evidenced by the fact that half of all sole proprietors earn salaries and wages along with their business income. For 2013 (the most recent year for statistics), more than 24.1 million taxpayers filed returns as sole proprietors.

Independent Contractors

One type of sole proprietor is the *independent contractor*. To illustrate, suppose you used to work for Corporation X. You have retired, but X gives you a consulting contract under which you provide occasional services to X. In your retirement, you decide to provide consulting services not only to X, but to other customers as well. You are now a consultant. You are an independent contractor to each of the companies for which you provide services. Similarly, you have a full-time job but earn extra money by performing chores for customers through TaskRabbit. Here too you are an independent contractor.

More precisely, an independent contractor is an individual who provides services to others outside an employment context. The providing of services becomes a business, an independent calling. In terms of claiming business deductions, classification as an independent contractor is generally more favorable than classification as an employee. (See "Tax Treatment of Income and Deductions in General," later in this chapter.) Therefore, many individuals whose employment status is not clear may wish to claim independent contractor status. Also, from the employer's perspective, hiring independent contractors is more favorable because the employer is not liable for employment taxes and need not provide employee benefits. (It costs about 30% more for an employee than an independent contractor after factoring in employment taxes, insurance, and benefits.) Federal employment taxes include Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA) as well as unemployment taxes under the Federal Unemployment Tax Act (FUTA).

You should be aware that the Internal Revenue Service (IRS) aggressively tries to reclassify workers as employees in order to collect employment taxes from employers. A discussion about worker classification can be found in Chapter 7.

There is a distinction that needs to be made between the classification of a worker for income tax purposes and the classification of a worker for employment tax purposes. By statute, certain employees are treated as independent contractors for employment taxes even though they continue to be treated as employees for income taxes. Other employees are treated as employees for employment taxes even though they are independent contractors for income taxes.

There are 2 categories of employees that are, by statute, treated as nonemployees for purposes of federal employment taxes. These 2 categories are real estate salespersons and direct sellers of consumer goods. These employees are considered independent contractors (the ramifications of which are discussed later in this chapter). Such workers are deemed independent contractors if at least 90% of the employees' compensation is determined by their output. In other words, they are independent contractors if they are paid by commission and not a fixed salary. They must also perform their services under a written contract that specifies they will not be treated as employees for federal employment tax purposes.

Statutory Employees

Some individuals who consider themselves to be in business for themselves—reporting their income and expenses as sole proprietors—may still be treated as employees for purposes of employment taxes. As such, Social Security and Medicare taxes are withheld from their compensation. These individuals include:

- Corporate officers
- Agent-drivers or commission-drivers engaged in the distribution of meat products, bakery products, produce, beverages other than milk, laundry, or dry-cleaning services
- Full-time life insurance salespersons
- Homeworkers who personally perform services according to specifications provided by the service recipient
- Traveling or city salespersons engaged on a full-time basis in the solicitation of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar businesses

Full-time life insurance salespersons, homeworkers, and traveling or city salespersons are exempt from FICA if they have made a substantial investment in the facilities used in connection with the performance of services.

Day Traders

Traders in securities may be viewed as being engaged in a trade or business in securities if they seek profit from daily market movements in the prices of securities (rather than from dividends, interest, and long-term appreciation) and these activities are substantial, continuous, and regular. Calling yourself a day trader does not make it so; your activities must speak for themselves.

Being a trader means you report your trading expenses on Schedule C, such as subscriptions to publications and online services used in this securities business. Investment interest can be reported on Schedule C (it is not subject to the net investment income limitation that otherwise applies to individuals).

Being a trader means income is reported in a unique way—income from trading is *not* reported on Schedule C. Gains and losses are reported on Schedule D unless you make a mark-to-market election. If so, then income and losses are reported on Form 4797. The mark-to-market election is explained in Chapter 2.

Gains and losses from trading activities are not subject to self-employment tax (with or without the mark-to-market election).

Husband-Wife Joint Ventures

Usually when 2 or more people co-own a business, they are in partnership. However, spouses who co-own a business and file jointly and conduct a joint venture can opt *not* to be treated as a partnership, which requires filing a partnership return (Form 1065) and reporting 2 Schedule K-1s (as explained later in this chapter). Instead, these “couplepreneurs” each report their share of income on Schedule C of Form 1040. To qualify for this election, each must materially participate in the business (neither can be a silent partner), and there can be no other co-owners. Making this election simplifies reporting while ensuring that each spouse receives credit for paying Social Security and Medicare taxes.

One-Member Limited Liability Companies

Every state allows a single owner to form a limited liability company (LLC) under state law. From a legal standpoint, an LLC gives the owner protection from personal liability (only business assets are at risk from the claims of creditors) as explained later in this chapter. But from a tax standpoint, a single-member LLC is treated as a “disregarded entity.” (The owner can elect to have the LLC taxed as a corporation, but this is not typical. An election may be made to be taxed as a corporation, followed by an S election, so that the owner can easily make tax payments through wage withholding rather than making estimated tax payments, as well as minimize Social Security and Medicare taxes.) If the owner is an individual (and not a corporation), all of the income and expenses of the LLC are reported on Schedule C of the owner’s Form 1040. In other words, for federal income tax purposes, the LLC is treated just like a sole proprietorship.

Tax Treatment of Income and Deductions in General

Sole proprietors, including independent contractors and statutory employees, report their income and deductions on Schedule C, see *Profit or Loss From*

Business (Figure 1.1). The net amount (profit or loss after offsetting income with deductions) is then reported as part of the income section on page 1 of your Form 1040. Such individuals may be able to use a simplified form for reporting business income and deductions: Schedule C-EZ, *Net Profit From Business* (see Figure 1.2). Individuals engaged in farming activities report

SCHEDULE C (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
▶ Information about Schedule C and its separate instructions is at *www.irs.gov/schedulec*.
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074
2016
Attachment Sequence No. 09

Name of proprietor | Social security number (SSN)

A Principal business or profession, including product or service (see instructions) | **B Enter code from instructions** ▶

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN),** (see instr.)

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2016? If "No," see instructions for limit on losses . ☐ Yes ☐ No

H If you started or acquired this business during 2016, check here . . . ▶ ☐

I Did you make any payments in 2016 that would require you to file Form(s) 1099? (see instructions) . . . ☐ Yes ☐ No

J If "Yes," did you or will you file required Forms 1099? . . . ☐ Yes ☐ No

Part I Income

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

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

8	Advertising . . .	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions) . . .	9		19	Pension and profit-sharing plans .	19	
				20	Rent or lease (see instructions):		
10	Commissions and fees .	10		a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see instructions)	11		b	Other business property . . .	20b	
12	Depletion . . .	12		21	Repairs and maintenance . . .	21	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions) . . .	13		22	Supplies (not included in Part III) .	22	
				23	Taxes and licenses . . .	23	
				24	Travel, meals, and entertainment:		
14	Employee benefit programs (other than on line 19) . .	14		a	Travel . . .	24a	
15	Insurance (other than health)	15		b	Deductible meals and entertainment (see instructions) .	24b	
16	Interest:			25	Utilities . . .	25	
a	Mortgage (paid to banks, etc.)	16a		26	Wages (less employment credits) .	26	
b	Other . . .	16b		27a	Other expenses (from line 48) . .	27a	
17	Legal and professional services	17		b	**Reserved for future use** . . .	27b	

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27a . . . ▶	28	
29	Tentative profit or (loss). Subtract line 28 from line 7 . . .	29	
30	Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions). **Simplified method filers only:** enter the total square footage of: (a) your home: ______ and (b) the part of your home used for business: ______ . Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30 . . .	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	
32	If you have a loss, check the box that describes your investment in this activity (see instructions). • If you checked 32a, enter the loss on both **Form 1040, line 12,** (or **Form 1040NR, line 13**) and on **Schedule SE, line 2.** (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3.** • If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.	32a ☐ All investment is at risk. 32b ☐ Some investment is not at risk.	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11334P **Schedule C (Form 1040) 2016**

FIGURE 1.1 Schedule C, Profit or Loss From Business