

Publication 334

Tax Guide for Small Business (For Individuals Who Use Schedule C)

For use in preparing

2023 Returns

Volume 2 of 4



Publication 334 (Rev 2023) Catalog Number 39249H
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Treating inventory as non-incidental material or supplies. If you account for inventories as materials and supplies that are not incidental, you deduct the amounts paid or incurred to acquire or produce the inventoriable items treated as non-incidental materials and supplies in the year in which they are first used or consumed in your operations. Inventory treated as non-incidental materials and supplies is used or consumed in your business in the year you provide the inventory to your customers.

Financial accounting treatment of inventories. Your financial accounting treatment of inventories is determined with regard to the method of accounting you use in your applicable financial statement (as defined in section 451(b)(3)) or, if you do not have an applicable financial statement, with regard to the method of accounting you use in your books and records that have been

prepared in accordance with your accounting procedures.

Changing your method of accounting for inventory. If you want to change your method of accounting for inventory, you must file Form 3115, Application for Change in Accounting Method. See *Change in Accounting Method*, later.

Items included in inventory. If you are required to account for inventories, include the following items when accounting for your inventory.

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

Valuing inventory. You must value your inventory at the beginning and end of each tax year to determine your cost of goods sold (Schedule C, line 42). To determine the value of your inventory, you need a method for identifying the items in your inventory and a method for valuing these items.

Inventory valuation rules cannot be the same for all kinds of businesses. The method you use to value your inventory must conform to generally accepted accounting principles for similar businesses and must clearly reflect income. Your inventory practices must be consistent from year to year.

More information. For more information about inventories, see Pub. 538.

Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of

property you produce or acquire for resale, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

Activities subject to the uniform capitalization rules. You may be subject to the uniform capitalization rules if you do any of the following, unless the property is produced for your use other than in a business or an activity carried on for profit.

- Produce real or tangible personal property. For this purpose, tangible personal property includes a film, sound recording, videotape, book, or similar property.
- Acquire property for resale.

Exceptions. These rules do not apply to the following.

1. Small business taxpayers, defined earlier under *Inventories*.
2. Property you produce if your indirect costs of producing the property are \$200,000 or less.

Special Methods

There are special methods of accounting for certain items of income or expense. These include the following.

- Amortization, discussed in chapter 7 of Pub. 225.
- Bad debts, discussed under Topic No. 453, [*Bad Debt Deduction*](#).
- Depletion, discussed in chapter 7 of Pub. 225.
- Depreciation, discussed in Pub. 946, *How To Depreciate Property*.

- Installment sales, discussed in Pub. 537, Installment Sales.
- Long-term contract methods of accounting. See section 460.

Change in Accounting Method

Once you have set up your accounting method, you must generally get IRS approval before you can change to another method. A change in your accounting method includes a change in:

1. Your overall method, such as from cash to an accrual method; and
2. Your treatment of any material item.

To get approval, you must file **Form 3115**. You can get IRS approval to change an accounting method under either the automatic change procedures or the advance consent request procedures. You may have to pay a user fee. For more information, see the Instructions for Form 3115.

Automatic change procedures. Certain taxpayers can presume to have IRS approval to change their method of accounting. The approval is granted for the tax year for which the taxpayer requests a change (year of change), if the taxpayer complies with the provisions of the automatic change procedures. No user fee is required for an application filed under an automatic change procedure generally covered in Revenue Procedure 2015-13, 2015-5 I.R.B.

419, which is available at [IRS.gov/IRB/2015-05 IRB#RP-2015-13](https://www.irs.gov/IRB/2015-05_IRB#RP-2015-13) (or its successor).

Generally, you must use Form 3115 to request an automatic change. For more information, see the Instructions for Form 3115.

3.

Dispositions of Business Property

Introduction

If you dispose of business property, you may have a gain or loss that you report on your tax return. However, in some cases, you may have a gain that is not taxable or a loss that is not deductible. This chapter discusses whether you have a disposition, how to figure the gain or loss, and where to report the gain or loss.

Useful Items

You may want to see:

Publication

- ☐ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

- ☐ **4797** Sales of Business Property
- ☐ **Sch D (Form 1040)** Capital Gains and Losses

See chapter 12 for information about getting publications and forms.

What Is a Disposition of Property?

A disposition of property includes the following transactions.

- You sell property for cash or other property.
- You exchange property for other property.
- You receive money as a tenant for the cancellation of a lease.
- You receive money for granting the exclusive use of a copyright throughout its life in a particular medium.
- You transfer property to satisfy a debt.

- You abandon property.
- Your bank or other financial institution forecloses on your mortgage or repossesses your property.
- Your property is damaged, destroyed, or stolen, and you receive property or money in payment.
- Your property is condemned, or disposed of under the threat of condemnation, and you receive property or money in payment.
- You give property away.

For details about damaged, destroyed, or stolen property, see Pub. 547, Casualties, Disasters, and Thefts. For details about other dispositions, see chapter 1 of Pub. 544.

Nontaxable exchanges. Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized and you cannot deduct any loss. Your gain or loss

will not be recognized until you sell or otherwise dispose of the property you receive.

Like-kind exchanges. A like-kind exchange is the exchange of property for other like-kind property. It is the most common type of nontaxable exchange. To be a like-kind exchange, the property traded and the property received must be **both** (a) real property, and (b) business or investment property.

Report the exchange of like-kind property on **Form 8824**, Like-Kind Exchanges. For more information about like-kind exchanges, see chapter 1 of Pub. 544.

Installment sales. An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you finance the buyer's purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale.

For more information about installment sales, see Pub. 537.

Sale of a business. The sale of a business is usually not a sale of one asset. Instead, all the assets of the business are sold. Generally, when this occurs, each asset is treated as being sold separately for determining the treatment of gain or loss.

Both the buyer and seller involved in the sale of a business must report to the IRS the allocation of the sales price among the business assets. Use **Form 8594**, Asset Acquisition Statement Under Section 1060, to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.

For more information about the sale of a business, see Pub. 544.

How Do I Figure a Gain or Loss?

Table 3-1. **How To Figure a Gain or Loss**

IF your...	THEN you have a...
adjusted basis is more than the amount realized	loss.
amount realized is more than the adjusted basis	gain.

Basis, adjusted basis, amount realized, fair market value, and amount recognized are defined next. You need to know these definitions to figure your gain or loss.

Basis. The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition. However, if you acquired the property by gift, by inheritance, or in some way other than buying

it, you must use a basis other than its cost. For more information about basis, see Pub. 551, Basis of Assets.

Adjusted basis. The adjusted basis of property generally is your original cost or other basis plus certain additions, and minus certain deductions such as depreciation and casualty losses. In determining gain or loss, the costs of transferring property to a new owner, such as selling expenses, are added to the adjusted basis of the property.

Amount realized. Generally, the amount you realize from a disposition is the total of all money you receive plus the fair market value of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and any liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts.

Amount recognized. Your gain or loss realized from a disposition of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income. Recognized losses are deductible from gross income. However, a gain or loss realized from certain exchanges of property is not recognized. See Nontaxable exchanges, earlier. Also, you cannot deduct a loss from the disposition of property held for personal use.

Is My Gain or Loss Ordinary or Capital?

You must classify your gains and losses as either ordinary or capital gains or losses. You must do this to figure your net capital gain or

loss. Generally, you will have a capital gain or loss if you dispose of a capital asset. For the most part, everything you own and use for personal purposes or investment is a capital asset.

Certain property you use in your business is not a capital asset. A gain or loss from a disposition of this property is an ordinary gain or loss. However, if you held the property longer than 1 year, you may be able to treat the gain or loss as a capital gain or loss. These gains and losses are called section 1231 gains and losses.

For more information about ordinary and capital gains and losses, see chapters 2 and 3 of Pub. 544.

Is My Capital Gain or Loss Short Term or Long Term?

If you have a capital gain or loss, you must determine whether it is long term or short term. Whether a gain or loss is long or short

term depends on how long you own the property before you dispose of it. The time you own property before disposing of it is called the holding period.

Table 3-2. Do I Have a Short-Term or Long-Term Gain or Loss?

IF you hold the property...	THEN you have a...
1 year or less	short-term capital gain or loss.
more than 1 year	long-term capital gain or loss.

For more information about short-term and long-term capital gains and losses, see chapter 4 of Pub. 544.

Where Do I Report Gains and Losses?

Report gains and losses from the following dispositions on the forms indicated. The instructions for the forms explain how to fill them out.

Dispositions of business property and depreciable property. Use **Form 4797**. If you have taxable gain, you may also have to use Schedule D (Form 1040).

Like-kind exchanges. Use **Form 8824**. You may also have to use Form 4797 and Schedule D (Form 1040).

Installment sales. Use **Form 6252**, Installment Sale Income. You may also have to use Form 4797 and Schedule D (Form 1040).

Casualties and thefts. Use **Form 4684**, Casualties and Thefts. You may also have to use Form 4797.

Condemned property. Use **Form 4797**. You may also have to use Schedule D (Form 1040).

4.

General Business Credits

Introduction

Your general business credit for the year consists of your carryforward of business credits from prior years plus the total of your current year business credits. In addition, your general business credit for the current year may be increased later by the carryback of business credits from later years. You subtract this credit directly from your tax.

Useful Items

You may want to see:

Form (and Instructions)

- ☐ **3800** General Business Credit

□ **6251** Alternative Minimum Tax—
Individuals

See chapter 12 for information about getting publications and forms.

Business Credits

All of the following credits are part of the general business credit. The form you use to figure each credit is shown in parentheses. You will also have to complete Form 3800.

Some credits have expiration dates. Check the instructions for each credit to make sure it is available for 2023.

Alternative fuel vehicle refueling property credit

(Form 8911). This credit applies to the cost of any qualified fuel vehicle refueling property. For more information, see Form 8911.

Biodiesel, renewable diesel, or sustainable aviation fuels credits (Form 8864). For more information, see Form 8864.

Biofuel producer credit (Form 6478). For more information, see Form 6478.

Carbon oxide sequestration credit (Form 8933). This credit is for carbon oxide that is captured at a qualified facility and disposed of in secure geological storage or used in a qualified enhanced oil or natural gas recovery project. For more information, see Form 8933.

Credit for employer social security and Medicare taxes paid on certain employee tips (Form 8846). This credit is generally equal to your (employer's) portion of social security and Medicare taxes paid on tips received by employees of your food and beverage establishment where tipping is customary. The credit applies regardless of whether the food is consumed on or off your

business premises. For more information, see Form 8846.

Credit for employer differential wage payments (Form 8932). This credit provides businesses with an incentive to continue to pay wages to an employee performing services on active duty in the uniformed services of the United States for a period of more than 30 days. For more information, see Form 8932.

Credit for employer-provided childcare facilities and services (Form 8882). This credit applies to the qualified expenses you paid for employee childcare and qualified expenses you paid for childcare resource and referral services. For more information, see Form 8882.

Credit for increasing research activities (Form 6765). This credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities, including energy

research. For more information, see Form 6765.

Credit for small employer health insurance premiums (Form 8941). This credit applies to the cost of certain health insurance coverage you provide to certain employees. For more information, see Form 8941.

Credit for small employer pension plan startup costs, auto-enrollment, and military spouse participation (Form 8881). This credit applies to pension plan startup costs of a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or SEP plan. For more information, see Pub. 560, Retirement Plans for Small Business.

Disabled access credit (Form 8826). This credit is a nonrefundable tax credit for an eligible small business that pays or incurs expenses to provide access to persons who have disabilities. You must pay or incur the

expenses to enable your business to comply with the Americans with Disabilities Act of 1990. For more information, see Form 8826.

Distilled spirits credit (Form 8906). This credit is available to distillers and importers of distilled spirits and eligible wholesalers of distilled spirits. For more information, see Form 8906.

Employer credit for paid family and medical leave (Form 8994). This credit applies for wages paid to qualifying employees while they are on family and medical leave, subject to certain conditions. For more information, see Form 8994.

Empowerment zone employment credit (Form 8844). You may qualify for this credit if you have employees and are engaged in a business in an empowerment zone for which the credit is available. For more information, see Form 8844.

Energy efficient home credit (Form 8908). This credit is available for eligible contractors of certain homes sold for use as a residence. For more information, see Form 8908.

Investment credit (Form 3468). The investment credit is the total of the several credits. For more information, see Form 3468.

Low sulfur diesel fuel production credit (Form 8896). For more information, see Form 8896.

Low-income housing credit (Form 8586). This credit generally applies to each qualified low-income building placed in service after 1986. For more information, see Form 8586.

New markets credit (Form 8874). This credit is for qualified equity investments made in qualified community development entities. For more information, see Form 8874.

Orphan drug credit (Form 8820). This credit applies to qualified expenses incurred in testing certain drugs for rare diseases and conditions. For more information, see Form 8820.

Clean vehicle credits (Form 8936). These credits are for certain clean vehicles placed in service during the tax year. For more information, see Form 8936.

Qualified railroad track maintenance credit (Form 8900). This credit applies to qualified railroad track maintenance expenditures paid or incurred during the tax year. For more information, see Form 8900.

Renewable electricity production credit (Form 8835). This credit is for renewable energy sources produced in the United States or U.S. territories from qualified energy resources at a qualified facility. For more information, see Form 8835.

Work opportunity credit (Form 5884).

This credit provides businesses with an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. For more information, see Form 5884.

How To Claim the Credit

To claim a general business credit, you will first have to get the forms you need to claim your current year business credits.

In addition to the credit form, you also need to file Form 3800.

5.

Business Income

Introduction

This chapter primarily explains business income and how to account for it on your tax return and what items are not considered

income, and it gives guidelines for selected occupations.

If there is a connection between any income you receive and your business, the income is business income. A connection exists if it is clear that the payment of income would not have been made if you did not have the business.

You can have business income even if you are not involved in the activity on a regular full-time basis. Income from work you do on the side in addition to your regular job can be business income. For example, you may be in the business of providing services for a ride-sharing business as a second job.

You report most business income, such as income from selling your products or services, on Schedule C. But you report the income from the sale of business assets, such as land and office buildings, on other forms instead of Schedule C. For information on selling business assets, see chapter 3.

Nonemployee compensation. Business income includes amounts you received in your business that were properly shown on Forms 1099-NEC. This includes amounts reported as nonemployee compensation in box 1 of the form. You can find more information in the instructions on the back of the Form 1099-NEC you received.

Payment card and third-party network transactions. If you are in a business, you may receive a Form 1099-K representing the total dollar amount of total reportable payment transactions. This may not be the amount you should report as income, as it may not include all the receipts and it may include items that are not included in your receipts (such as sales tax).

Business income deduction. Income you report on Schedule C may be qualified business income and entitle you to a deduction on Form 1040 or 1040-SR, line 13.

See Form 8995-A or Form 8995 to figure your deduction, if any.

Kinds of Income

You must report on your tax return all income you receive from your business unless it is excluded by law. In most cases, your business income will be in the form of cash, checks, and credit card charges. But business income can be in other forms, such as property or services. These and other types of income are explained next.



If you are a U.S. citizen who has business income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt from tax under U.S. law. If you live outside the United States, you may be able to exclude part or all of your foreign-source business income. For details, see Pub. 54, Tax Guide for U.S. Citizens and Resident Aliens Abroad.

Bartering for Property or Services

Bartering is an exchange of property or services. You must include in your gross receipts, at the time received, the fair market value of property or services you receive in exchange for something else. If you exchange services with another person and you both have agreed ahead of time on the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Example 1. You are a self-employed lawyer. You perform legal services for a client, a small corporation. In payment for your services, you receive shares of stock in the corporation. You must include the fair market value of the shares in income.

Example 2. You are an artist and create a work of art to compensate your landlord for the rent-free use of your apartment. You must include the fair rental value of the

apartment in your gross receipts. Your landlord must include the fair market value of the work of art in their rental income.

Example 3. You are a self-employed accountant. Both you and a house painter are members of a barter club, an organization that each year gives its members a directory of members and the services each member provides. Members get in touch with other members directly and bargain for the value of the services to be performed.

In return for accounting services you provided for the house painter's business, the house painter painted your home. You must include in gross receipts the fair market value of the services you received from the house painter. The house painter must include the fair market value of your accounting services in their gross receipts.

Example 4. You are a member of a barter club that uses credit units to credit or debit members' accounts for goods or services

provided or received. As soon as units are credited to your account, you can use them to buy goods or services or sell or transfer the units to other members.

You must include the value of credit units you received in your gross receipts for the tax year in which the units are credited to your account.

The dollar value of units received for services by an employee of the club, who can use the units in the same manner as other members, must be included in the employee's gross income for the tax year in which received. It is wages subject to social security and Medicare taxes (FICA), FUTA taxes, and income tax withholding. See Pub. 15.

Example 5. You operate a plumbing business and use the cash method of accounting. You join a barter club and agree to provide plumbing services to any member for a specified number of hours. Each member has

access to a directory that lists the members of the club and the services available.

Members contact each other directly and request services to be performed. You are not required to provide services unless requested by another member, but you can use as many of the offered services as you wish without paying a fee.

You must include the fair market value of any services you receive from club members in your gross receipts when you receive them even if you have not provided any services to club members.

Information returns. If you are involved in a bartering transaction, you may have to file either of the following forms.

- Form 1099-B, Proceeds From Broker and Barter Exchange Transactions.
- Form 1099-MISC.

For information about these forms, see the General Instructions for Certain Information Returns.

Real Estate Rents

If you are a real estate dealer who receives income from renting real property or an owner of a hotel, motel, etc., who provides services (maid services, etc.) for guests, report the rental income and expenses on Schedule C. If you are not a real estate dealer or the kind of owner described in the preceding sentence, report the rental income and expenses on Schedule E. For more information, see Pub. 527, Residential Rental Property.

Real estate dealer. You are a real estate dealer if you are engaged in the business of selling real estate to customers with the purpose of making a profit from those sales. Rent you receive from real estate held for sale to customers is subject to SE tax.

However, rent you receive from real estate held for speculation or investment is not subject to SE tax.

Trailer park owner. Rental income from a trailer park is subject to SE tax if you are a self-employed trailer park owner who provides trailer lots and facilities and substantial services for the convenience of your tenants.

You are generally considered to provide substantial services for tenants if they are primarily for the tenants' convenience and are not normally provided to maintain the lots in a condition for occupancy. Services are substantial if the compensation for the services makes up a material part of the tenants' rental payments.

Examples of services that are not normally provided for the tenants' convenience include supervising and maintaining a recreational hall provided by the park, distributing a monthly newsletter to tenants, operating a

laundry facility, and helping tenants buy or sell their trailers.

Examples of services that are normally provided to maintain the lots in a condition for tenant occupancy include city sewerage, electrical connections, and roadways.

Hotels, boarding houses, and apartments. Rental income you receive for the use or occupancy of hotels, boarding houses, or apartment houses is subject to SE tax if you provide services for the occupants.

Generally, you are considered to provide services for the occupants if the services are primarily for their convenience and are not services normally provided with the rental of rooms for occupancy only. An example of a service that is not normally provided for the convenience of the occupants is maid service. However, providing heat and light, cleaning stairways and lobbies, and collecting trash are services normally provided for the occupants' convenience.

Prepaid rent. Advance payments received under a lease that does not put any restriction on their use or enjoyment are income in the year you receive them. This is generally true no matter what accounting method or period you use.

Lease bonus. A bonus you receive from a lessee for granting a lease is an addition to the rent. Include it in your gross receipts in the year received.

Lease cancellation payments. Report payments you receive from your lessee for canceling a lease in your gross receipts in the year received.

Payments to third parties. If your lessee makes payments to someone else under an agreement to pay your debts or obligations, include the payments in your gross receipts when the lessee makes the payments. A common example of this kind of income is a lessee's payment of your property taxes on leased real property.

Settlement payments. Payments you receive in settlement of a lessee's obligation to restore the leased property to its original condition are income in the amount that the payments exceed the adjusted basis of the leasehold improvements destroyed, damaged, removed, or disconnected by the lessee.

Personal Property Rents

If you are in the business of renting personal property (equipment, vehicles, formal wear, etc.), include the rental amount you receive in your gross receipts on Schedule C. Prepaid rent and other payments described under *Real Estate Rents*, earlier, can also be received for renting personal property. If you receive any of those payments, include them in your gross receipts as explained in that discussion.

Interest and Dividend Income

Interest and dividends may be considered business income.

Interest. Interest received on notes receivable that you have accepted in the ordinary course of business is business income. Interest received on loans is business income if you are in the business of lending money.

Uncollectible loans. If a loan payable to you becomes uncollectible during the tax year and you use an accrual method of accounting, you generally must include in gross income qualified stated interest accrued up to the time the loan became uncollectible. If the accrued interest that you previously included later becomes uncollectible, you may be able to take a bad debt deduction. See *Bad Debts* in chapter 8.

Unstated interest and Original Issue Discount (OID). If little or no interest is charged on an installment sale contract, you may have to treat a part of each payment as unstated interest. See *Unstated Interest and Original Issue Discount (OID)* in Pub. 537.

Dividends. Generally, dividends are business income to dealers in securities. For most sole proprietors and statutory employees, however, dividends are nonbusiness income. If you hold stock as a personal investment separately from your business activity, the dividends from the stock are nonbusiness income.

If you receive dividends from business insurance premiums you deducted in an earlier year, you must report all or part of the dividend as business income on your return. To find out how much you have to report, see *Recovery of items previously deducted* under *Other Income*, later.

Canceled Debt

The following explain the general rule for including canceled debt in income and the exceptions to the general rule.

General Rule

Generally, if your debt is canceled or forgiven, other than as a gift or bequest to you, you must include the canceled amount in your gross income for tax purposes. Report the canceled amount on line 6 of Schedule C if you incurred the debt in your business. If the debt is a nonbusiness debt, report the canceled amount on line 8c of Schedule 1 (Form 1040).

Exceptions

The following discussion covers some exceptions to the general rule for canceled debt.

Price reduced after purchase. If you owe a debt to the seller for property you bought and the seller reduces the amount you owe, you generally do not have income from the reduction. Unless you are bankrupt or insolvent, treat the amount of the reduction

as a purchase price adjustment and reduce your basis in the property.

Deductible debt. You do not realize income from a canceled debt to the extent the payment of the debt would have led to a deduction.

Example. You get accounting services for your business on credit. Later, you have trouble paying your business debts, but you are not bankrupt or insolvent. Your accountant forgives part of the amount you owe for the accounting services. How you treat the canceled debt depends on your method of accounting.

- Cash method—You do not include the canceled debt in income because payment of the debt would have been deductible as a business expense.
- Accrual method—You include the canceled debt in income because the expense was deductible when you incurred the debt.

For information on the cash and accrual methods of accounting, see chapter 2.

Exclusions

Do not include canceled debt in income in the following situations. However, you may be required to file **Form 982**, Reduction of Tax Attributes Due to Discharge of Indebtedness. For more information, see Form 982.

1. The cancellation takes place in a bankruptcy case under title 11 of the U.S. Code (relating to bankruptcy). See Pub. 908, Bankruptcy Tax Guide.
2. The cancellation takes place when you are insolvent. You can exclude the canceled debt to the extent you are insolvent. See Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments.
3. The canceled debt is a qualified farm debt owed to a qualified person. See

chapter 3 of Pub. 225, Farmer's Tax Guide.

4. The canceled debt is a qualified real property business debt. This situation is explained later.
5. The canceled debt is qualified principal residence indebtedness which is discharged after 2006. See the Instructions for Form 982 for more information about this exclusion.

If a canceled debt is excluded from income because it takes place in a bankruptcy case, the exclusions in situations 2 through 5 do not apply. If it takes place when you are insolvent, the exclusions in situations 3 and 4 do not apply to the extent you are insolvent.

Debt. For purposes of this discussion, debt includes any debt for which you are liable or which attaches to property you hold.

Qualified real property business debt.

You can elect to exclude (up to certain limits) the cancellation of qualified real property business debt. If you make the election, you must reduce the basis of your depreciable real property by the amount excluded. Make this reduction at the beginning of your tax year following the tax year in which the cancellation occurs. However, if you dispose of the property before that time, you must reduce its basis immediately before the disposition.

Cancellation of qualified real property business debt. Qualified real property business debt is debt (other than qualified farm debt) that meets all the following conditions.

1. It was incurred or assumed in connection with real property used in a trade or business. Real property used in a trade or business does not include real property developed and held

primarily for sale to customers in the ordinary course of business.

2. It was secured by such real property.
3. It was incurred or assumed at either of the following times.
 - a. Before January 1, 1993.
 - b. After December 31, 1992, if incurred or assumed to acquire, construct, or substantially improve the real property.
4. It is debt to which you choose to apply these rules.

Qualified real property business debt includes refinancing of debt described in (3) above, but only to the extent it does not exceed the debt being refinanced.



If you are the owner of a disregarded entity (for example, a single-member LLC), see Qualified

Real Property Business Indebtedness in chapter 1 of Pub. 4681 to see if you qualify for this exclusion.

You cannot exclude more than either of the following amounts.

1. The excess (if any) of:
 - a. The outstanding principal of qualified real property business debt (immediately before the cancellation); over
 - b. The fair market value (immediately before the cancellation) of the business real property that is security for the debt, reduced by the outstanding principal amount of any other qualified real property business debt secured by this property

immediately before the
cancellation.

2. The total adjusted bases of depreciable real property held by you immediately before the cancellation. These adjusted bases are determined after any basis reduction due to a cancellation in bankruptcy or insolvency, or of qualified farm debt. Do not take into account depreciable real property acquired in contemplation of the cancellation.

Election. To make this election, complete Form 982 and attach it to your income tax return for the tax year in which the cancellation occurs. You must file your return by the due date (including extensions). If you timely filed your return for the year without making the election, you can still make the election by filing an amended return within 6 months of the due date of the return

(excluding extensions). For more information, see *When To File* in the form instructions.

Other Income

The following discussion explains how to treat other types of business income you may receive.

Restricted property. Restricted property is property that has certain restrictions that affect its value. If you receive restricted stock or other property for services performed, the fair market value of the property in excess of your cost is included in your income on Schedule C when the restriction is lifted. However, you can choose to be taxed in the year you receive the property. For more information on including restricted property in income, see Pub. 525, *Taxable and Nontaxable Income*.

Gains and losses. Do not report on Schedule C a gain or loss from the disposition of property that is neither stock in trade nor

held primarily for sale to customers. Instead, you must report these gains and losses on other forms. For more information, see chapter 3.

Promissory notes. Report promissory notes and other evidences of debt issued to you in a sale or exchange of property that is stock in trade or held primarily for sale to customers on Schedule C. In general, you report them at their stated principal amount (minus any unstated interest) or issue price (for debt instruments with OID) when you receive them.

Lost income payments. If you reduce or stop your business activities, report on Schedule C any payment you receive for the lost income of your business from insurance or other sources. Report it on Schedule C even if your business is inactive when you receive the payment.

Damages. You must include in gross income compensation you receive during the tax year as a result of any of the following injuries connected with your business.

- Patent infringement.
- Breach of contract or fiduciary duty.
- Antitrust injury.

Economic injury. You may be entitled to a deduction against the income if it compensates you for actual economic injury. Your deduction is the smaller of the following amounts.

- The amount you receive or accrue for damages in the tax year reduced by the amount you pay or incur in the tax year to recover that amount.
- Your loss from the injury that you have not yet deducted.

Punitive damages. You must also include punitive damages in income.

Kickbacks. If you receive any kickbacks, include them in your income on Schedule C. However, do not include them if you properly treat them as a reduction of a related expense item, a capital expenditure, or cost of goods sold.

Recovery of items previously deducted. If you recover a bad debt or any other item deducted in a previous year, include the recovery in income on Schedule C. However, if all or part of the deduction in earlier years did not reduce your tax, you can exclude the part that did not reduce your tax. If you exclude part of the recovery from income, you must include with your return a computation showing how you figured the exclusion.

Exception for depreciation. This rule does not apply to depreciation. You recover depreciation using the rules explained next.

Recapture of depreciation. In the following situations, you have to recapture the depreciation deduction. This means you include in income part or all of the depreciation you deducted in previous years.

Listed property. If your business use of listed property (explained in chapter 8 under *Depreciation*) falls to 50% or less in a tax year after the tax year you placed the property in service, you may have to recapture part of the depreciation deduction. You do this by including in income on Schedule C part of the depreciation you deducted in previous years. Use Part IV of **Form 4797** to figure the amount to include on Schedule C. For more information, see *What Is the Business-Use Requirement?* in chapter 5 of Pub. 946. That chapter explains how to determine whether property is used more than 50% in your business.

Section 179 property. If you take a section 179 deduction (explained in chapter 8 under *Depreciation*) for an asset and before the end of the asset's recovery period the percentage of business use drops to 50% or less, you must recapture part of the section 179 deduction. You do this by including in income on Schedule C part of the deduction you took. Use Part IV of Form 4797 to figure the amount to include on Schedule C. See chapter 2 of Pub. 946 to find out when you recapture the deduction.

Sale or exchange of depreciable property. If you sell or exchange depreciable property at a gain, you may have to treat all or part of the gain due to depreciation as ordinary income. You figure the income due to depreciation recapture in Part III of Form 4797. For more information, see chapter 4 of Pub. 544.

Items That Are Not Income

In some cases, the property or money you receive is not income.

Appreciation. Increases in value of your property are not income until you realize the increases through a sale or other taxable disposition.

Consignments. Consignments of merchandise to others to sell for you are not sales. The title of merchandise remains with you, the consignor, even after the consignee possesses the merchandise. Therefore, if you ship goods on consignment, you have no profit or loss until the consignee sells the merchandise. Merchandise you have shipped out on consignment is included in your inventory until it is sold.

Do not include merchandise you receive on consignment in your inventory. Include your profit or commission on merchandise consigned to you in your income when you

sell the merchandise or when you receive your profit or commission, depending upon the method of accounting you use.

Construction allowances. If you enter into a lease after August 5, 1997, you can exclude from income the construction allowance you receive (in cash or as a rent reduction) from your landlord if you receive it under both the following conditions.

- Under a short-term lease of retail space.
- For the purpose of constructing or improving qualified long-term real property for use in your business at that retail space.

Amount you can exclude. You can exclude the construction allowance to the extent it does not exceed the amount you spent for construction or improvements.

Short-term lease. A short-term lease is a lease (or other agreement for occupancy or use) of retail space for 15 years or less. The

following rules apply in determining whether the lease is for 15 years or less.

- Take into account options to renew when figuring whether the lease is for 15 years or less. But do not take into account any option to renew at fair market value determined at the time of renewal.
- Two or more successive leases that are part of the same transaction (or a series of related transactions) for the same or substantially similar retail space are treated as one lease.

Retail space. Retail space is real property leased, occupied, or otherwise used by you as a tenant in your business of selling tangible personal property or services to the general public.

Qualified long-term real property.

Qualified long-term real property is nonresidential real property that is part of, or otherwise present at, your retail space and

that reverts to the landlord when the lease ends.

Exchange of like-kind property. Generally, if you exchange real property used for business or held as an investment solely for other business or investment real property of a like kind, no gain or loss is recognized. This means that the gain is not taxable and the loss is not deductible. For more information, see Form 8824.

Leasehold improvements. If a tenant erects buildings or makes improvements to your property, the increase in the value of the property due to the improvements is not income to you. However, if the facts indicate that the improvements are a payment of rent to you, then the increase in value would be income.

Loans. Money borrowed through a bona fide loan is not income.

Sales tax. State and local sales taxes imposed on the buyer, which you were required to collect and pay over to state or local governments, are not income.

Guidelines for Selected Occupations

This section provides information to determine whether your earnings should be reported on Schedule C (Form 1040).

Direct seller. You must report all income you receive as a direct seller on Schedule C. This includes any of the following.

- **Income from sales—**Payments you receive from customers for products they buy from you.
- **Commissions, bonuses, or percentages** you receive for sales and the sales of others who work under you.
- **Prizes, awards, and gifts** you receive from your selling business.

You must report this income regardless of whether it is reported to you on an information return.

You are a direct seller if you meet all the following conditions.

1. You are engaged in one of the following trades or businesses.
 - a. Selling or soliciting the sale of consumer products either in a home or other place that is not a permanent retail establishment, or to any buyer on a buy-sell basis or a deposit-commission basis for resale in a home or other place of business that is not a permanent retail establishment.
 - b. Delivering or distributing newspapers or shopping news (including any services directly

related to that trade or business).

2. Substantially all your pay (whether paid in cash or not) for services described above is directly related to sales or other output (including performance of services) rather than to the number of hours worked.
3. Your services are performed under a written contract between you and the person for whom you perform the services, and the contract provides that you will not be treated as an employee for federal tax purposes.

Executor or administrator. If you administer a deceased person's estate, your fees are reported on Schedule C if you are one of the following.

1. A professional fiduciary.

2. A nonprofessional fiduciary (personal representative) and both of the following apply.
 - a. The estate includes an active trade or business in which you actively participate.
 - b. Your fees are related to the operation of that trade or business.
3. A nonprofessional fiduciary of a single estate that requires extensive managerial activities on your part for a long period of time, provided these activities are enough to be considered a trade or business.

If the fees do not meet the above requirements, report them on line 8z of Schedule 1 (Form 1040).

Fishing crew member. If you are a member of a crew that catches fish or other aquatic life, your earnings are reported on Schedule C

if you meet all the requirements shown in chapter 10 under *Fishing crew member*.

Insurance agent, former. Termination payments you receive as a former self-employed insurance agent from an insurance company because of services you performed for that company are not reported on Schedule C if all the following conditions are met.

- You received payments after your agreement to perform services for the company ended.
- You did not perform any services for the company after your service agreement ended and before the end of the year in which you received the payment.
- You entered into a covenant not to compete against the company for at least a 1-year period beginning on the date your service agreement ended.

- The amount of the payments depended primarily on policies sold by you or credited to your account during the last year of your service agreement or the extent to which those policies remain in force for some period after your service agreement ended, or both.
- The amount of the payment did not depend to any extent on length of service or overall earnings from services performed for the company (regardless of whether eligibility for the payments depended on length of service).

Insurance agent, retired. Income paid by an insurance company to a retired self-employed insurance agent based on a percentage of commissions received before retirement is reported on Schedule C. Also, renewal commissions and deferred commissions for sales made before retirement are generally reported on Schedule C.

However, renewal commissions paid to the survivor of an insurance agent are not reported on Schedule C.

Newspaper carrier or distributor. You are a direct seller and your earnings are reported on Schedule C if all the following conditions apply.

- You are in the business of delivering or distributing newspapers or shopping news (including directly related services such as soliciting customers and collecting receipts).
- Substantially all your pay for these services directly relates to your sales or other output rather than to the number of hours you work.
- You perform the services under a written contract that says you will not be treated as an employee for federal tax purposes.

This rule applies whether or not you hire others to help you make deliveries. It also applies whether you buy the papers from the publisher or are paid based on the number of papers you deliver.

Newspaper or magazine vendor. If you are age 18 or older and you sell newspapers or magazines, your earnings are reported on Schedule C if all the following conditions apply.

- You sell newspapers or magazines to ultimate consumers.
- You sell them at a fixed price.
- Your earnings are based on the difference between the sales price and your cost of goods sold.

This rule applies whether or not you are guaranteed a minimum amount of earnings. It also applies whether or not you receive credit for unsold newspapers or magazines you return to your supplier.

Notary public. Fees you receive for services you perform as a notary public are reported on Schedule C. These payments are not subject to SE tax (see the Instructions for Schedule SE (Form 1040)).

Public official. Public officials generally do not report what they earn for serving in public office on Schedule C. This rule applies to payments received by an elected tax collector from state funds on the basis of a fixed percentage of the taxes collected. Public office includes any elective or appointive office of the United States or its territories, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

Public officials of state or local governments report their fees from the public on Schedule C if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal-state agreement.

Real estate agent or direct seller. If you are a licensed real estate agent or a direct seller, your earnings are reported on Schedule C if both the following apply.

- Substantially all your pay for services as a real estate agent or direct seller directly relates to your sales or other output rather than to the number of hours you work.
- You perform the services under a written contract that says you will not be treated as an employee for federal tax purposes.

Dealer in section 1256 contracts. If you are a dealer in options or commodities, your gains and losses from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts) or property related to those contracts (such as stock used to hedge options) are reported on

Schedule C. For more information, see sections 1256 and 1402(i).

Securities or commodities trader. You are a trader in securities or commodities if you are engaged in the business of buying and selling securities or commodities for your own account. As a trader in securities or commodities (including if you made the section 475(f) mark-to-market election as a trader in securities or commodities), your gain or loss from the disposition of securities or commodities is not reported on Schedule C. For more information about traders in securities or commodities, see Pub. 550, Investment Income and Expenses, and [*Topic No. 429, Traders in Securities*](#).

Accounting for Your Income

Accounting for your income for income tax purposes differs at times from accounting for financial purposes. This section discusses

some of the more common differences that may affect business transactions.

Figure your business income on the basis of a tax year and according to your regular method of accounting (see chapter 2). If the sale of a product is an income-producing factor in your business, you usually have to use inventories to clearly show your income. Dealers in real estate are not allowed to use inventories. For more information on inventories, see chapter 2.

Income paid to a third party. All income you earn is taxable to you. You cannot avoid tax by having the income paid to a third party.

Example. You rent out your property and the rental agreement directs the lessee to pay the rent to your son. The amount paid to your son is gross income to you.

Cash discounts. These are amounts the seller permits you to deduct from the invoice price for prompt payment. For income tax purposes, you can use either of the following two methods to account for cash discounts.

1. *Deduct the cash discount from purchases (see Line 36—Purchases Less Cost of Items Withdrawn for Personal Use in chapter 6).*
2. Credit the cash discount to a discount income account.

You must use the chosen method every year for all your purchase discounts.

If you use the second method, the credit balance in the account at the end of your tax year is business income. Under this method, you do not reduce the cost of goods sold by the cash discounts you received. When valuing your closing inventory, you cannot reduce the invoice price of merchandise on hand at the close of the tax year by the

average or estimated discounts received on the merchandise.

Trade discounts. These are reductions from list or catalog prices and are usually not written into the invoice or charged to the customer. Do not enter these discounts on your books of account. Instead, use only the net amount as the cost of the merchandise purchased. For more information, see Trade discounts in chapter 6.

Payment placed in escrow. If the buyer of your property places part or all of the purchase price in escrow, you do not include any part of it in gross sales until you actually or constructively receive it. However, upon completion of the terms of the contract and the escrow agreement, you will have taxable income, even if you do not accept the money until the next year.

Sales returns and allowances. Credits you allow customers for returned merchandise and any other allowances you make on sales

are deductions from gross sales in figuring net sales.

Advance payments. Special rules dealing with an accrual method of accounting for payments received in advance are discussed in chapter 2 under Accrual Method.

Insurance proceeds. If you receive insurance or another type of reimbursement for a casualty or theft loss, you must subtract it from the loss when you figure your deduction. You cannot deduct the reimbursed part of a casualty or theft loss.

For information on casualty or theft losses, see Pub. 547.

6.

How To Figure Cost of Goods Sold

Introduction

If you make or buy goods to sell, you can deduct the cost of goods sold from your gross receipts on Schedule C. However, to determine these costs, you must value your inventory at the beginning and end of each tax year.

This chapter applies to you if you are a manufacturer, wholesaler, or retailer or if you are engaged in any business that makes, buys, or sells goods to produce income. This chapter does not apply to a personal service business, such as the business of a doctor, lawyer, carpenter, or painter. However, if you work in a personal service business and also sell or charge for the materials and supplies

normally used in your business, this chapter applies to you.



There are exceptions for small business taxpayers that may change how you figure cost of goods sold for your business. For more information, see chapter 2.

Figuring Cost of Goods Sold on Schedule C, Lines 35 Through 42

Figure your cost of goods sold by filling out lines 35 through 42 of Schedule C. These lines are reproduced below and are explained in the discussion that follows.

35 Inventory at beginning of year.

If different from last year's closing inventory, attach explanation.....

36 Purchases less cost of items withdrawn for personal use.....

- 37** Cost of labor. Do not include any amounts paid to yourself..... _____
- 38** Materials and supplies..... _____
- 39** Other costs..... _____
- 40** Add lines 35 through 39..... _____
- 41** Inventory at end of year..... _____
- 42 Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4..... _____

Line 35—Inventory at Beginning of Year

If you are a merchant, beginning inventory is the cost of merchandise on hand at the beginning of the year that you will sell to customers. If you are a manufacturer or producer, it includes the total cost of raw materials, work in process, finished goods,

and materials and supplies used in manufacturing the goods (see Inventories in chapter 2).

Opening inventory will usually be identical to the closing inventory of the year before. You must explain any difference in a schedule attached to your return.

Donation of inventory. If you contribute inventory (property that you sell in the course of your business), the amount you can claim as a contribution deduction is the smaller of its fair market value on the day you contributed it or its basis. The basis of donated inventory is any cost incurred for the inventory in an earlier year that you would otherwise include in your opening inventory for the year of the contribution. You must remove the amount of your contribution deduction from your opening inventory. It is not part of the cost of goods sold.

If the cost of donated inventory is not included in your opening inventory, the inventory's basis is zero and you cannot claim a charitable contribution deduction. Treat the inventory's cost as you would ordinarily treat it under your method of accounting. For example, include the purchase price of inventory bought and donated in the same year in the cost of goods sold for that year.

A special rule may apply to certain donations of food inventory. See Pub. 526, Charitable Contributions.

Example 1. You are a calendar year taxpayer who uses an accrual method of accounting. In 2023, you contributed property from inventory to a church. It had a fair market value of \$600. The closing inventory at the end of 2022 properly included \$400 of costs due to the acquisition of the property, and in 2022, you properly deducted \$50 of administrative and other expenses attributable to the property as business

expenses. The charitable contribution allowed for 2023 is \$400 (\$600 – \$200). The \$200 is the amount that would be ordinary income if you had sold the contributed inventory at fair market value on the date of the gift. The cost of goods sold you use in determining gross income for 2023 must not include the \$400. You remove that amount from opening inventory for 2023.

Example 2. If, in Example 1, you acquired the contributed property in 2023 at a cost of \$400, you would include the \$400 cost of the property in figuring the cost of goods sold for 2023 and deduct the \$50 of administrative and other expenses attributable to the property for that year. You would not be allowed any charitable contribution deduction for the contributed property.

Line 36—Purchases Less Cost of Items Withdrawn for Personal Use

If you are a merchant, use the cost of all merchandise you bought for sale. If you are a manufacturer or producer, this includes the cost of all raw materials or parts purchased for manufacture into a finished product.

Trade discounts. The differences between the stated prices of articles and the actual prices you pay for them are called trade discounts. You must use the prices you pay (not the stated prices) in figuring your cost of purchases. Do not show the discount amount separately as an item in gross income.

An automobile dealer must record the cost of a car in inventory reduced by any manufacturer's rebate that represents a trade discount.

Cash discounts. Cash discounts are amounts your suppliers let you deduct from your purchase invoices for prompt payments.

There are two methods of accounting for cash discounts. You can either credit them to a separate discount account or deduct them from total purchases for the year. Whichever method you use, you must be consistent. If you want to change your method of figuring inventory cost, you must file Form 3115. For more information, see *Change in Accounting Method* in chapter 2.

If you credit cash discounts to a separate account, you must include this credit balance in your business income at the end of the tax year. If you use this method, do not reduce your cost of goods sold by the cash discounts.

Purchase returns and allowances. You must deduct all returns and allowances from your total purchases during the year.

Merchandise withdrawn from sale. If you withdraw merchandise for your personal or family use, you must exclude this cost from the total amount of merchandise you bought for sale. Do this by crediting the purchases or

sales account with the cost of merchandise you withdraw for personal use. You must also charge the amount to your drawing account.

A drawing account is a separate account you should keep to record the business income you withdraw to pay for personal and family expenses. As stated above, you also use it to record withdrawals of merchandise for personal or family use. This account is also known as a withdrawals account or personal account.

Line 37—Cost of Labor

Labor costs are usually an element of cost of goods sold only in a manufacturing or mining business. Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold. In a manufacturing business, labor costs properly allocable to the cost of goods sold include both the direct and indirect labor used

in fabricating the raw material into a finished, saleable product.

Direct labor. Direct labor costs are the wages you pay to those employees who spend all their time working directly on the product being manufactured. They also include a part of the wages you pay to employees who work directly on the product part time if you can determine that part of their wages.

Indirect labor. Indirect labor costs are the wages you pay to employees who perform a general factory function that does not have any immediate or direct connection with making the saleable product, but that is a necessary part of the manufacturing process.

Other labor. Other labor costs not properly chargeable to the cost of goods sold can be deducted as selling or administrative expenses. Generally, the only kinds of labor costs properly chargeable to your cost of goods sold are the direct or indirect labor

costs and certain other costs treated as overhead expenses properly charged to the manufacturing process, as discussed later under *Line 39—Other Costs*.

Line 38—Materials and Supplies

Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges. You deduct them as a business expense when you use them. Business expenses are discussed in chapter 8.

Line 39—Other Costs

Examples of other costs incurred in a manufacturing or mining process that you charge to your cost of goods sold are as follows.

Containers. Containers and packages that are an integral part of the product manufactured are a part of your cost of goods

sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.

Freight-in. Freight-in, express-in, and cartage-in on raw materials, supplies you use in production, and merchandise you purchase for sale are all part of cost of goods sold.

Overhead expenses. Overhead expenses include expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. The overhead expenses you have as direct and necessary expenses of the manufacturing operation are included in your cost of goods sold.

Line 40—Add Lines 35 Through 39

The total of lines 35 through 39 equals the cost of the goods available for sale during the year.

Line 41—Inventory at End of Year

Subtract the value of your closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) from line 40. Inventory at the end of the year is also known as closing or ending inventory. Your ending inventory will usually become the beginning inventory of your next tax year.

Line 42—Cost of Goods Sold

When you subtract your closing inventory (inventory at the end of the year) from the cost of goods available for sale, the remainder is your cost of goods sold during the tax year.

7.

Figuring Gross Profit

Introduction

After you have figured the gross receipts from your business (chapter 5) and the cost of

goods sold (chapter 6), you are ready to figure your gross profit. You must determine gross profit before you can deduct any business expenses. These expenses are discussed in chapter 8.

Businesses that sell products. Figure your gross profit by first figuring your net receipts. Figure net receipts (line 3) on Schedule C by subtracting any returns and allowances (line 2) from gross receipts (line 1). Returns and allowances include cash or credit refunds you make to customers, rebates, and other allowances off the actual sales price.

Next, subtract the cost of goods sold (line 4) from net receipts (line 3). The result is the gross profit from your business.