



Schedule C Issues Facing the Tax Professional

National Society of Tax Professionals

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Tax Gap Issues

- Difference between tax that taxpayers should pay vs. what is actually paid in a timely manner
- Overall **Voluntary** Compliance Rate **81.7%**
- Overall Compliance **after** enforcement **83.1%**
- Annual Gross Tax Gap **\$458 Billion**
- **Enforcement efforts collects (\$52 Billion)**
- **Leaving an Annual Net Tax Gap \$406 Billion**

Tax Gap Issues: Individual Returns

- Tax Gap has 3 components:
 - **Failure to file** returns **\$28 Billion**
 - **Underpayment:** *failure to pay* reported tax **\$46 Billion**
 - **Underreporting:** bulk of the problem **\$376 Billion**
 - Individual Taxpayers account for: **\$296 Billion** of the tax gap

Schedule C & Tax Gap Issues

- All individual Income Tax Returns **\$296 Billion**
- Schedule C issues: about **\$122 Billion**
- **Self-employment Tax \$57 Billion**
- Result of **understating** income and **overstating** deductions
- Impacts income tax and self-employment tax

Statistics of Income Bulletin

- Quarterly report which identifies Schedule C reporting by industry code
- Identifies the revenue from every Schedule C
- Identifies each line of deductions
- Geographic identification is possible as well as gender and age in 5 year increments
- **The IRS knows more than you think**

Statistical Data for 2013 Returns

- Returns with Schedule C: **24,074,684**
- Schedule C registered as LLC: **1,324,196**
- Total Receipts: **\$1 Trillion, 342 Billion**
- Net Income after all losses **\$302.3 Billion**
- Returns with Net Income: **17,972,057**
- **Car & Truck Expenses: \$66,133,657,000**
- **Contract Labor: \$35,420,947,000**

Sole Proprietorship Operation

- Simplest business entity to create
- One owner: no agreements required and files no documents with federal government
- Capital structure not independent from the owner
- No separate federal income tax return required:
Form 1040-Schedule C



Tax Return Filing Requirements

- No separate income tax return filed for a sole proprietorship
- The “*check-the-box*” regulations provide individual business owners with:
 1. Limited liability and
 2. Pass through taxation
- *A single member LLC* files a **Schedule C**
- *Separate businesses* owned by same individual: file a *separate* **Schedule C’s**



A Separate Schedule C for Each Separate Business

- Rev. Rul. **81-90**
- Prevents disguising losses of one activity against another activity with gains
- **Sec. 6011(a)** provides that regulations may prescribe separate reporting in instructions and forms
- **Sec. 6662(a)** accuracy penalties may be imposed if intentional disregard or negligence



Husband & Wife Businesses

- “Qualified Joint Ventures” of married couples not treated as partnerships
- Conduct of a “trade or business” where both spouses materially participate
- An “***election***” made by both spouses to allocate income, deductions and credits based on respective ownership interest
- Separate **Schedule C** for each spouse



A Separate Schedule S/E

- Addresses issues dealing with the “tax gap”
- Could increase overall tax liability on **Form 1040**
- Separate “social security” benefits for each spouse
- Defines “legal ownership interest” in the business



Ease of Liquidation or Sale

- Transfer of business ownership: an asset by asset disposition by sole proprietor
- Gain or loss recognized on each business asset both tangible and intangible
- Measure difference of FMV of each asset against adjusted basis on date of disposition
- Subjected to “recapture” rules



Sec. 280A

Home Office Deduction

- Principal place of business test
- Used “*exclusively and regularly*” by taxpayer to conduct “*administrative or management activities*” of a trade or business
- No other **fixed location** where taxpayer conducts “*substantial*” administrative or management activities of ***the*** business



Home Office Deduction

- The “function” test of the Solimon decision not an issue
- House Committee Report support
- Taxpayer may perform administrative and management activities at another location where activity not substantial
- Substantial non-administrative and non-management activity at another location



Simplified Option: Rev. Proc. 2013-13

- **\$5** Standard deduction on a *maximum* of **300** Sq. Ft. :
Maximum Deduction **\$1,500**
- **No** deduction allowed for *mortgage interest* and *real estate taxes* for home office purposes
- **No** *depreciation* deduction and **no** *recapture*
- Standard Deduction *limited* to gross income from the business and cannot be carried over and claimed as a deduction in any other year



Medical Insurance Premiums

- **Sec. 162(I)** provides deductibility: **Page 1 of Form 1040** for Health and Long-term Care
- Coverage for taxpayer, spouse and dependents during months of the year when taxpayer is self-employed
- Not eligible to participate in a subsidized plan
- Circular issues of **Sec. 36B** Premium Assistance Credit on **Form 8962**

Pension Plans Available

- Simplified Employee Pensions: SEPs
- Keogh and Profit Sharing Plans
- Individual Solo **Sec. 401(k)** Plans
- SIMPLE Plans



Hiring of Related Parties

- Deductible compensation and benefits allowable for spouses and children providing services to or for the business
- Children under age 18 not subjected to Social Security and Medicare
- Reduction of taxpayer's AGI
- Reduction of family unit's tax



Hobby vs. Business

- **Sec. 183:** no deduction for an activity not engaged in for profit
- Deductions to extent of income generated from the particular activity
- **Reg. Sec. 1.183-2(b)** factors which help in determining trade or business status
- Burden of proof



NSTP's Suggested References

- IRS Publications:
 - 334 Tax Guide for Small Business
 - 463 Travel, Entertainment, Gift & Car Expenses
 - 533 Self Employment Tax
 - 535 Business Expenses
 - 551 Basis of Assets
 - 583 Starting a Business and keeping Records
 - 587 Business Use of your Home
 - 3207 CD Rom for Small Businesses

NSTP's Suggested References

- IRS Audit Techniques Guides:
- “Cash Intensive Businesses” includes issues dealing with digital cash and Form 1099-K issues
- “Activities Not Engaged in for Profit”
- “Child Care Provider”
- Quarterly Statistics of Income Bulletin (SOI)

NSTP

- **Come to the booth for the handout on this presentation and on NSTP's other presentation which is:**
- **“Tax Professional’s Guide to Understanding the Importance of the Substantiation of Business Expense Deductions”**