



Tackling the Tough Issues of the Sole Proprietorship

*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 **\$384 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 2015 Returns

- Returns with Schedule C: **25,226,245**
- **Schedule C EZ: 5,425,105**
- Schedule C registered as **LLC: 1,715,430**
- Total Receipts: **\$1 Trillion, 443.6 Billion**
- Net Income after all losses: **\$331.8 Billion**
- Returns with net income: **18,784,750**



Statistical Data for 2015 Returns

- **Car & Truck Expenses: \$89,810,369,000**
- **Salaries & Wages: \$89,416,413,000**
- **Contract Labor: \$54,170,585,000**
- **Home Office Deduction: \$9,817,446,000** *including depreciation of \$2,750,068,000*



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

- The “*check-the-box*” regulations provide individual business owners with:
 - Limited liability and
 - Pass through taxation
- *A single member LLC* files a **Schedule C**
- *Separate businesses* owned by same individual requires the filing of a *separate* **Schedule C** for *each* activity



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 requirements* in instructions and forms
- **Sec. 6662(a)** *accuracy related penalties* may be imposed if *intentional disregard* or *negligence* (greater of: **\$5,000** or **10%** of underpayment)



New Code Sec. 199A

- Qualified *Business Income (QBI) Deduction*
- *The lesser of:*
 - **20% of the QBI** or
 - 20% of **taxable income** over the sum of any net capital gain **(as defined in Code Sec. 1(h))**



Phase-out of the 20% Deduction

- ***Taxable income*** before the **QBI** deduction *less* a threshold amount based on filing status
 - **Single:** \$157,500 to \$207,500 (**\$50,000**)
 - **Married Joint:** \$315,000 to \$415,000 (**\$100,000**)
 - **Note:** **Sec. 6662(a)** *accuracy related penalties on underpayments* are changed to the *greater of:* **\$5,000** or **5%** of the tax that should have been reported

New Code Sec. 199A

- Qualified *Business Income (QBI) Deduction*
- *The lesser of:*
 - **20% of the QBI** or
 - *The greater of:*
 - **50%** of the wages paid **or**
 - **25%** of the wages paid **plus 2.5%** of the unadjusted basis of qualifying assets used in the qualified business



Qualified Business Income (QBI)

- The net amount of *qualified items* of income, gain, deduction and losses with respect to any *Qualified Trade or Business (QTB)*
- Net amount of all combined **QBI**
- **QTB** defined as *any* trade or business *other than* a **Specified Service Trade or Business (SSTB)**
- **SSTB** does *not* include engineering or architecture



Qualified Trade or Business

- Involves the performance of services in the fields of:
 - ✓ health, law, **accounting**, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or **any** trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees

Spousal 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 SE

- 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 *separate* 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(l)** 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
- Defined Benefit Plans



Hiring of Related Parties

- Deductible compensation and benefits allowable for spouses and children providing services to or for the business
- Children *under* age of **18** not subject to Social Security and Medicare
- Reduction of taxpayer's AGI
- Reduction of family unit's tax
- **Sec. 105 Plans**



Hobby vs. Business

- **Sec. 183:** no deductions allowed for any activity not engaged in for profit
- Deductions only to the extent of income generated from the particular activity **but post 12/31/2017 and before 1/1/2026**
- **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



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)

National *Society* of Tax Professionals

- **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”**

