



Introduction

This lesson will help you prepare an accurate return for taxpayers who have business income, including self-employment income. Form 1040 is used to report income from a business or profession operated as a sole proprietor or independent contractor.

Preparation of tax returns with Schedule C, Profit or Loss From Business (Sole Proprietorship), are in scope for VITA/TCE under certain limited conditions and with expenses of \$35,000 or less.

This lesson covers recordkeeping requirements for taxpayers with business income and expenses. Refer to Publication 334, Tax Guide for Small Business and Publication 583, Starting a Business and Keeping Records, for more information. You will learn how business income is determined and how it affects eligibility for certain tax credits.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine how to report business income
- Determine what business expenses are within the scope for the VITA/TCE programs
- Identify “red flags” when preparing a Schedule C return with earned income credit (EIC)
- Determine what records should be maintained

What do I need?

- Form 13614-C
- Publication 4012
- Publication 334
- Publication 463
- Form 1099-K
- Form 1099-MISC
- Form 1099-NEC
- Schedule C
- Schedule C Instructions
- Schedule SE
- Optional:**
- Publication 535
- Publication 583

Where do I get business income information?

Business income information may come from the following:

- Forms 1099-MISC, Miscellaneous Income
- Forms 1099-NEC, Nonemployee Compensation
- Forms W-2, Wage and Tax Statement, with Statutory Employee checked in Box 13
- Taxpayer’s books and records
- Forms 1099-K, Payment Card and Third Party Network Transactions

Based on your interview and the completion of the taxpayer’s intake and interview sheet, you may discover that the taxpayer or spouse had business income from being self-employed or working as an independent contractor. Taxpayers are self-employed if they carry on an unincorporated trade or business as a sole proprietor or independent contractor. These taxpayers may not have income statements for their business income and expenses. The information to prepare their tax return comes from their records.

Carefully review the intake and interview sheet and ask follow-up questions to determine if the taxpayer or spouse had business income. Taxpayers may not think of themselves as “self-employed” if they have a small home business or work part-time as an independent contractor.



CAUTION Taxpayers who must answer Yes to the virtual currency question on Form 1040 should be referred to a professional tax preparer. Identify these situations as early in the interview as possible. See the Instructions for Form 1040 for details on virtual currency.



TIP Income received from all sources in a self-employed taxpayer's business must be reported, unless excluded by law.



TIP There are two temporary credits that may apply to self-employed taxpayers who were affected by the coronavirus.

- Credit for sick leave for certain self-employed individuals
- Credit for family leave for certain self-employed individuals

See Publication 4491, Payments and Miscellaneous Refundable Credits lesson, and the Volunteer Resource Guide, Tab H, Other Taxes, Payments and Refundable Credits, for details.

Cash Income

Some taxpayers may indicate that they received cash income for self-employment activity. This income must be reported, unless excluded by law.

If taxpayers do not have adequate records of the cash income they received, you may be able to assist them with simple record reconstruction. See the section on reconstructing records later in this lesson.

Form 1099-NEC, Nonemployee Compensation

Taxpayers who are independent contractors should receive Form 1099-NEC showing the income they earned from payers who are required to file Forms 1099. The amount from Form(s) 1099-NEC, along with any other business income payments, are reported on their tax return.

A taxpayer does not have to conduct regular full-time business activities to be self-employed. Having a part-time business in addition to a regular job or business may be self-employment. Ask for any Form(s) 1099-NEC that document this income. During the interview, confirm the taxpayer's activities are a business and not a hobby. Subcontractors or individuals (including for-hire drivers) who receive less than \$600 may not receive Form 1099-NEC, but still must report all their income. Also ask for documentation of any business income that was not reported on Form W-2 or Form 1099-NEC (e.g., payments received from individual clients who do not need to file Form 1099).

example

Tim works as an independent contractor for ABC Construction Company. The company sent Tim a Form 1099-NEC that shows he received \$15,000 for the work he did for them. He also received cash payments of \$4,000 from several different individuals for the work he completed. He did not receive Forms 1099-NEC for the \$4,000. Tim must include the \$4,000 cash payments as self-employment income along with the \$15,000 from Form 1099-NEC.

Form 1099-MISC, Miscellaneous Income

Taxpayers may receive other business income on Form 1099-MISC, Boxes 2 and 3. Refer to Schedule C instructions for more information. Box 2 royalties from the taxpayer's own personal services are generally reported on Schedule C. Examples include authors and composers. If from another person's services, they are generally reported as other income in Box 3. An example is inherited royalties.



CAUTION Bartering is an exchange of property or services. Bartering is beyond the scope of the VITA/TCE Programs.

Form 1099-K, Payment Card and Third Party Network Transactions

Form 1099-K is used by third-party networks (such as Visa, Mastercard, or others) to report transactions processed for taxpayers, including those who use their automobiles for hire or ride share services such as

example

Darryl used his car only for personal purposes during the first 6 months of the year. During the last 6 months of the year, he drove the car a total of 18,000 miles. Of those miles, 15,000 miles were driven providing transportation through a ride-sharing service. He received a Form 1099-K showing the income he received from the ride-sharing business. Darryl can deduct the 15,000 miles using the standard mileage rate as well as any other ordinary and necessary business expenses, such as supplies, a cell phone, food and drinks for passengers, parking fees, tolls, roadside assistance plans, business insurance, and taxes.

Uber, Lyft, Sidecar, etc. Taxpayers may not receive the Form 1099-K if the amount is less than \$600, but the amount received must still be reported.

Qualified Medicaid Waiver Payments

Qualified Medicaid waiver payments **may be excluded from gross income**. To be qualified Medicaid waiver payments, the care provider and the care recipient must reside in the same home. When the care provider and the care recipient do not live together in the same home, the Medicaid waiver payments are fully taxable.

A taxpayer may choose to include qualified Medicaid waiver payments in the calculation of earned income for the earned income credit (EIC) and additional child tax credit (ACTC). The taxpayer may include qualified Medicaid waiver payments in earned income even if the taxpayer chooses to exclude those payments from gross income.

- A taxpayer may not choose to include or exclude only a portion of qualified Medicaid waiver payments. Either include all or none of the qualified Medicaid waiver payments for the taxable year in earned income.
- If the taxpayer chooses to include qualified Medicaid waiver payments in earned income, that amount will be included in the calculation for both the EIC and the ACTC.

Refer the Volunteer Resource Guide, Tab D, Income, Entering the Medicaid Waiver Payments.

How is business income reported?

Form 1040, Schedule C

Form 1040, Schedule C, is used to report income from a business operated or a profession practiced as a sole proprietor. Schedule C shows the income and expenses and the net income amount is carried to Form 1040. An activity qualifies as a business if the primary purpose for engaging in the activity is for income or profit and the taxpayer is involved in the activity with continuity and regularity. For example, a sporadic activity or a hobby does not qualify as a business. A hobby is an activity typically undertaken for pleasure during leisure time.

To report income from an activity not for profit, see the instructions for Form 1040 and Publication 17, Other Income. This topic is out of scope. Refer any taxpayers with not-for-profit activity to a professional tax preparer.

Form 1040, Schedule C, is also used to report wages and expenses the taxpayer had as a statutory employee or certain income shown on Form 1099-MISC or Form 1099-NEC.



Some employers misclassify workers as independent contractors and report their earnings on Form 1099-MISC or Form 1099-NEC. Taxpayers who believe they have been misclassified should contact the IRS and ask for help.



Volunteer tax preparers who have Advanced certification can assist with preparation of the limited Schedule C.



Tax Software Hint: The tax software calculates net profit after income and expense entries are made. Next, the software transfers the net profit to the applicable line on Schedule SE, Self-Employment Tax, to compute the self-employment tax. Amounts are then transferred to the applicable lines of Form 1040.

The following terms are used in the preparation of business returns:

Definition of Terms	
Business expenses	Business expenses are amounts that are ordinary and necessary to carry on the business.
Cash method of accounting	The cash method of accounting reports all income when received and deducts all expenses when paid.
Inventory	Inventory is the items the taxpayer buys or makes for resale to others. Taxpayers with inventories should be referred to a professional tax preparer.
Depreciation	The cost of items that are expected to last more than a year should be spread over a period of years rather than deducted in the year of purchase. If the taxpayers have such a cost, they should be referred to a professional tax preparer.
Election to expense business assets	An election is available to immediately expense qualifying business assets, known as a “179 deduction”. Taxpayers who wish to expense business assets should be referred to a professional tax preparer.

What is in scope for VITA/TCE?

Volunteers can assist taxpayers who have returns that require Schedule C with certain limits:

- Have less than \$35,000 in business expenses
- Use the cash method of accounting
- Have no inventory at any time during the year
- Did not have a net loss from the business
- Have no employees during the year and did not pay contract labor for services (out of scope issue)
- Are not required to file Form 4562, Depreciation and Amortization, for this business (depreciation and the election to expense business assets are out of scope for the VITA/TCE programs)
- Do not deduct expenses for business use of a home

During the interview, if you discover taxpayers have issues that fall outside the scope of the VITA/TCE programs, refer them to a professional tax preparer.



More than one Schedule C can be prepared if the taxpayers have more than one business.

The net profit or loss will be reported on Form 1040. The net profit will also need to be shown on Schedule SE in order to calculate the self-employment tax. Schedule SE will be covered in a later lesson.

Taxpayer Interview and Tax Law Application

As you review the intake and interview sheet with taxpayers, ask questions to determine if they have any self-employment income, their accounting method, and their business expenses, as shown in this sample interview:

SAMPLE INTERVIEW

VOLUNTEER SAYS...

What kind of business do you have and were you the sole owner?

Do you have a record of your business income and expenses for last year?

Do you use the cash method of accounting?

And what were your expenses?

Do you keep any parts in inventory?

And you say you had a good year? In other words, did you make a profit?

Do you plan on deducting expenses for the business use of your home?

Okay, and how much business income did you have?

[On page 2 of the intake and interview sheet, indicate Jason's responses to these questions.]

JASON RESPONDS...

I install air conditioners and, yes, I own the business myself. No partners or employees.

Yeah, I've got a separate checking account for my business. I had a pretty decent first year actually.

Yes. I have a printout of my year-end summary here.

Well, I do the installations myself; I spend a lot of money on parts, tools that last less than a year, and equipment repairs. My expenses for the year were \$2,212.

No, I purchase the parts when an order is placed with me.

That's correct.

No, I don't.

My gross totaled \$30,762.



EXERCISE

Question 1: Based on the information in the sample interview, is Jason's return in scope for VITA/TCE? Yes No

How do you clarify taxpayers' business income and expenses?

All IRS-certified volunteers must exercise due diligence when preparing tax returns. Due diligence means doing your part to ensure tax returns are correct.

This means, as a volunteer, you must do your part when preparing or reviewing a tax return to ensure the information on the return is correct and complete. Generally, you can rely in good faith on information from a taxpayer without requiring documentation as verification.

However, when preparing a tax return with a Schedule C and the earned income credit (EIC), take additional steps to determine that the net self-employment income used to calculate the amount of, or eligibility for, EIC is correct and complete. Additional clarification or inquiries should be made if the information furnished by the taxpayer appears to be incorrect, incomplete, or inconsistent. Taxpayers sometimes want to over report or under report their income to qualify for or maximize the amount of EIC.

Ask sufficient questions of taxpayers claiming self-employment income to be satisfied that:

- The taxpayer actually conducts a business
- The taxpayer has records to support income and expenses, or can reasonably reconstruct income and expense records
- All income and related expenses have been included on the taxpayer's Schedule C

Emphasize to taxpayers that in the event of an IRS audit, they would need to provide receipts to support their reported income and expenses.

What Schedule C situations raise a “red flag”?

As a volunteer preparing a tax return with Schedule C, watch for examples of incorrect, incomplete, or inconsistent information, such as:

- Schedule C income reported in round numbers
- Schedule C cash businesses as the only source of income on a return claiming EIC
- Schedule C with little or no expenses when expenses would be expected
- Schedule C taxpayers with little or no records for income and expenses
- Any Schedule C income that qualifies the taxpayer for the maximum EIC
- Schedule C without a Form 1099

Taxpayer Interview and Tax Law Application

A taxpayer, Dana, comes in to have her tax return prepared. She tells you she runs her own babysitting business and wants to claim the EIC. To assist the taxpayer in completing an accurate return, you need to ask more questions to determine if Dana did incur allowable business expenses and that the income she reported is correct.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

DANA RESPONDS...

Tell me about your business, and were you the sole owner?

I have a babysitting service that I handle all by myself.

Do you have a record of your business income and expenses for last year?

Well, I'm not very good at keeping records, but I can tell you that I made \$14,000 over the course of the year. I didn't have any expenses.

How did you determine that you made a net profit of \$14,000?

I based my income on deposits to my checking account.

I see. We may be able to reconstruct your business income based on your deposits. Did you bring any bank statements or your checkbook record with you today?

No, I'm sorry.

How many children did you care for, and was this a full-time or part-time job for you?

Babysitting is just part-time. I watch several of my neighbors' children along with my own kids who are 8 and 10 years old.

What is your fee for babysitting?

It averages about \$10 an hour.

Do you have a calendar or schedule of the children present each day?

No, but I may be able to come up with one.

Do you have a business license or permit, and do you watch the children in your own home or in a daycare facility or in the client's home?

My home and sometimes at my neighbors' homes. I don't need a permit.

Do you buy any supplies such as food, diapers, toys, or other items necessary for the business?

Sometimes I need to buy supplies. But I didn't bring receipts with me.

Did you intend to deduct expenses for the business use of your home?

No, I don't think so.

Be aware that the IRS requires that you report all income and allowable expenses on your tax return. In the event of an IRS audit, you will be responsible for providing support for the income and expenses claimed on your return. Before we can proceed, you'll need to gather some additional facts and records. I'll write down a list of items that could help us more accurately calculate your net profit from your business.

OK – thanks. I'll see what I can pull together.

The information provided by the taxpayer appears to be both inconsistent and incomplete, because it is unlikely that someone who operates this type of business:

1. Has no business expenses. Most businesses have expenses, even if it is just a few dollars here and there.
2. Has annual gross receipts from the business that are an exact round dollar amount, and that amount maximizes EIC.

The volunteer cannot complete a return based on information provided, but gives Dana the chance to gather materials to document her business.

What business expenses are within scope for the VITA/TCE programs?

Taxpayers deduct the costs of running their business. These costs are known as business expenses. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the taxpayer's industry. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. All ordinary and necessary expenses incurred in a self-employed taxpayer's business must be reported. See the Instructions for Schedule C for more detailed information on deductible business expenses. Examples of these expenses include the following:

Advertising

Advertising expenses are the costs associated with promoting the business through various means including internet ads, newspapers, magazines, billboards, racing sponsors, and television spots.



Every self-employed taxpayer must claim all allowable deductions in computing net earnings from self-employment.

Car and Truck Expenses

A taxpayer who uses a car or truck in a business may be able to deduct the costs of operating and maintaining the vehicle. This is true even if the taxpayer used the vehicle for hire. Vehicle expenses can be calculated using actual expenses or the standard mileage rate. Actual expenses include depreciation. The calculation of depreciation is outside the scope of the VITA/TCE programs. If the taxpayers have used actual expenses in the past, or wish to use actual expenses in the current year, they must be referred to a professional tax preparer.

For the standard mileage deduction, the current standard mileage rate is multiplied by the number of business miles.

Self-employed taxpayers can also deduct the business part of interest on a car loan, state and local personal property tax on the car, parking fees, and tolls, whether or not they claim the standard mileage rate. For-hire drivers may have other deductible car expenses such as cellular service, fees, and ride-sharing insurance in addition to using the standard mileage rate. Commuting and other personal automobile expenses such as depreciation, lease payments, maintenance and repairs, gasoline (including gasoline taxes), oil, insurance, parking tickets, traffic fines, or vehicle registration fees are not deductible.

example

Wendy is a self-employed masseuse and does not maintain an office in her home. She does neck massages for office workers and travels to three office buildings each work day. It is 10 miles from home to the first office and 5 miles from the last office back home. These 15 miles are commuting miles and, therefore, not deductible. The 13 miles Wendy drives from the first office to the second office and 5 miles from the second office to the third office are deductible. Of the 33 miles driven each work day, 18 miles are deductible.



For-hire drivers who have mileage in between customer pick-ups can claim the mileage as a business expense.

Commissions and Fees

Commissions or fees are paid to both individuals and businesses. If payments to a single individual are \$600 or more, the taxpayer must report the payments on Form 1099-MISC or Form 1099-NEC. In this case, the taxpayer's return is out of scope for the VITA/TCE programs.

Insurance

Insurance policies and coverage are deductible for the business operation. This includes property and business liability insurance.

If the standard mileage rate is used, no deduction is allowed for regular automobile insurance premiums. A for-hire driver's cost of extra liability coverage can be added to the standard mileage rate if separate from the main policy.

Health insurance for the sole proprietor and his or her family is not deductible as a business expense on Schedule C. However, these medical premiums may be deducted on Form 1040 as an adjustment to gross income, subject to qualifications.

Other Interest

This category can include interest paid on business operating loans, but not mortgage interest. Business interest includes the business portion of interest on a car loan – it can be added to the standard mileage rate.

Legal and Professional Services

Expenses included on this line are fees paid to professionals, such as attorneys, accountants, appraisers, and engineers.

Legal fees paid to acquire business assets are not deductible. These costs are added to the basis of the property. Some accountant fees and attorney fees may be for personal services (e.g., tax returns, wills, or estates) and are not deductible as business expenses.

Payments over \$600 may require a Form 1099-MISC or 1099-NEC to be filed, which makes the return out of scope.

Office Expense

Office expense generally includes supplies such as pens, paper, and postage.

Rent or Lease – Vehicle, Machinery, and Equipment

This category includes rental fees for cars, trucks, vans, machinery, equipment, and other personal property. Vehicle leases of more than 30 days are out of scope. If the taxpayer uses the standard mileage rate method for business miles of a leased vehicle, the return remains in scope.

Repairs and Maintenance

Repairs on equipment, office space, and buildings are some possible expenditures reflected in this category. Expenses that should *not* be reflected are:

- Capital equipment that is improperly expensed (see Cost Recovery in Publication 535, Business Expenses).
- Repairs that substantially improve a facility or equipment that should be capitalized.

Also see the de minimis expense election below under Other Expenses.

Supplies

Supplies expense includes costs for general operating supplies not associated with the cost of goods sold.

Taxes and Licenses

Taxpayers can deduct taxes and license fees paid in the operation of their business. Examples include:

- State and local sales taxes imposed on the taxpayer as the seller of goods or services
- Real estate and personal property taxes on business assets
- Certain licenses and regulatory fees

Travel and Meals

Travel expenses are the ordinary and necessary expenses of traveling away from home for business. Examples of deductible travel and meal expenses are in the Volunteer Resource Guide, Income tab.



A temporary exception allows a 100% deduction for food or beverages from restaurants. See the Temporary Provisions lesson for more details.

Utilities

Utilities typically consist of normal electric, gas, water, and telephone expenses incurred for the business. There should be no deduction for personal expenses or expenses for a home office in this category.

example

Kiana runs a small business from her home. She has only one phone line and frequently makes long-distance calls for business. The cost of the phone line cannot be deducted, but Kiana can deduct the long-distance charges for her business calls.

Other Expenses

Taxpayers may also be able to deduct other ordinary and necessary business expenses not deducted elsewhere on Schedule C. Taxpayers can deduct the cost of their education expenses (including certain related travel) related to the trade or business.

Taxpayers must be able to show the education maintains or improves skills required in their trade or business, or that it is required by law or regulations, for keeping license to practice, status, or job. See Form Schedule C Instructions (Part V – Other Expenses) and Publication 535 for more information.

Taxpayers may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property used in the taxpayer's trade or business. They may use this safe harbor to deduct amounts paid for tangible property up to \$2,500 per invoice or item (substantiated by invoice) if they have accounting procedures in place whereby they deduct amounts paid for business property if the costs of such property are under a certain de minimis amount.

The de minimis safe harbor election does not include amounts paid for inventory and land. The election applies for the taxable year and, if made, applies to each expenditure meeting the criteria for the election in the taxable year. Make the election by attaching a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to a timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include the taxpayer's name, address, and Taxpayer Identification Number, as well as a statement that the taxpayer is making the de minimis safe harbor election.

example

Barry makes his living as a handyman and earned \$17,438 during the tax year. In the same year, Barry bought a new ladder for \$450 and uses it exclusively in his business. In keeping his books and records, Barry uses an accounting procedure whereby he deducts amounts he pays for business equipment if the cost of the equipment is \$1,000 or less. Under the de minimis safe harbor, Barry can deduct the full cost of the ladder as a business expense, as well as any other equipment purchases for \$1,000 or less, by attaching the required statement to his timely filed tax return.

How do I complete Schedule C?

On Schedule C, business expenses are broken down by category.

General Information Section

Using the Volunteer Resource Guide, Tab D, Income, complete lines A-J. Pay special attention to these items:

- Check accounting method. (Only cash method is in scope for the VITA/TCE programs; if taxpayers use another method, refer them to a professional tax preparer.)
- Check the “Yes” or “No” box for: Did the taxpayer “materially participate” in the operation of the business?
 - In general, the taxpayer materially participates if based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year. See the Schedule C Instructions for specific tests to determine if the taxpayer meets the requirements for material participation.
 - If the taxpayer meets one of the tests for material participation, check the “Yes” box, otherwise the answer is “No.” If there is uncertainty about the taxpayer materially participating in the business, refer them to a professional tax preparer.
- Check the “Yes” or “No” box for: Did the business make any payments in the tax year that would require filing of Form(s) 1099?
- If Yes, did or will the business file required Forms 1099? Check the “Yes” or “No” box.

In general, taxpayers who seek assistance through the VITA/TCE programs may be required to file Form 1099-MISC or Form 1099-NEC for payments in the amount of \$600 or more for services performed for a trade or business by people not treated as its employees or for rent paid. The taxpayer must file Form 1099-NEC or Form 1099-MISC to report contract labor or rent payments. For a complete listing of Forms 1099 and the requirements for filing each one, refer to the chart in the General Form 1099 Instructions.

If the taxpayer responds Yes to making payments that would require the filing of Form(s) 1099, the income tax return and any related Form 1099 preparation are both out of scope for the VITA/TCE programs. The taxpayer must be referred to a professional tax preparer even if the taxpayer indicates they have already filed the Forms 1099.

Part I: Income

Enter each Form 1099-MISC or 1099-NEC that the taxpayer received. Also enter income that was not reported on a Form. The combined total represents the gross receipts from the taxpayer’s trade or business. Refer to the Volunteer Resource Guide for the software entries, including when the income was reported on Form W-2 and the “Statutory Employee” box on that form is checked.



Determine if the taxpayer received business income that was not reported on Form 1099-NEC. For example, tips received by self-employed hair stylists or manicurists are to be included in gross receipts on Schedule C.

Statutory Employees

A “Statutory employee” can report the income and claim expenses related to that income on Schedule C. Enter the statutory employee income from Form W-2, Box 1, on line 1 of Schedule C. Social Security and Medicare taxes should have been withheld from the earnings; therefore, the taxpayer does not owe self-employment tax on these earnings. Be sure to indicate that this is a statutory employee on the input screen so that the self-employment tax is not computed by the software. Statutory employees include full-time life insurance agents, certain agent or commission drivers, traveling salespersons, and certain home workers.

Self-employment income and statutory employee income cannot be reported on the same Schedule C. The taxpayer must file two separate Schedules C.

Part II: Expenses

On Schedule C there is a separate line for the most common expenses that are incurred in a business. Review the taxpayer's business expense information. The taxpayer will decide whether a particular expense is ordinary and necessary for their business. Your role is to inform the taxpayer of the rules and ask probing interview questions to resolve incomplete or inconsistent data.

Part III: Cost of Goods Sold

This relates to inventory and is out of scope for the VITA/TCE programs.

Part IV: Information on Your Vehicle

This includes information for claiming the standard mileage rate for vehicle expenses.

Part V: Other Expenses

This includes all ordinary and necessary expenses not deducted elsewhere on Schedule C. Report the cost of purchases as other expenses and not as cost of goods sold for a small business using the cash method of accounting.



EXERCISES (continued)

Question 2: Daniel has his own business. He received Form 1099-NEC for \$13,000 for work he completed as an independent contractor. He also received cash payments that total \$2,500 for other jobs he completed for different individuals. Must Daniel report the cash payments of \$2,500 on his return? Yes No

Question 3: Ellen has a small business. The gross income from her business is \$40,000, her business expenses total \$11,500, and she must file a Schedule C. Is Ellen's tax return in scope for the VITA/TCE programs? Yes No



TIP Taxpayers who report a profit on Schedule C may be able to deduct up to 20% of their qualified business income on Form 1040 as a qualified business income deduction. For more information, see the Standard Deduction and Tax Computation Lesson or the instructions for Form 1040.

Recordkeeping

Why keep records?

Everyone in business must keep records. Good records will help the taxpayer do the following:

- Monitor the progress of their business
- Prepare their financial statements
- Identify source of receipts
- Keep track of deductible expenses
- Prepare tax returns
- Support items reported on tax returns

Kinds of records to keep

Except in a few cases, the law does not require any specific kind of records. Taxpayers can choose any recordkeeping system suited to their business that clearly shows their income and expenses.

The recordkeeping system should include a summary of business transactions. This summary is usually made in the taxpayers' books and records (for example, accounting journals and ledgers). The books and records must show the gross income, as well as the deductions and credits. For most small businesses, the business checkbook is the main source for entries in the business books and records. In addition, supporting documents must be kept.

Supporting documents

Purchases, sales, payroll, and other transactions in the business generate supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents contain information that must be recorded in the business books and records.



When a business involves the use of a vehicle, a mileage log would be a supporting document.

It is important to keep these documents organized and in a safe place because they support the entries in the business books and records, and on the tax return. For instance, organize them by year and type of income or expense.



Records include electronic records. Taxpayers should retain paper and electronic records that support their tax return data.

Reconstructing records

Make adequate inquiries to be satisfied that the taxpayer is carrying on a business and that the income and expenses reported on the tax return are substantially correct and complete.

You may help a taxpayer with simple record reconstruction. Assisting the taxpayer in reconstruction will help teach the taxpayer about recordkeeping. Extensive record reconstruction should be performed by the taxpayer or a paid preparer. If you are not satisfied with the accuracy of the reconstructed records, you have the right to decline to prepare the return. See your Site Coordinator for guidance in these situations.

The goal of record reconstruction is to use available documentation to develop a sound and reasonable estimate of the taxpayer's business income and expenses to support the Schedule C prepared. When reconstructing records, you can use such tools as:

- Appointment books or calendars
- Online map tools
- IRS standard allowances
- Checkbooks and canceled checks
- Cash apps and accounting software
- Bank or credit card statements
- Lists of regular clients
- Partial receipts or sales tax records
- Cell phone records, call history, or computer logs
- Prior year returns

How long to keep records

Generally, taxpayers must keep records that support income or deductions on a return until the statute of limitations for that return runs out.

The statute of limitations is the time period in which a taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. For more information on recordkeeping see Publication 583, *Starting a Business and Keeping Records*.

Taxpayer Interview and Tax Law Application

Remember our taxpayer, Dana, with a babysitting business? She said she made \$14,000 in net profit from her business, and wants to claim the EIC. After careful interviewing, the volunteer has determined the return cannot be completed without record reconstruction. The volunteer asked Dana to go home and return with some documentation to support her claims.

Based on the taxpayer's materials and additional questions, you can now determine if Dana should be claiming expenses for the business use of her home. If she can, refer the taxpayer to a professional tax preparer.

SAMPLE INTERVIEW

VOLUNTEER SAYS...

Nice to see you again, and I see you have some additional materials. What kind of documentation were you able to put together?

That sounds great. First, let's multiply the number of children that you cared for by the corresponding charged rate to confirm your income figure. Did you also bring documents to support your business expenses?

OK, then we'll calculate a reasonable estimate of expenses incurred.

DANA RESPONDS...

As you suggested, I completed a calendar that shows the number of children that I cared for on each date.

Yes, I have some grocery store receipts, canceled checks, bank statements, and credit card statements. I have highlighted the regular purchases I made for my business.

Good. I'm sure my first estimate of \$14,000 business income is not accurate after all. I appreciate learning what I need to do to keep track of my income and expenses.

What about self-employment tax?

A taxpayer must file Schedule SE if he or she has net earnings from self-employment of \$400 or more. The tax is computed on Schedule SE and transferred to Form 1040, and is added to other taxes owed. The Schedule SE is attached to Form 1040, and is discussed in the Other Taxes lesson.

Self-employed taxpayers may claim an adjustment to income for part of their Social Security and Medicare taxes.



Taxpayers who file Schedule C may be able to take a deduction for self-employment health insurance. For more information, see the Adjustments to Income lesson.



Tax Software Hint: Self-employment tax and the deductible part of self-employment tax are automatically calculated. The software then enters these amounts on the applicable lines of Form 1040.

Summary

This lesson explained:

- Where to get business income and expense information
- Cash income must be reported
- Subcontractors or individuals who receive less than \$600 may not receive Form 1099-MISC, Form 1099-NEC, or Form 1099-K, but still must report all cash income
- Additional inquiries about the taxpayer's income and expenses may be necessary to ensure an accurate return
- Certain situations involving Schedule C and EIC should raise "red flags"
- How business income or loss is reported (a loss would make the return out of scope)
- What business expenses are within scope for the VITA/TCE programs
- How to complete Schedule C
- The records that should be maintained
- How to complete a simple record reconstruction

What situations are out of scope for the VITA/TCE programs?

The following are out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

Schedule C with:

- Hobby income or not-for-profit activity
- Bartering income
- Expenses over \$35,000
- Returns and allowances
- Cost of goods sold (inventory)
- Expenses for employees
- Business use of home
- Contract labor
- Casualty losses
- Vehicle expenses reported as actual expenses
- Depreciation or the election to expense business assets (other than the de minimus expense safe harbor election)
- Rental or lease expenses – vehicle leases of more than 30 days
- Accounting methods other than the cash method
- Net losses
- A "No" response that indicates the taxpayer does not meet any of the tests for material participation, or is uncertain about materially participating in a business
- Taxpayers who receive any credit card or similar payments that are not includible in income

- A “Yes” response indicating there is a requirement to file Form(s) 1099
- Income from the manufacture, distribution, or trafficking of controlled substances (such as marijuana)
- Taxpayers who must answer Yes to the virtual currency question on Form 1040



TAX LAW APPLICATION

To gain a better understanding of the tax law, complete the practice return(s) for your course of study using the practice lab on L<.



EXERCISE ANSWERS

Answer 1: Yes. Jason meets all requirements to be considered in scope for the VITA/TCE programs.

Answer 2: Yes. The cash payments must be included in Daniel’s gross receipts the same as the \$13,000 reported on Form 1099-NEC. Cash payments are compensation for his services and must be reported on his Schedule C.

Answer 3: Yes. Ellen’s business expenses are under \$35,000.

Notes
