Department of the Treasury

Internal Revenue Service

Tax Guide for Small Business

(For Individuals Who Use Schedule C or C-EZ)

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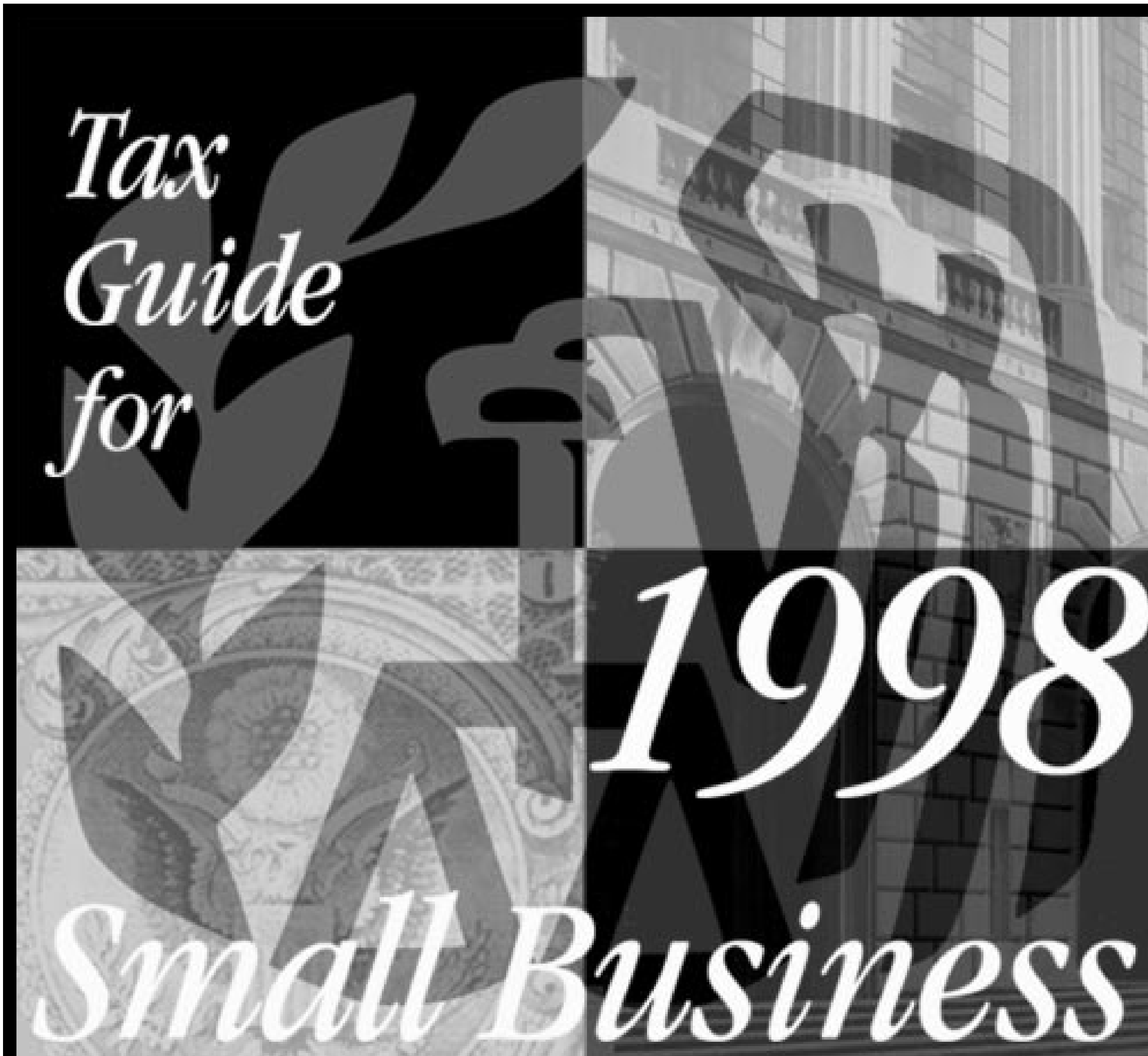

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Contents

Introduction

This publication is for small business owners who complete Schedule C or C–EZ of Form 1040. To use this publication, you will generally need the following forms.

- Form 1040 and its instructions.
- Schedule C or C–EZ and its instructions.

See *How To Get More Information* for information on ordering these forms if you don't already have them.

The purpose of this publication is to provide general information about the federal tax laws that apply to sole proprietors and to statutory employees.

A sole proprietor is someone who owns an unincorporated business by himself or herself. A statutory employee has a checkmark in box 15 of his or her Form W–2, *Wage and Tax Statement.* Statutory employees have to use Schedule C or C–EZ to report their wages and expenses.

This publication does not cover the topics listed in the following table. (See *How To Get More Information* for information about ordering forms and publications.)

If you need information about:	You should get:
Partnerships	Publication 541
Corporations	Publication 542
S corporations	Instructions for Form 1120S
Farming	Publication 225
Direct selling	Publication 911
Commercial fishing	Publication 595
Recordkeeping	Publication 583

What you need to know. Table A provides a list of questions you need to answer to help you meet your federal tax obligations. After each question is the location in this publication where you will find the related discussion.

The IRS mission. Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Important Changes for 1998

The following are some of the tax changes for 1998. For information on other changes, get Publication 553, *Highlights of 1998 Tax Changes.*

Research credit. The research credit was set to expire on June 30, 1998. It has been extended for expenses paid or incurred before July 1, 1999.

Work opportunity credit. The work opportunity credit was set to expire on June 30, 1998. It has been extended to qualified first-year wages you pay to individuals who begin work for you before July 1, 1999.

Welfare-to-work credit. The welfare-to-work credit is a new credit employers can take for qualified wages they pay to qualified long-term family assistance recipients who begin work after December 31, 1997, and before July 1, 1999. It is part of the general business credit.

In the first year of employment, the credit is 35% of the first $10,000 of qualified wages paid to that employee. In the second year, the credit is 50% of the first $10,000 of qualified wages paid to that employee.

For more information about this credit, see *Welfare-to-work credit* in chapter 4.

Private delivery services. You can use certain private delivery services designated by the IRS to meet the “timely mailing as timely filing/paying” rule for tax returns and payments. The IRS publishes a list of the designated private delivery services in September of each year. The list published in September 1998 includes the following.

- Airborne Express (Airborne)—Overnight Air Express Service, Next Afternoon Service, and Second Day Service.
- DHL Worldwide Express (DHL)—DHL “Same Day” Service and DHL USA Overnight.

Table A. **What You Need To Know About Federal Taxes**

(**Note:** *The following is a list of questions you need to answer so you can fill out your federal income tax return. Chapters are given to help you find the related discussion in this publication.*)

☞ **What Must I Know**	☞ **Where To Find The Answer**
What kinds of federal taxes do I have to pay? How do I pay them?	See chapter 1.
What forms must I file?	See chapter 1.
What must I do if I have employees?	See *Employment Taxes* in chapter 1.
Do I have to start my tax year in January? Or may I start it in any other month?	See *Accounting Periods* in chapter 2.
What method can I use to account for my income and expenses?	See *Accounting Methods* in chapter 2.
What kinds of business income do I have to report on my tax return?	See chapter 5.
What kinds of business expenses can I deduct on my tax return?	See chapter 8.
What kinds of expenses are not deductible as business expenses?	See *Expenses You Cannot Deduct* in chapter 8.
What happens if I have a business loss? Can I deduct it?	See chapter 9.
What must I do if I disposed of business property during the year 1998?	See chapter 3.
What are my rights as a taxpayer?	See chapter 11.
Where do I go if I need help with federal tax matters?	See *How To Get More Information.*

- Federal Express (FedEx)—FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day.
- United Parcel Service (UPS)—UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

The private delivery service can tell you how to get written proof of the mailing date.

CAUTION *Private delivery services cannot deliver items to P.O. boxes. You must use the U.S. Postal Service to mail any item to an IRS P.O. box address.*

Section 179 deduction. For 1998, this deduction is increased to $18,500. For information on the section 179 deduction, see *Depreciation* in chapter 8.

Health insurance deduction for the self-employed. For 1998, this deduction is increased to 45% of the amount you paid for medical insurance for yourself and your family. For more information, see *Insurance* in chapter 8.

Self-employment tax. The maximum net earnings from self-employment subject to the social security part of self-employment tax has increased to $68,400 in 1998. For more information, see *Self-Employment Tax* in chapter 1.

Standard mileage rate. The standard mileage rate for the cost of operating your car, van, pickup, or panel truck in 1998 is 32.5 cents per mile for all business miles. Starting in 1998, you can use this rate for a leased vehicle. See *Car and Truck Expenses* in chapter 8.

Estimated tax. You generally have to make estimated tax payments if you expect to owe taxes, including self-employment tax, of $1,000 or more when you file your return. For more information about estimated tax, see *How Do I Pay the Income Tax?* in chapter 1.

Individual retirement arrangements (IRAs). If you or your spouse are covered by an employer's retirement plan, the income amounts at which your IRA deduction begins to be phased out (reduced or eliminated) have been increased for most individuals. Also, there may be no 10% additional tax on withdrawals from your traditional IRA before age 59½ if the withdrawals do not exceed certain higher education expenses or, in some cases, are used to buy, build, or rebuild a first home.

There are two new IRAs. One is called the ***Roth IRA.*** Contributions to this IRA are not deductible. $2,000 is the maximum amount you can contribute, but this limit is reduced by contributions on your behalf (other than employer contributions) to your traditional IRAs and is phased out for certain higher income individuals. Distributions from this IRA are not taxable if certain requirements are met.

The other new IRA is called the ***Education IRA***. It allows you a way to save for higher education expenses. Contributions to this IRA are also not deductible. $500 is the maximum amount that can be contributed each year for a child until he or she reaches age 18. But this amount may be less if there are higher income individuals contributing. Distributions are excludable from the beneficiary's income to the extent they do not exceed qualified higher education expenses during the year.

For more information about these changes, get Publication 590.

Important Changes for 1999

The following are some of the tax changes for 1999. For information on other changes, get Publication 553.

941TeleFile. Beginning with the 1st quarter of 1998, many employers were able to file Form 941 by phone. If you receive 941TeleFile with your Form 941 package, check page TEL–1 of the *941TeleFile Instructions* to see if you qualify for this quick, convenient, and easy method of filing. There is no charge for the call.

941On-Line Filing. In 1998, a limited number of employers were allowed to file Form 941 by using commercially available software to create the return and then transmitting the return electronically to IRS through a third party. 941On-Line uses Electronic Data Interchange (EDI) format. In 1999, IRS expects to make the 941On-Line filing option available nationwide.

Electronic deposits of taxes. If your total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in 1996 or 1997, or you did not deposit employment taxes but had deposits of other depository taxes that were more than $50,000 in 1995, 1996, or 1997, you must make electronic deposits for ***all*** depository tax liabilities that occur after December 31, 1998. For more information, see *Electronic deposits* under *Depositing Employment Taxes* in chapter 1.

Employment tax deposits. In some cases, the IRS can waive the penalty for failure to timely deposit employment taxes for first-time depositors. For deposits required after January 18, 1999, this waiver is expanded to include the first deposit required after a required change in frequency of deposits.

Self-employment tax. The maximum net earnings from self-employment subject to the social security part of self-employment tax increases to $72,600 in 1999.

Business use of your home. You can deduct expenses for the business use of your home if you use part of your home exclusively and regularly as your principal place of business and meet certain other requirements. New rules that take effect in 1999 expand the definition of "principal place of business." The part of your home used for business also will qualify as your principal place of business if its use meets both the following tests.

- You use it exclusively and regularly for administrative or management activities of your trade or business.
- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

For information about deducting expenses for business use of your home, see Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers).*

Health insurance deduction for the self-employed. For 1999, this deduction is increased to 60% of the amount you paid for medical insurance for yourself and your family. For more information, see *Insurance* in chapter 8.

1. Filing and Paying Business Taxes

This chapter explains the business taxes you may have to pay and the forms you may have to file. It also discusses taxpayer identification numbers.

Table 1–1 near the end of this chapter lists the federal taxes you may have to pay, the forms you use to report them, and their due dates.

TIP *You may want to get Publication 509. It has tax calendars that tell you when to file returns and make tax payments.*

Identification Numbers

This section explains three types of taxpayer identification numbers, who needs them, when to use them, and how to get them.

Social security number (SSN). You generally use your SSN as your taxpayer identification number. You must put this number on each of your individual income tax forms, such as Form 1040 and its schedules.

To apply for an SSN, use Form SS–5, *Application for a Social Security Card.* This form is available from Social Security Administration (SSA) offices or by calling 1–800–772–1213.

Individual taxpayer identification number (ITIN). The IRS will issue an ITIN to an alien who does not have (and is not eligible to get) a social security number (SSN). To apply for an ITIN, file Form W–7, *Application for IRS Individual Taxpayer Identification Number,* with the IRS. It usually takes about 30 days to get an ITIN. Enter the ITIN wherever an SSN is requested on a tax return. If you must include another person's SSN on your return and that person does not have and cannot get an SSN, enter that person's ITIN.

CAUTION *An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.*

Employer identification number (EIN). You must also have an EIN to use as a taxpayer identification number if you do either of the following.

- Pay wages to one or more employees.
- File pension or excise tax returns.

If you must have an EIN, include it along with your SSN on your Schedule C or C–EZ.

You can get an EIN either through the mail or by telephone. But first you must fill out Form SS–4, *Application for Employer Identification Number.* This form is available from SSA offices or by calling the IRS at 1–800–TAX–FORM (1–800–829–3676).

New EIN. You may need to get a new EIN if either the form or the ownership of your business changes. For more information, get Publication 1635, *Understanding Your EIN*.

When you need identification numbers of other persons. In operating your business, you will probably make certain payments you must report on information returns. These payments are discussed under *Information Returns,* later in this chapter. You must give the recipient of these payments (the payee) a statement showing the total amount paid during the year. You must include the payee's identification number and your identification number on the returns and statements.

Employee. If you have employees, you must get an SSN from each of them. Record the name and SSN of each employee exactly as they are shown on the employee's social security card. If the employee's name is not correct as shown on the card, the employee should request a new card from the SSA. This may occur if the employee's name has changed due to marriage or divorce.

If your employee does not have an SSN, he or she should file Form SS–5 with the SSA.

Other payee. If you make payments to someone who is not your employee and you must report the payments on an information return, get that person's SSN. If you must report payments to an organization, such as a corporation or partnership, you must get its EIN.

To get the payee's SSN or EIN, use Form W–9, *Request for Taxpayer Identification Number and Certification.* This form is available from IRS offices.

A payee who does not provide you with an identification number may be subject to backup withholding. For information on backup withholding, see the Form W–9 instructions and the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Income Tax

This part explains whether you have to file an income tax return and when you file it. It also explains how you pay the tax.

Do I Have To File an Income Tax Return?

You have to file an income tax return for 1998 if your gross income was at least the amount shown in the second column.

You Must File a Return If—

Your Filing Status Is:	And Your Income Is At Least:
Single	
Under 65	$ 6,950
65 or older	8,000
Head of Household	
Under 65	$ 8,950
65 or older	10,000
Married, Joint Return	
Both under 65	$12,500
One spouse 65 or older	13,350
Both 65 or older	14,200
Not living with spouse at end of year (or on date spouse died)	2,700
Married, Separate Return	
All (any age)	$ 2,700
Qualifying Widow(er) with Dependent Child	
Under 65	$ 9,800
65 or older	10,850

Exception. Even if your income was less than the amount shown above, you still have to file an income tax return if your net earnings from self-employment for 1998 were $400 or more. See *Self-Employment Tax,* later.

More information. See the Form 1040 instructions for more information on who must file a return for 1998.

How Do I File?

You file your income tax return on Form 1040 and attach Schedule C or Schedule C–EZ. You enter the amount of net profit or loss from Schedule C or Schedule C–EZ on page 1 of Form 1040. Use Schedule C to figure your net profit or loss from your business. If you operated more than one business as a sole proprietorship, you must attach a separate Schedule C for each business. You can use the simpler Schedule C–EZ if you operated only one business as a sole proprietorship, you did not have a net loss, and you meet the other requirements listed in Part I of the schedule. (Part I of Schedule C–EZ is printed in chapter 10.)

What are my filing options? You may be able to file a paperless return, or a return with less paper. Some of the options available to you are the following.

1) IRS *e-file* (electronic filing). This alternative includes the following options.

a) Using a tax professional who is an authorized IRS *e-file* provider.

b) Using your personal computer.

c) Using a telephone (TeleFile).

2) Computerized returns (the 1040PC return, which is prepared on a personal computer and generally has fewer pages than a conventional return).

For details about IRS *e-file*, see the Form 1040 instructions.

When is my tax return due? Form 1040 for calendar year 1998 is due by April 15, 1999. If you use a fiscal year (explained in chapter 2), your return is due by the 15th day of the 4th month after the end of your fiscal year. If you file late, you may have to pay penalties and interest. If you cannot file your return on time, use Form 4868 to request an automatic 4-month extension.

How Do I Pay the Income Tax?

The federal income tax is a pay-as-you-go tax. You must pay the tax as you earn or receive income during the year. An employee usually has income tax withheld from his or her pay. If you do not pay your tax through withholding, or do not pay enough tax that way, you might have to pay estimated tax. You generally have to make estimated tax payments if you expect to owe taxes, including self-employment tax (discussed later), of $1,000 or more when you file your return. Use Form 1040–ES to figure and pay the tax. If you do not have to make estimated tax payments, you may pay any tax due when you file your return. For more information on estimated tax, see Publication 505, *Tax Withholding and Estimated Tax.*

Penalty for underpayment of tax. If you did not pay enough income tax and self-employment tax for 1998 by withholding or by making estimated tax payments, you may have to pay a penalty on the amount not paid. IRS will figure the penalty for you and send you a bill. Or you can use Form 2210, *Underpayment of Tax by Individuals, Estates, and Trusts,* to see if you have to pay a penalty and to figure the penalty amount. For more information, see Publication 505.

Self-Employment Tax

Self-employment tax (SE tax) is the social security and Medicare tax for people like you who work for themselves. When you pay SE tax, you are contributing to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

You must pay SE tax if you meet either of the following conditions.

1) Your net earnings from self-employment (excluding income described in (2) below) are $400 or more.

2) You performed services for a church as an employee and received income of $108.28 or more.

CAUTION *If you earned income as a statutory employee, you do not pay SE tax on that income.*

The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). The maximum amount of net earnings subject to the social security part for 1998 is $68,400. All of your net earnings are subject to the Medicare part.

Use Schedule SE (Form 1040) to figure your SE tax.

For more information, see Publication 533, *Self-Employment Tax.*

TIP *Deduct one-half of your SE tax as an adjustment to income on line 27 of Form 1040.*

Employment Taxes

This section briefly discusses the employment taxes you must pay, the forms you must file to report them, and other forms that must be filed when you have employees.

Employment taxes are the following items.

- Federal income tax withholding.
- Social security and Medicare taxes.
- Federal unemployment (FUTA) tax.

TIP *If you have employees, you will need to get Publication 15,* Circular E, Employer's Tax Guide. *This publication explains your tax responsibilities as an employer.*

Federal Income, Social Security, and Medicare Taxes

You withhold federal income tax from your employee's wages. To figure how much federal income tax to withhold from each wage payment, use the employee's Form W–4 (discussed later) and the methods described in Publication 15.

Social security and Medicare taxes pay for benefits the workers and their families receive under the Federal Insurance Contributions Act (FICA). Social security tax pays for benefits under the old-age, survivors, and disability insurance part of FICA. Medicare tax pays for benefits under the hospital insurance part.

The maximum amount of wages subject to social security tax for 1998 is $68,400. For 1999, the maximum amount is $72,600. The employee tax rate for social security is 6.2%. You withhold tax from the employee's wages at this rate. The employer tax rate for social security is also 6.2%. You pay tax at this rate out of your own funds.

There is no limit on the amount of wages subject to Medicare tax. The employee tax rate for Medicare is 1.45%. You withhold tax from the employee's wages at this rate. The employer tax rate for Medicare is also 1.45%. You pay tax at this rate out of your own pocket.

You report these taxes on Form 941, *Employer's Quarterly Federal Tax Return.* Some of the IRS *e-file* options available for filing your Form 941 are the following.

- Using a reporting agent — 941*e-file.*
- Using the telephone — 941TeleFile.
- Using a personal computer and third party transmitter — 941On-Line Filing. IRS expects to make this option available nationwide in 1999.

TIP *You can deduct the employer's part of social security and Medicare taxes on Schedule C.*

Federal Unemployment (FUTA) Tax

The federal unemployment tax is part of the federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. You report and pay FUTA tax separately from social security and Medicare taxes and withheld income tax.

The FUTA tax is figured on the first $7,000 in wages paid to each employee annually. The gross FUTA tax rate is 6.2%. However, you are given a credit of up to 5.4% for the state unemployment tax you pay. You pay FUTA tax only from your own funds. Employees do not pay this tax or have it withheld from their pay.

Report federal unemployment tax on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return.* If you qualify, you can use the simpler Form 940–EZ instead. See Publication 15 to find out if you can use this form.

TIP *You can deduct FUTA tax on Schedule C.*

Family Employees

If your employee is a member of your family, use the following rules to determine if his or her wages are subject to employment taxes.

Employing your child. Payments for the services of your child under the age of 18 who works for you in your business are not subject to social security and Medicare taxes. If these services are for work other than in your business, such as domestic work in your private home, they are not subject to social security and Medicare taxes until your child reaches 21.

Payments for the services of your child under the age of 21 who works for you whether or not in your business are not subject to FUTA tax.

The above rules apply even if you pay your child regular wages. The wages for these services are not subject to social security, Medicare, or FUTA taxes. But they may still be subject to income tax withholding.

Employing your spouse. If your spouse works for you in your business, the wages you pay to him or her are subject to income tax withholding and social security and Medicare taxes, but not to FUTA tax. However, the services of your spouse employed by you in other than your business, such as domestic service in your private home, are not subject to social security, Medicare, and FUTA taxes.

Employing your parent. If your parent works for you in your business, the wages you pay to him or her are subject to income tax withholding and social security and Medicare taxes. Social security and Medicare taxes do not apply to wages paid to your parent for services not performed in your business, but they do apply to domestic services if both the following conditions are met.

- Your parent cares for your child who lives with you and is under 18 or requires adult supervision for at least 4 continuous weeks in a calendar quarter due to a mental or physical condition.
- You are a widowed, divorced, or married to a person who, because of a physical or mental condition, cannot care for your child during that period.

Depositing Employment Taxes

This section briefly explains how you deposit employment taxes. You can usually deposit them by mail, but in some cases you ***must*** deposit them electronically.

Deposits by mail. You generally must deposit income tax withheld and both the employer and employee social security and Medicare taxes (minus any advance earned income credit payments) by mailing or delivering your payment with Form 8109, *Federal Tax Deposit Coupon,* to an authorized financial institution or Federal Reserve bank. You also deposit FUTA tax using Form 8109 if your FUTA tax liability is more than $100. The IRS will send you a coupon book 5 to 6 weeks after you receive your employer identification number (discussed earlier). For details, see Publication 15.

Electronic deposits. If your total deposits of social security, Medicare, and withheld income taxes were more than $50,000 in calendar year 1996 or 1997, or you did not deposit employment taxes but had deposits of other depository taxes that were more than $50,000 in 1995, 1996, or 1997, you must make electronic deposits for ***all*** depository tax liabilities that occur after December 31, 1998. If you were required to deposit by electronic funds transfer in prior years, continue to do so in 1999. You must use the Electronic Federal Tax Payment System (EFTPS) to make electronic deposits. Even if you do not have to make electronic deposits, you may voluntarily participate in EFTPS. To enroll in EFTPS, call 1–800–945–8400 or 1–800–555–4477. For general information about EFTPS, call 1–800–829–1040.

Penalty for not using EFTPS. If you are required to make deposits by electronic funds transfer and do not do so, you may be subject to a penalty. However, if you are first required to use EFTPS after June 30, 1997, but do not do so, no penalty for failure to use EFTPS will be imposed before January 1, 1999.

CAUTION *Employers who do not withhold income, social security, or Medicare taxes from employees, or who withhold taxes but do not deposit them or pay them to the IRS, may be subject to a penalty of the unpaid tax, plus interest. Employers may also be subject to a penalty if they deposit the taxes late. In some cases the IRS can waive the penalty for first-time* *depositors. For deposits required to be made after January 18, 1999, this waiver is expanded to include the first deposit required after a required change in frequency of deposits. For more information, see Publication 15.*

Hiring Employees

When hiring employees, have them fill out Form I–9 and Form W–4. If your employees qualify for advance payments of the earned income credit, they must give you a Form W–5.

Form I–9. You must verify that each new employee is legally eligible to work in the United States. Both you and the employee must complete the Immigration and Naturalization Service (INS) Form I–9, *Employment Eligibility Verification.* You can get the form from INS offices. Call the INS at 1–800–755–0777 for more information about your responsibilities.

Form W–4. Each employee must fill out Form W–4, *Employee's Withholding Allowance Certificate.* You will use the filing status and withholding allowances shown on this form to figure the amount of income tax to withhold from your employee's wages.

Form W–5. An eligible employee who has a qualifying child is entitled to receive advance earned income credit (EIC) payments with his or her pay during the year. To get these payments, the employee must give you a properly completed Form W–5, *Earned Income Credit Advance Payment Certificate.* You are required to make advance EIC payments to employees who give you a completed and signed Form W–5. For more information, see Publication 15.

Wage Reporting—Form W–2

After the calendar year is over, you must give copies of Form W–2, *Wage and Tax Statement,* to each employee to whom you paid wages during the year. You must also send copies to the Social Security Administration. See *Information Returns,* later in this chapter, for more information on Form W–2.

Excise Taxes

This section explains the excise taxes you may have to pay and the forms you have to file if you do any of the following.

- Manufacture or sell certain products.
- Operate certain kinds of businesses.
- Use various kinds of equipment, facilities, or products.

For more information on excise taxes, see Publication 510, *Excise Taxes for 1999.*

Form 720. The federal excise taxes reported on Form 720, *Quarterly Federal Excise Tax Return,* consist of several broad categories including the following taxes.

- Environmental taxes.
- Communications taxes.
- Fuel taxes.
- Tax on the first retail sale of heavy trucks and trailers.
- Luxury tax on passenger cars.
- Manufacturers' taxes on the sale or use of a variety of different products.

Form 2290. There is a federal excise tax on trucks, truck tractors, and buses used on public highways. The tax applies to vehicles having a taxable gross weight of 55,000 pounds or more. Report the tax on Form 2290, *Heavy Vehicle Use Tax Return.* For more information, see the instructions for Form 2290.

ATF forms. If you produce, sell, or import guns, tobacco, or alcohol products or if you manufacture equipment for their production, you may be liable for one or more excise taxes. Report these taxes on forms filed with the Bureau of Alcohol, Tobacco, and Firearms (ATF).

Depositing excise taxes. If you have to file a quarterly excise tax return on Form 720, you may have to deposit your excise taxes ***before*** the return is due. For details on depositing excise taxes, see Publication 510.

Information Returns

If you make or receive payments in your business, you may have to report them to the IRS on information returns. The IRS compares the payments shown on the information returns with each person's income tax return to see if the payments were included in income. You must give a copy of each information return you are required to file to the recipient or payer. In addition to the forms described below, you may have to use other returns to report certain kinds of payments or transactions. For more details on information returns and when you have to file them, see the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

Form 1099–MISC. You use Form 1099–MISC, *Miscellaneous Income,* to report certain payments you make in your business. These payments include the following items.

- Payments of $600 or more for services performed for your business by people not treated as your employees, such as fees to subcontractors, attorneys, accountants, or directors.
- Rent payments of $600 or more, other than rents paid to real estate agents.
- Prizes and awards of $600 or more that are not for services, such as winnings on TV or radio shows.
- Royalty payments of $10 or more.
- Payments to certain crew members by operators of fishing boats.

Table 1-1. **Which Forms Must I File?**

If You are Liable For:	Use Form:	Due By:[1]
Income tax	1040 and Schedule C[2] or C-EZ	15th day of 4th month after end of tax year
Self-employment tax	Schedule SE	File with Form 1040.
Estimated tax	1040-ES	15th day of 4th, 6th and 9th months of tax year, and 15th day of 1st month after the end of tax year
Social security and Medicare taxes and income tax withholding	941 8109 (to make deposits)[3]	April 30, July 31, October 31, and January 31 See Publication 15.
Providing information on social security and Medicare taxes and income tax withholding	W-2 (to employee) W-2 and W-3 (to the Social Security Administration)	January 31 Last day of February
Federal unemployment (FUTA) tax	940 or 940-EZ 8109 (to make deposits)[3]	January 31 April 30, July 31, October 31, and January 31, but only if the liability for unpaid tax is more than $100
Filing information returns for payments to nonemployees and transactions with other persons	See *Information Returns.*	Forms 1099—to the recipient by January 31 and to the IRS by February 28 Other forms—See *Instructions for Forms 1099, 1098, 5498, and W-2G.*
Excise tax	See *Excise Taxes.*	See the instructions to the forms.

[1]If a due date falls on a Saturday, Sunday, or legal holiday, the due date is the next business day. For more information, get Publication 509, *Tax Calendars for 1999.*

[2]File a separate schedule for each business.

[3]Do not use if you deposit taxes electronically.

You also use Form 1099–MISC to report sales by you of $5,000 or more of consumer goods to a person for resale anywhere other than in a permanent retail establishment.

Form W–2. You must file Form W–2, *Wage and Tax Statement,* to report payments to your employees, such as wages, tips, and other compensation, withheld income, social security, and Medicare taxes, and advance earned income credit (EIC) payments. For more information on what to report on Form W–2, see the *Instructions for Form W–2 and W–3.*

Penalties. The law provides for the following penalties if you do not file Form 1099–MISC or Form W–2 or do not correctly report the information. For more information, see the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

- ***Failure to file information returns.*** A penalty applies if you do not file information returns by the due date, if you do not include all required information, or if you report incorrect information.
- ***Failure to furnish correct payee statements.*** A penalty applies if you do not furnish a required statement to a payee by the required date, if you do not include all required information, or if you report incorrect information.

Waiver of penalty. A penalty will not apply if you can show that the failure was due to reasonable cause and not willful neglect.

In addition, there is no penalty for failure to include all the required information, or for including incorrect information, on a *de minimis* (small) number of information returns if you correct the errors by August 1 of the year the returns are due. (A de minimis number of returns is the greater of 10 or ½ of 1% of the total number of returns you are required to file for the year.)

Form 8300. You must file Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business,* if you receive more than $10,000 in cash in one transaction, or two or more related business transactions. Cash includes U.S. and foreign coin and currency. It also includes certain monetary instruments such as cashier's and traveler's checks and money orders. For more information, see Publication 1544, *Reporting Cash Payments of Over $10,000 (Received in a Trade or Business).*

Penalties. There are civil and criminal penalties, including up to 5 years in prison, for not filing Form 8300 or for filing (or causing the filing) of a false or fraudulent form, or for structuring a transaction to evade reporting requirements.

2. Accounting Periods and Methods

You must figure taxable income and file a tax return on the basis of an annual accounting period called a "tax year." Also, you must consistently use an accounting method that accurately accounts for income and expenses for the tax year.

Accounting Periods

Your "tax year" is the annual accounting period you use for keeping your records and reporting your income and expenses. You can use one of the following accounting periods.

- A calendar tax year.
- A fiscal tax year.

You adopt a tax year when you file your first income tax return. You must adopt your first tax year by the due date (not including extensions) for filing a return for that year.

Calendar tax year. A calendar tax year is 12 consecutive months beginning January 1 and ending December 31.

You must adopt the calendar tax year if any of the following apply.

- You do not keep adequate records.
- You have no annual accounting period.
- Your present tax year does not qualify as a fiscal year.

If you filed your first return using the calendar tax year, and you later begin business as a sole proprietor, you must continue to use the calendar tax year unless you get IRS approval to change (discussed later).

If you adopt the calendar tax year for your annual accounting period, you must maintain your books and records and report your income and expenses for the period from January 1 through December 31 of each year.

CAUTION *You figure employment taxes (discussed in chapter 1) on a calendar year basis, even if you adopt a fiscal tax year for your annual accounting period. You report withheld income tax and social security and Medicare taxes for each calendar quarter. You report federal unemployment tax for the calendar year.*

Fiscal tax year. A regular fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52–53 week year is a fiscal tax year that varies from 52 to 53 weeks.

If you adopt a fiscal tax year, you must maintain your books and records and report your income and expenses using the same tax year.

For more information on fiscal tax years, including 52–53 week years, get Publication 538, *Accounting Periods and Methods.*

Change in accounting period. Once you have chosen your tax year, you may have to get IRS approval to change it. To get approval, you must file Form 1128, *Application to Adopt, Change, or Retain a Tax Year*. You may have to pay a fee. For more information, see Publication 538.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. Your accounting method includes not only the overall method of accounting you use, but also the accounting treatment you use for any material item.

You choose your accounting method when you file your first tax return. After that, if you want to change your accounting method, you must first get IRS approval. See *Change in Accounting Method,* later.

Kinds of methods. Generally, you may figure your taxable income under any of the following accounting methods.

- Cash method.
- Accrual method.
- Special methods of accounting for certain items of income and expenses.
- Combination method using elements of two or more of the above.

Business and personal items. You may account for business and personal items under different accounting methods. For example, you may figure the income from your business under an accrual method even though you use the cash method to figure personal items.

Two or more businesses. If you operate more than one business, you generally can use a different accounting method for each separate and distinct business if the method you use for each clearly shows your income. For example, if you operate a personal service business and a manufacturing business, you may use the cash method for the personal service business and an accrual method for the manufacturing business.

No business will be considered separate and distinct if you do not keep a complete and separable set of books and records for that business.

Cash Method

The cash method of accounting is used by most sole proprietors and statutory employees who have no inventories. However, if inventories are necessary in accounting for your income, you must use an accrual method for your sales and purchases. If you do not have to keep inventories, you usually will use the cash method.

Income

With the cash method, you include in your gross income all items of income you actually or constructively receive during the year. You must include property and services you receive in your income at their fair market value.

Example. On December 30, 1997, Mrs. Sycamore sent you a check for interior decorating services you provided to her. You received the check on January 2, 1998. You must include the amount of the check in income for 1998.

Constructive receipt. You have constructive receipt of income when an amount is credited to your account or made available to you without restriction. You do not need to have possession of it. If you authorize someone to be your agent and receive income for you, you are treated as having received it when your agent received it.

Example. You have interest credited to your bank account in December 1998. You must include it in your gross income for 1998 and not for 1999 when you withdraw it or it is entered in your passbook.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying the tax on the income. You must report the income in the year the property is made available to you without restriction.

Example. Frances Jones, a service contractor, was entitled to receive a $10,000 payment on a contract in December 1998. She was told in December that her payment was available. At her request, she was not paid until January 1999. She must include this payment in her 1998 income because it was constructively received in 1998.

Checks. Receipt of a valid check by the end of the tax year is constructive receipt of income in that year, even if you cannot cash or deposit the check until the following year.

Example. Dr. Redd received a check for $500 on December 31, 1998, from a patient. She could not deposit the check in her business account until January 2, 1999. She must include this fee in her income for 1998.

Debts paid by another person or canceled. If your debts are paid by another person or are canceled by your creditors, you may have to report part or all of this debt relief as income. If you receive income in this way, you constructively receive the income when the debt is canceled or paid. See *Canceled Debt,* under *Kinds of Income* in chapter 5.

Repayment of income. If you include an amount in income and in a later year you have to repay all or part of it, you can usually deduct the repayment in the year in which you make it. If the amount you repay is over $3,000, a special rule applies. For details about the special rule, see *Repayments (claim of right)* in chapter 16 of Publication 535, *Business Expenses.*

Expenses

Usually, you must deduct expenses in the tax year in which you actually pay them. However, you can deduct expenses you pay in advance only in the year to which they apply.

Example. You are a calendar year taxpayer and in 1998 you pay $1,000 for a business insurance policy that is effective on July 1, 1998, for a 1-year period. You may deduct $500 in 1998 and $500 in 1999.

Accrual Method

Under an accrual method of accounting, you generally report income in the year earned, and deduct or capitalize expenses in the year incurred. The purpose of an accrual method of accounting is to match your income and your expenses in the correct year.

Income—General Rule

Generally, you include all items of income in your gross income when you earn them, even though you may receive payment in another tax year. You include an income item in your gross income in the tax year in which all events that fix your right to receive the income have happened, and you can figure the amount with reasonable accuracy.

Example. You are a calendar-year, accrual method taxpayer. You sold a computer on December 28, 1998. You billed the customer in the first week of January 1999, but you did not receive payment until February 1999. You must include the amount of the sale in your income for 1998 because you earned the income in 1998.

Income—Special Rules

The following are special rules that apply to advance payments, estimating income, and changing a payment schedule for services.

Estimating income. When you include an amount in gross income on the basis of a reasonable estimate, and you later determine the exact amount, take the difference, if any, into account in the tax year in which you made the determination.

Change in payment schedule for services. If you contract to perform services for a basic rate, you must include the basic rate in your income as services are performed and accrue. You must accrue the basic rate even if, as a matter of convenience, you agree to receive payments at a lower rate until you complete your services, at which time you will receive the difference between the basic rate and the amount actually paid to you.

Advance payments for services. Generally, if you use an accrual method of accounting, you report an advance payment for services to be performed in a later year in income in the you receive the payment. However, if you receive advance payments for services to be performed by the end of the next tax year, you can choose to postpone including the advance payments in income until you earn them. However, you cannot postpone including them beyond the year after the year you receive them.

For more information about reporting advance payments for services, see Publication 538. That publication also explains special rules for reporting the following types of income.

- Advance income you get for service agreements.
- Advance income you get under guarantee or warranty contracts.
- Prepaid interest.
- Prepaid rent.

Advance payments from sales. If you use an accrual method of accounting, any advance payments you receive for future sales or other dispositions of goods are included in your income under special rules. Under these rules, advance payments include those you receive under an agreement for future sales of goods you hold primarily for sale to your customers in the ordinary course of your business. They also include payments you receive under agreements for building, installing, or manufacturing items if you do not complete the agreement in the tax year.

If the advance payments are for contracts involving both the sale and service of goods, it may be necessary to treat them as two agreements. An agreement includes a gift certificate that can be redeemed for goods. Treat amounts that are due and payable as amounts you received.

You generally include the amounts in income in the tax year in which you receive them, or you can use an alternative method. For information about the alternative method, see Publication 538.

Expenses

You deduct or capitalize business expenses when you become liable for them, whether or not you pay them in the same year. Liability occurs in the tax year in which you meet the all events test and the economic performance rule.

All events test. Before you can deduct or capitalize an expense, all events must have occurred that fix the fact of the liability and you must be able to figure the amount of the liability with reasonable accuracy.

Economic performance rule. Generally, you cannot deduct business expenses until economic performance occurs. If your expense is for property or services provided to you, or for use of property by you, economic performance occurs as the property or services are provided or as the property is used. If your expense is for property or services that you provide to others, economic performance occurs as you provide the property or services. An exception allows certain recurring expenses to be treated as incurred during a tax year even though economic performance has not occurred. See Publication 538 for more information on the economic performance rule.

Example. You are a calendar-year taxpayer who uses an accrual method of accounting and in December 1998 you buy office supplies. You received the supplies and are billed for them in December, but you pay for the supplies in January 1999. You can deduct the expense in 1998 because all events that fix the fact of liability have occurred, the amount of the liability can be reasonably determined, and economic performance occurred in that year.

Your office supplies may qualify as a recurring expense. In that case, you may be able to deduct the expense in 1998 even if economic performance (delivery of the supplies to you) did not occur until 1999.

Inventories. Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor. If inventories are necessary to show income correctly, only an accrual accounting method can be used for purchases and sales. Inventories are discussed in chapter 6.

Special Rules for Related Persons

You cannot deduct business expenses and interest owed to a related person who uses the cash method of accounting ***until*** you make the payment and the corresponding amount is includible in the gross income of the related person. Determine the relationship, for this rule, as of the end of the tax year for which the expense or interest would otherwise be deductible. If a deduction is not allowed under this rule, the rule will continue to apply even if your relationship with the person ends before the expenses or interest are includible in the gross income of that person.

Related persons include members of your immediate family—only brothers and sisters (either whole or half), husband and wife, ancestors, and lineal descendants. For a list of other related persons, see Publication 538.

Special Methods

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

- Depreciation, discussed in Publication 946.
- Deduction for bad debts, discussed in chapter 14 of Publication 535.
- Installment sales, discussed in Publication 537.

Combination Method

Generally, you may use any combination of cash, accrual, and special methods of accounting if the combination clearly shows income and you use it consistently. However, the following restrictions apply.

- If inventories are necessary to account for your income, you must use an accrual method for purchases and sales. You can use the cash method for all other items of income and expenses. See *Inventories* in the discussion of expenses under *Accrual Method,* earlier.
- If you use the cash method for figuring your income, you must use the cash method for reporting your expenses.
- If you use an accrual method for figuring your income, you must use an accrual method for reporting your expenses.

Any combination that includes the cash method is treated as the cash method, subject to the limits applied to that method.

Change in Accounting Method

Once you have set up your accounting method, you must get IRS approval before you can change to another method. A change in accounting method not only includes a change in your overall system of accounting, but also a change in the treatment of any material item. For examples of changes that require approval and information on how to get approval for the change, see Publication 538.

3. Dispositions of Business Property

If you dispose of business property, you may have a gain or loss that you report on Form 1040. However, in some cases you may have a gain that is not taxable or a loss that is not deductible. This chapter will alert you to whether you have a disposition, how to figure the gain or loss, and where to report the gain or loss.

What Is a Disposition of Property?

A disposition of property includes the following transactions.

- You sell business 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 or right to exploit 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.
- Your bank or other financial institution 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.

For details about damaged, destroyed, or stolen property, see Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).* For details about the other dispositions, see chapter 1 in Publication 544, *Sales and Other Dispositions of Assets.*

Nontaxable exchanges. Certain exchanges of property are not taxable. This means that you are not taxed on any gain from the exchange and you cannot deduct any loss. Gain or loss on the exchange is not recognized it for tax purposes until you sell or otherwise dispose of the property you receive.

Like-kind exchanges. A like-kind exchange is the exchange of property for the same kind of 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 of the following.

- Business or investment property.
- Like property.

For details about like-kind exchanges, see chapter 1 in Publication 544.

Installment sales. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called installment sales. If you finance the buyer's purchase of your own property, instead of having the buyer get a loan or mortgage, you probably have an installment sale.

For more information about installment sales, see Publication 537, *Installment Sales.*

How Do I Figure a Gain or Loss?

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

If:	Then:
Adjusted basis is more than amount realized	You have a loss
Amount realized is more than adjusted basis	You have a gain

The following are definitions of basis, adjusted basis, amount realized, fair market value, and amount recognized. You need to know these definitions to figure your gain or loss.

Basis. Your cost or purchase price of property is usually its basis for figuring gain or loss from its sale or other disposition. However, if you got the property by gift, inheritance, or in some way other than buying it, you must use a basis other than its cost. For more information about basis, see Publication 551, *Basis of Assets.*

Adjusted basis. The adjusted basis of your property is your original cost or other basis plus certain additions and minus certain deductions such as depreciation and casualty losses.

Amount realized. 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 liabilities to which the property you transferred is subject, such as real estate taxes or a mortgage.

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

Amount recognized. Your gain or loss realized from a disposition of property is usually a recognized gain or loss for tax purposes. This means that you include the gain in gross income or deduct the loss from gross income. However, there are exceptions to this rule discussed earlier, under *Nontaxable exchanges.* 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 for more 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 in Publication 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 Publication 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, *Sales of Business Property.* If you have a taxable gain, you may also have to use Schedule D (Form 1040).

Like-kind exchanges. Use Form 8824, *Like-Kind Exchanges.* 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 Credit and Electric Vehicle Credit

Your general business credit consists of your carryover of business credits from prior years plus the total of your current year business credits. (The electric vehicle credit, which is not part of the general business credit, is explained at the end of this chapter.) You subtract these credits directly from your tax.

All of the following credits are part of the general business credit. The form you use to figure each credit is shown in parentheses. Be sure you also read *Claiming the General Business Credit* later because you may also have to fill out Form 3800 in certain situations.

Alcohol fuels credit (Form 6478). This credit applies to alcohol you sold or used as fuel. Alcohol, for purposes of this credit, includes ethanol and methanol. It does not include alcohol produced from petroleum, natural gas, coal, or peat. Nor does it include alcohol of less than 150 proof. For more information, see Form 6478.

Credit for contributions to selected community development corporations (Form 8847). This credit applies to part of each qualified cash contribution (including 10-year loans and long-term investments) you made to a selected community development corporation (CDC). Your contribution must be made to one of 20 CDCs selected by the Secretary of Housing and Urban Development (HUD). For more information, including a list of selected CDCs, see Form 8847.

Credit for taxes paid on certain employee tips (Form 8846). The 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. However, you cannot get credit for your part of social security and Medicare taxes on those tips that are used to meet the federal minimum wage rate that applies to the employee under the Fair Labor Standards Act. For more information, see Form 8846.

Disabled access credit (Form 8826). The disabled access 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.

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.

Enhanced oil recovery credit (Form 8830). This credit applies to your qualified enhanced oil recovery costs for the tax year. See Form 8830 for more information.

Indian employment credit (Form 8845). This credit applies to part of the qualified wages and health insurance costs (up to $20,000 per employee) you paid or incurred during a tax year that is more than the sum of the comparable costs you (or your predecessor) paid or incurred during calendar year 1993. The employee must be an enrolled member, or the spouse of an enrolled member, of an Indian tribe. The employee must perform substantially all of his or her services within an Indian reservation while living on or near the reservation. For more information, see Form 8845.

Investment credit (Form 3468). The investment credit is the sum of the following three credits.

- Reforestation credit.
- Rehabilitation credit.
- Energy credit.

Reforestation credit. The reforestation credit applies to part of the expenses you incur each year to forest or reforest property you hold for growing trees for sale or use in the commercial production of timber products. For information about these expenses, see chapter 12 in Publication 535.

Rehabilitation credit. This credit applies to expenses you incur to rehabilitate certain buildings. For more information, see the instructions for Form 3468.

Energy credit. This credit applies to certain expenses for solar or geothermal energy property you placed in service during the tax year. For more information, see the instructions for Form 3468.

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

Orphan drug credit (Form 8820). The orphan drug credit applies to qualified expenses incurred in testing certain drugs, known as “orphan drugs for rare diseases and conditions.” See Form 8820 for more information.

Renewable electricity production credit (Form 8835). The renewable electricity production credit is available to sellers of electricity. It is based on electricity that was sold to unrelated persons and was produced from qualified energy resources at a qualified facility during the 10-year period after the facility is placed in service. For more information, see Form 8835.

Research credit (Form 6765). The research credit is designed to encourage businesses to increase the amounts they spend on research and experimental activities. The credit is generally 20% of the amount by which your research expenses for the year are more than your base amount. For more information, see Form 6765.

CAUTION *This credit is not available for amounts paid or incurred after June 30, 1999.*

Work opportunity credit (Form 5884). The work opportunity credit provides an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. The amount of the credit depends on when the individual begins working for you.

- If the individual begins work ***before October 1, 1997***, the credit equals 35% of the qualified first-year wages you paid. The maximum credit for each individual is $2,100.
- If the individual begins work ***after September 30, 1997***, and works for you for at least 400 hours, the credit equals 40% of qualified first-year wages you paid. The maximum credit for that individual is $2,400. If an individual works less than 400 hours but at least 120 hours, the credit equals 25% of qualified first-year wages. The maximum credit for that individual is $1,500. No credit is allowed if the number of hours worked is less than 120.

For more information, see Form 5884.

State certification required. An individual is not considered a member of a targeted group unless your state employment security agency certifies him or her as a member. This certification requirement can be satisfied in either of the following ways.

- By the day the individual starts work for you, you can receive a certification from your state employment security agency that the individual is a member of a targeted group.
- By the day you offer a job to the individual, you can complete **Form 8850,** *Pre-Screening Notice and Certification Request for Work Opportunity and Welfare-to-Work Credits,* and send it to your state employment security agency within 21 days after the individual starts work. You must receive the certification before claiming the credit.

CAUTION *You cannot claim the work opportunity credit for wages paid to targeted group members who began work before October 1, 1996, or after June 30, 1999.*

Welfare-to-work credit (Form 8861). The welfare-to-work credit is a new credit you can take for qualified wages you pay to qualified long-term family assistance recipients who start work for you after December 31, 1997, and before July 1, 1999.

The credit is available only during the first 2 years of work. In the first year, the credit is 35% of the first $10,000 of qualified wages you pay an employee. In the second year, the credit is 50% of the first $10,000 of qualified wages paid to that employee.

Qualified wages. Qualified wages are generally wages subject to the Federal Unemployment Tax Act (FUTA) without regard to the $7,000 limit. (But see *Special rules for agricultural and railroad employees* later.) More than half the wages you pay must be for work done by employees in your trade or business. Qualified wages also generally include the following amounts that are normally excludable from the employee's gross income.

- Amounts received for medical care under accident and health plans.
- Employer contributions to accident and health plans.
- Amounts excludable under an educational assistance program (or that would be excludable but for the expiration of the program).
- Amounts excludable under a dependent care assistance program.

Qualified wages do not include the following items.

- Wages that were paid to an employee during any period when you received payments for that employee from a federally funded on-the-job training program.
- Wages for which you received work supplementation payments under the Social Security Act.
- Wages for services of replacement workers during a strike or lockout.

Special rules for agricultural and railroad employees. You can take the credit for agricultural employees who meet the other requirements if their services qualify under FUTA as agricultural labor for more than half of any pay period. Base your credit for each employee on the first $10,000 in wages subject to social security and Medicare taxes paid or incurred for that person during the year.

You can take the credit for railroad employees who meet the other requirements if more than half of their wages qualify under the Railroad Unemployment Insurance Act (RUIA). Base your credit for each employee on the first $833.33 per month of RUIA wages paid or incurred to that person.

Qualified long-term family assistance recipient. A qualified long-term family assistance recipient is an individual who is certified by a state employment security agency (SESA) as meeting one of the following requirements.

- The individual is a member of a family that has received assistance payments from AFDC or a successor program for at least 18 consecutive months ending on the hiring date.
- The individual is a member of a family that receives assistance payments from AFDC or a successor program for any 18 months (whether or not consecutive) starting after August 5, 1997, and is hired not more than 2 years after the end of the earliest 18-month period.
- The individual is a member of a family that stops being eligible for assistance payments after August

5, 1997, because federal or state law limits the maximum period that assistance is payable, and the individual is hired not more than 2 years after that eligibility for assistance ends.

CAUTION *You must receive certification from your SESA before claiming the credit. To receive certification, submit* **Form 8850,** Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits, *to your SESA no later than 21 days after the employee begins work for you.*

In addition to being certified as a qualified long-term family assistance recipient, the employee must meet all the following rules.

1) The employee must work for you for one of the following time periods.

   a) 180 days.

   b) 400 hours.

2) The employee cannot be your relative.

3) The employee cannot be an employee you rehired unless he or she was a qualified long-term family assistance recipient when employed earlier.

Coordination with the work opportunity credit. If you take the welfare-to-work credit for an employee during the tax year, you cannot take the work opportunity credit for that employee during that tax year.

More information. For more information about the welfare-to-work credit, see **Form 8861.**

Claiming the General Business Credit

If you meet all the following conditions, use only the form shown in parentheses with each of the credits discussed above.

- You have only one current year business credit.
- You have no carryback or carryover.
- The credit (other than the low-income housing credit) is not from a passive activity. See Form 8582–CR for information about passive activity credits.

If you do not meet all these conditions, you ***must*** also fill out Form 3800, *General Business Credit.*

CAUTION *Although the empowerment zone employment credit is part of the general business credit,* **never** *report it on Form 3800.*

Electric Vehicle Credit

This credit applies to a qualified electric vehicle you place in service during the year. You figure the credit on Form 8834. For information about the credit, see chapter 15 of Publication 535. That chapter explains what vehicle qualifies for the credit, the credit limit, how to claim the credit on your tax return, the rules for recapturing the credit, and adjustments to the basis of the vehicle.

5.

Business Income

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

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.

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

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.

CAUTION *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 Publication 54,* Tax Guide for U.S. Citizens and Resident Aliens Abroad.

Property or Services (Barter)

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 bartering. 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 his or her 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 his or her 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), federal unemployment taxes (FUTA), and income tax withholding. See *Employment Taxes* in chapter 1.

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, *Miscellaneous Income.*

For information about these forms, see the *Instructions for Forms 1099, 1098, 5498, and W–2G.*

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 or C–EZ. 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, instead of on Schedule C or C–EZ.

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 true no matter what accounting method or period you use.

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

Lease cancellation payments. Report payments that you receive from your lessee for canceling a lease in 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 get in your gross receipts on Schedule C or C–EZ. Prepaid rent and other payments described in the preceding *Real Estate Rents* discussion 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 must include in gross income interest accrued up to the time the loan became uncollectible. If the accrued interest later becomes uncollectible, you may be able to take a bad debt deduction. See chapter 14 in Publication 535.

Unstated interest. If little or no interest is charged on an installment sale, a part of each payment may be treated as unstated interest. See *Unstated Interest* in Publication 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,* later.

Canceled Debt

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

General Rule

Generally, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your gross income for tax purposes. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

Example. You got a mortgage loan on your home several years ago at a relatively low rate of interest. This year, in return for your paying off the loan early, the lending institution cancels part of the remaining principal. You must include the amount canceled in gross income.

Exceptions

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

Deductible debt. You do not realize income from debt cancellation to the extent that payment of the debt would have given rise to a deduction.

Example. You own a business and get accounting services on credit. Later, when you are having trouble paying your business debts (you are not bankrupt or insolvent), your accountant forgives part of the amount you owe for the accounting services. How you treat the cancellation depends on your method of accounting:

- Cash method – You do not include the debt cancellation in income because payment for the services would have been deductible as a business expense.
- An accrual method – You must include your accountant's cancellation of the debt in income. This is because, under an accrual method of accounting, you deduct the expense when you incur the liability, not when you pay it.

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

Price reduced after purchase. If you owe a debt to the seller for property you purchased and the seller reduces the amount you owe, generally you do not have income from the reduction. You treat the reduction as a purchase price adjustment and reduce your basis in the property.

Excluded Debt

Do not include a canceled debt in gross income in the following situations.

1) The cancellation takes place in a bankruptcy case under title 11 of the United States Code (the federal bankruptcy code). See Publication 908.
2) The cancellation takes place when you are insolvent and the amount excluded is not more than the amount by which you are insolvent. See Publication 908.
3) The canceled debt is a qualified farm debt and it is canceled by a qualified person. See chapter 4 in Publication 225.
4) The canceled debt is qualified real property business debt. This situation is explained next.

If a debt cancellation is excluded from income because it takes place under the bankruptcy code, items (2), (3), and (4) do not apply. If it takes place when you are insolvent, items (3) and (4) do not apply to the extent you are insolvent.

Qualified real property business debt. You can choose to exclude (up to certain limits) the cancellation of qualified real property business debt. If you make the choice, 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.

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.

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, insolvency, or of qualified farm debt. Do not take into account depreciable real property acquired in contemplation of the cancellation.

Choice. To make this choice, 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 the extensions). If you do not make the choice on a timely filed return, you must get approval from the IRS to make the choice.

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 or C–EZ 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 Publication 525.

Gains and losses. Do not report on Schedule C or C–EZ 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 or C–EZ. In general, you report them at their stated principal amount (minus any unstated interest) when you receive them.

Lost income payments. If you reduce or stop your business activities, report on Schedule C or C–EZ any payment you receive for the lost income of your business from insurance or other sources. Report it on Schedule C or C–EZ 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 that are 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 or C–EZ. However, do not include them if you properly treat them as a reduction of a related expense item, cost of goods sold, or a capital expenditure.

Recovery of items previously deducted. If you recover a bad debt, prior tax, or any item deducted in a previous year, include the recovery in income on Schedule C or C–EZ. However, if all or part of the deduction in earlier years did not reduce your tax, you do not have to include all of the recovery. 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.

Example. Joe Smith, a sole proprietor, had gross income of $8,000, a bad debt deduction of $300, and other allowable deductions of $7,700. He also had personal exemptions of $5,400. He would not pay income tax even if he did not deduct the bad debt. Therefore, he will not have to report as income any part of the $300 he may recover in any future year.

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 that you include in income part or all of the depreciation you deducted in previous years.

Business use of listed property falls to 50% or less. 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, *Sales of Business Property,* to figure the amount to include on Schedule C. See *Applying the Predominant Use Test* in chapter 4 of Publication 946. That chapter explains how to determine whether property is used more than 50% in your business.

Property not predominantly used in business. 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 it is not used predominantly in business, 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, *Sales of Business Property,* to figure the amount to include on Schedule C. See chapter 2 in Publication 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 report as income all or part of the gain due to depreciation. You figure the income due to depreciation recapture in Part III of Form 4797. For more information, see chapter 4 in Publication 544, *Sales and Other Dispositions of Assets.*

Items That Are Not Income

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

Loans. Money borrowed through a bona fide loan 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.

Leasehold improvements. If a tenant erects buildings or makes improvements to your property, the increase in the value of the property that is 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.

Exchange of property for like property. If you exchange your business property or property you hold for investment solely for property of a like kind to be used in your business or to be held for investment, no gain or loss is recognized. This means that the gain is not taxable and the loss is not deductible. A common type of nontaxable exchange is the trade-in of a business automobile for another business automobile. See chapter 1 in Publication 544 for information about nontaxable exchanges.

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 that you have shipped out on consignment is included in your inventory until it is sold.

Do not include merchandise that 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 that 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 options to renew into account 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.

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. See chapter 6 for more information on inventories.

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 that 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.

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

You must use the method you choose 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 usually are 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. 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.

Insurance proceeds. If you receive insurance or another type of reimbursement for your 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 Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness).*

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.*

6. How To Figure Cost of Goods Sold

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 maintain inventories.

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 personal service businesses, such as those of doctors, lawyers, carpenters, and painters. However, if those working in personal service businesses also sell or charge for the materials and supplies that are normally used in their businesses, this chapter applies to them.

Inventories

Inventories are necessary to clearly show income when the production, purchase, or sale of merchandise is an income-producing factor in your business. They are the starting point when figuring cost of goods sold.

The most common kinds of inventories are the following items.

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

You need to know the value of inventories at the beginning and end of each tax year to determine the 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 practices used for similar businesses. The method must clearly show income. To clearly show income, you must consistently use the same inventory method from year to year.

For more information about inventories, see Publication 538. That publication explains the following topics.

- What to include in inventory.
- What not to include in inventory.
- How to identify items in inventory.
- How to value items in inventory.
- How to claim a loss of inventory because of a casualty or theft.

CAUTION *If you maintain inventories in your business, you must use an accrual method of accounting for your purchases and sales. See chapter 2.*

Schedule C Lines 35 – 42

You figure your cost of goods sold by filling out lines 35–42 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 page 1, 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* earlier in this chapter).

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

Donation of inventory. If you donate any inventory item to a charitable organization, the amount of your deductible contribution is the fair market value of the item minus the amount that would be ordinary income if you had sold the item at its fair market value on the date of the gift.

You must remove from opening inventory the costs and expenses for the contributed property that you incurred in earlier years. They are not a part of cost of goods sold for figuring gross income for the year of the contribution. Costs and expenses for the contributed property that you incurred in the year of the contribution are deductible as part of cost of goods sold for that year, if this treatment of costs and expenses is proper under your accounting method. If you take such a deduction, those costs and expenses that you incurred in the year of the contribution are not treated as resulting in a basis for the contributed property.

Example 1. You are a calendar year taxpayer who uses an accrual method of accounting. In 1998, you contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 1997 properly included $400 of costs due to the acquisition of the property, and in 1997, you properly deducted $50 of administrative and other expenses attributable to the property as business expenses. The amount of the charitable contribution allowed for 1998 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 1998 must not include the $400. You remove that amount from opening inventory for 1998.

Example 2. If, in Example 1, you acquired the contributed property in 1998 at a cost of $400, you would include the $400 cost of the property in figuring the cost of goods sold for 1998, 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 the amount of a 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 may 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 get permission from the IRS. See Publication 538 for information on how to change it.

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. You do this by crediting the purchases or sales account with the cost of merchandise you withdraw for personal use. You should 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 usually are 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 that are properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, salable 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 salable product, but that is a necessary part of the manufacturing process.

Other labor. Other labor costs that are not properly chargeable to the cost of goods sold may be deducted as selling or administrative expenses. Generally, the only kinds of labor costs that are properly chargeable to your cost of goods sold are the direct or indirect labor costs, and certain other costs that are treated as overhead expenses properly charged to the manufacturing process, as discussed below 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 that you use in production, and merchandise that 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

You 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. Your ending inventory will become the beginning inventory of your next tax year.

Line 42 Cost of Goods Sold

When you subtract your closing inventory from the cost of goods available for sale, the remainder is your cost of goods sold during the tax year. When you subtract your cost of goods sold from your adjusted gross receipts, the remainder is your gross profit from sales. See chapter 7, which shows how to figure gross profit.

7.

Figuring Gross Profit

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.

If you are filing Schedule C–EZ, your gross profit is your gross receipts plus certain other amounts, explained later under *Additions to Gross Profit.*

If you are filing Schedule C, you figure your gross profit by first figuring your net receipts. Do this 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.

You do not have to figure the cost of goods sold if the sale of merchandise is not an income-producing factor for your business. Your gross profit is the same as your net receipts—gross receipts minus any refunds, rebates, or other allowances. Most professions and businesses that sell services rather than products can figure gross profit directly from net receipts in this way.

Illustration. This illustration of the gross profit section of the income statement of a retail business shows how gross profit is figured.

Income Statement
Year Ended December 31, 1998

Gross receipts	$400,000
Minus: Returns and allowances	14,940
Net receipts	$385,060
Minus: Cost of goods sold	288,140
Gross profit	$ 96,920

The cost of goods sold for this business is figured as follows:

Inventory at beginning of year		$ 37,845
Plus: Purchases	$285,900	
Minus: Items withdrawn for personal use	2,650	283,250
Goods available for sale		$321,095
Minus: Inventory at end of year		32,955
Cost of goods sold		$288,140

Items To Check

Consider the following items before figuring your gross profit.

Gross receipts. At the end of each business day, make sure your records balance with your actual cash and credit receipts for the day. You may find it helpful to use cash registers to keep track of receipts. You should also use a proper invoicing system and keep a separate bank account for your business.

Sales tax collected. Check to make sure your records show the correct sales tax collected.

Inventory at beginning of year. Compare this figure with last year's ending inventory. The two amounts should be the same.

Purchases. If you take any inventory items for your personal use — use them yourself, provide them to your family, or give them as personal gifts, etc. — be sure to remove them from the cost of goods sold. For details on how to adjust cost of goods sold, see *Merchandise withdrawn from sale* in chapter 6.

Inventory at end of year. Check to make sure your procedures for taking inventory are adequate. These procedures should provide you with a way of making sure that all items have been included in the inventory and that proper pricing techniques have been used.

Avoid using adding machine tapes as the only evidence for your inventory. Inventory forms are available at office supply stores. These forms have columns for recording the description, quantity, unit price, and value of each inventory item. Each page has space to record who made the physical count, who priced the items, who made the extensions, and who proofread the calculations. These forms will help satisfy you that the total inventory is accurate. They will also provide you with a permanent record to support its validity.

Inventories are explained in Publication 538.

Testing Gross Profit Accuracy

If you are in a retail or wholesale business, you can check the accuracy of your gross profit figure. First, divide gross profit by net receipts. The resulting percentage measures the average spread between the merchandise cost of goods sold and the selling price.

Next, compare this percentage to your markup policy. Little or no difference between these two percentages shows that your gross profit figure is accurate. A large difference between these percentages may show that you did not accurately figure sales, purchases, inventory, or other items of cost. You should determine the reason for the difference.

Example. Joe Able operates a retail business. On the average, he marks up his merchandise so that he will realize a gross profit of 33⅓% on its sales. The net receipts (gross receipts minus returns and allowances) shown on his income statement for 1998 is $300,000. His cost of goods sold is $200,000. This results in a gross profit of $100,000 ($300,000 – $200,000). To test the accuracy of this year's results, Joe divides gross profit ($100,000) by net receipts ($300,000). The resulting 33⅓% confirms his markup policy of 33⅓%.

Additions to Gross Profit

If your business has income from a source other than its regular business operations, enter the income on line 6 of Schedule C and add it to gross profit. The result is gross business income. If you use Schedule C–EZ, include the income on line 1 of the schedule. Some examples are income from an interest-bearing checking account, income from scrap sales, and amounts recovered from bad debts.

8. Business Expenses

You can deduct the current operating costs of running your business. They are known as business expenses. These are costs you do not have to capitalize or include in the cost of goods sold.

To be deductible, a business expense must be both ordinary and necessary. An ***ordinary*** expense is one that is common and accepted in your field of business. A ***necessary*** expense is one that is appropriate and helpful for your business. An expense does not have to be indispensable to be considered necessary.

If you have an expense that is partly for business and partly personal, you can deduct only the business part.

TIP *Keep records of your business expenses separately from records of your personal expenses.*

Bad Debts

If someone owes you money you cannot collect, you have a bad debt. A business bad debt is a loss from the worthlessness of a debt that falls in either of the following categories.

- It was created or acquired in your business, or
- It was closely related to your business when it became partly or totally worthless. (A debt is closely related to your business if your primary motive for incurring the debt is a business reason.)

Business bad debts are mainly the result of credit sales (accounts or notes receivable) to customers. They can also be the result of loans to suppliers, clients, employees, or distributors.

To take the bad debt deduction, there must be a true creditor-debtor relationship between you and the person or organization that owes you money. That person or organization must have a legal obligation to pay you a fixed sum of money. A bad debt may be claimed only if the income that the debt represents had been included in income in the year of deduction or in an earlier year. You must show that the debt is worthless and will remain that way. You must have taken reasonable steps to collect the debt.

For more information about business bad debts, see chapter 14 in Publication 535. That chapter explains the following.

- Definition of business bad debts.
- How to treat business bad debts.
- Where to deduct business bad debts.

For information about nonbusiness bad debts, see Publication 550, *Investment Income and Expenses.*

Car and Truck Expenses

If you use your car or truck in your business, you can deduct the costs of operating and maintaining your vehicle. You can deduct expenses for local transportation and traveling away from home overnight on business.

Local transportation. You can deduct local transportation expenses when you drive from one workplace to another within your tax home area. Generally, your tax home is your regular place of business, regardless of where you maintain your family home. It includes the entire city or general area in which your business is located.

Example. You operate a printing business out of rented office space. You use your van to deliver completed jobs to your customers. You can deduct the cost of round-trip transportation between your customers and your print shop.

CAUTION *You* **cannot** *deduct the costs of driving your car or truck between your home and your main or regular workplace. These costs are personal commuting expenses.*

Your workplace can be your home if you have an office in your home that qualifies as your ***principal place of business.*** See Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers)*, for information on determining if your home office qualifies as a principal place of business.

Example. You are a graphics designer. You operate your business out of your home. Your home qualifies as your principal place of business. You occasionally have to drive to your clients to deliver your completed work. You can deduct the cost of the round-trip transportation between your home and your clients.

Overnight travel. See *Travel, Meals, and Entertainment* later for the discussion on overnight travel expenses, which include meals and lodging.

What Are the Methods for Deducting Car and Truck Expenses?

For local transportation or overnight travel by car or truck, you generally can use either of the following methods.

- Actual expenses.
- Standard mileage rate.

Actual expenses. If you deduct actual expenses, you can deduct the cost of the following items:

Depreciation	Lease fees	Rental fees
Garage rent	Licenses	Repairs
Gas	Oil	Tires
Insurance	Parking fees	Tolls

If you use your vehicle for both business and personal purposes, you must divide your expenses between business and personal use.

Example. You are the sole proprietor of a flower shop. You drove your van 20,000 miles during the year. 16,000 miles were for delivering flowers to customers and 4,000 miles were for personal use. You can claim only 80% (16,000 ÷ 20,000) of the cost of operating your van as a business expense.

Standard mileage rate. Instead of figuring actual expenses, you may be able to use the standard mileage rate to figure the deductible costs of operating your car, van, pickup, or panel truck for business purposes. You can use the standard mileage rate for a vehicle that you own or lease. The standard mileage rate in 1998 is 32.5 cents for all business miles. To figure your deduction, multiply your business miles by 32.5 cents.

If you choose to take the standard mileage rate, you ***cannot*** deduct actual expenses except for business-related parking fees and tolls.

If you want to use the standard mileage rate for a car or truck, you must choose to use it in the first year you place the vehicle in service in business. In later years, you can choose to use the standard mileage rate or actual expenses, subject to special rules.

More information. For more information about the rules for claiming car and truck expenses, see Publication 463, *Travel, Entertainment, Gift, and Car Expenses.* That publication explains the following items.

- When you cannot use the standard mileage rate.
- How to figure depreciation on your vehicle.
- What to do if you lease a vehicle.
- What to do if you dispose of your vehicle.
- What records to keep.

Reimbursing Your Employees for Expenses

You generally can deduct the amount you reimburse your employees for car and truck expenses. The reimbursement you deduct and the manner in which you deduct it depend in part on whether you reimburse the expenses under an accountable plan or a nonaccountable plan. For details, see chapter 16 in Publication 535. That chapter explains accountable and nonaccountable plans and tells you whether to report the reimbursement on your employee's Form W–2, *Wage and Tax Statement.*

Depreciation

If property you acquire to use in your business has a useful life of more than one year, you generally cannot deduct the entire cost as a business expense in the year you acquire it. You must spread the cost over more than one tax year and deduct part of it each year on Schedule C or C–EZ. This method of deducting the cost of business property is called depreciation.

The discussion here is brief. You will find more information about depreciation in the following publications.

- Publication 946, *How To Depreciate Property.*
- Publication 534, *Depreciating Property Placed in Service Before 1987.*

What can be depreciated. You can depreciate property if it meets all of the following basic requirements.

- The property must be used in business or held for the production of income.
- The property must have a determinable useful life and that life must be longer than one year.
- The property must be something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.

What cannot be depreciated. You cannot depreciate any of the following items.

- Property placed in service and disposed of in the same year.
- Inventory (explained in chapter 6).
- Land.
- Repairs and replacements that do not increase the value of your property, make it more useful, or lengthen its useful life. You can deduct these amounts on line 21 of Schedule C.

Depreciation method. The method for depreciating most tangible property placed in service after 1986 is called the Modified Accelerated Cost Recovery System (MACRS). (Tangible property is any property that can be seen or touched.) MACRS is discussed in detail in Publication 946.

For property placed in service after 1980 and before 1987, you generally must use the Accelerated Cost Recovery System (ACRS). ACRS is discussed in detail in Publication 534.

Section 179 deduction. You can choose to deduct a limited amount (for 1998, up to $18,500) of the cost of certain depreciable property in the year you buy it for use in your business. This deduction is known as the "section 179 deduction." For more information, get Publication 946. It explains what costs you can and cannot deduct, how to figure the deduction, and when to recapture the deduction.

Listed property. There are limits on the depreciation deductions you can claim on listed property. The following items are listed property.

- Any passenger automobile.
- Any other transportation vehicle.
- Any property of a type generally used for entertainment, recreation, or amusement.
- Certain computer and related peripheral equipment.
- Any cellular telephone (or similar telecommunications equipment) placed in service or leased in a tax year beginning after 1989.

If you do not use your listed property more than 50% in business use during any tax year, you cannot choose the section 179 deduction and you must depreciate the property according to special rules. Listed property is discussed in detail in Publications 534 and 946.

Form 4562. Use Form 4562, *Depreciation and Amortization,* to report depreciation and the section 179 deduction. Use it if you are claiming any of the following.

- Depreciation on property placed in service during the tax year.
- A section 179 deduction.
- Depreciation on any listed property (regardless of when it was placed in service).

CAUTION *If you have to use Form 4562, you must file Schedule C instead of Schedule C–EZ.*

Insurance

You can generally deduct premiums you pay for the following kinds of insurance related to your trade or business.

1) Fire, theft, flood, or similar insurance.
2) Merchandise and inventory insurance.
3) Car and other vehicle insurance for vehicles used in your business if you do not use the standard mileage rate to figure your car expenses.
4) Credit insurance on losses from unpaid debts.
5) Liability insurance.
6) Use and occupancy and business interruption insurance. This insurance pays you for lost profits if your business is shut down due to a fire or other cause. Report the proceeds as ordinary income.
7) Overhead insurance. This insurance pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness.
8) Workers' compensation insurance set by state law that covers any claims for bodily injuries or job-related diseases suffered by employees in your business, regardless of fault.
9) Contributions to a state unemployment insurance fund. You can deduct these contributions as taxes if they are considered taxes under state law.

You cannot deduct the following kinds of insurance premiums.

- Life insurance premiums. You generally cannot deduct the cost of life insurance paid on your own life. However, see chapter 10 in Publication 535 for information on when life insurance premiums are deductible.
- Self-insurance reserve funds. You cannot deduct amounts credited to a reserve you set up for self-insurance. This applies even if you cannot get business insurance coverage for certain business risks. However, your actual losses may be deductible.
- Loss of earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability. However, see item (7) in the previous list.

Health insurance deduction for the self-employed. You may be able to deduct 45% of the amount you paid for medical insurance for yourself and your family. You deduct this amount on line 28 of Form 1040. To find out if you can take this deduction, see chapter 10 in Publication 535.

More information. For more information about deducting insurance, see chapter 10 in Publication 535. That chapter explains when to deduct insurance premiums and how to figure your health insurance deduction.

Interest

Interest is the amount you pay to use borrowed money. You can generally deduct on Schedule C or C–EZ all interest you pay or accrue in the tax year on a debt related to your business. To take the deduction, you must have a true obligation to pay a fixed or determinable sum of money.

You cannot deduct on Schedule C or C–EZ the interest you paid on personal loans. If a loan is part business and part personal, you must divide the interest between the personal part and the business part.

Example. In 1998, you paid $600 interest on a car loan. During 1998, you used the car 60% for business and 40% for personal purposes. You are claiming actual expenses on the car. You can only deduct $360 (60% of $600) for 1998 on Schedule C or C–EZ. The remaining interest of $240 is a nondeductible personal expense.

For more information about deducting interest, see chapter 8 in Publication 535. That chapter explains the following items.

- Interest you can deduct.
- Interest you cannot deduct.
- How to allocate interest between personal and business use.
- When to deduct interest.
- The rules for a below-market interest rate loan. (This is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.)

Legal and Professional Fees

Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses directly related to operating your business are deductible on Schedule C or C–EZ. However, you usually cannot deduct legal fees you pay to acquire business assets. Add them to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you take a business deduction only for the part of the fee related to your business. The personal portion of legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529, *Miscellaneous Deductions,* for more information.

Tax preparation fees. You can deduct on Schedule C or C–EZ the cost of preparing that part of your tax return relating to your business as a sole proprietor. You can deduct the remaining cost on Schedule A (Form 1040) if you itemize your deductions.

You can also deduct on Schedule C or C–EZ fees you pay or incur in resolving asserted tax deficiencies for your business as a sole proprietor or statutory employee.

Pension Plans

Retirement plans are savings plans that offer you tax advantages to set aside money for your own and your employee's retirement.

Contributions to a plan may be made by you, or by both you and your employees. If your plan meets the qualification requirements, you generally can deduct your contributions to the plan when you made them. Your employees generally are not taxed on your contributions or increased in the plan's assets until they are distributed to them.

You can choose the following retirement plans.

- Simplified employee pension (SEP).
- Savings incentive match plan for employees (SIMPLE).
- Keogh plan.
- Individual retirement arrangement (IRA).
- Roth IRA.

Simplified employee pension (SEP). A simplified employee pension (SEP) is a written plan that allows you to make deductible contributions toward your own and your employees' retirement without getting involved in the more complex Keogh plan.

Under a SEP, you make the contributions to an individual retirement arrangement (called a SEP-IRA), which is owned and controlled by you or one of your employees. The contributions to each employee's SEP-IRA cannot be more than the smaller of 15% of the employee's compensation or $30,000. The same limit applies to your own SEP-IRA.

Contributions to a SEP-IRA *may not* be designated as a Roth IRA, and contributions to a SEP-IRA will not affect the amount that an individual can contribute to a Roth IRA.

Contributions to a SEP-IRA are deductible within limits and generally are not taxable to the plan participants. The most you can deduct for your contributions for your employees is 15% of the compensation paid to them during the year. When figuring the deduction for your contributions made to your own SEP-IRA, compensation is your net earnings from self-employment after making certain adjustments.

You deduct contributions for yourself on line 29 of Form 1040. You deduct contributions for your employees on line 19 of Schedule C.

CAUTION *You are no longer allowed to establish a salary reduction arrangement under a SEP (called a SARSEP). However, participants (including new participants) in a SARSEP that was established before 1997 can continue to elect to have their employer contribute part of their pay to the plan.*

More information. For details about SEPs, see Publication 560, *Retirement Plans for Small Business.*

SIMPLE retirement plan. A SIMPLE plan is a written salary reduction arrangement that allows an employer with 100 or fewer employees to provide for elective contributions, mandatory employer contributions, and immediate 100% vesting to a SIMPLE retirement account on behalf of each eligible employee. Under a SIMPLE plan, employees may choose whether to make salary reduction contributions to the SIMPLE plan rather than receiving these amounts as part of their regular compensation. In addition, you will contribute matching or nonelective contributions on behalf of eligible employees. You deduct contributions for yourself on line 29 of Form 1040. You deduct all contributions (including matching contributions) on behalf of employees on the appropriate line of Schedule C.

You can set up this plan if you meet both the following requirements.

- Have no more than 100 employees who received at least $5,000 in compensation in the preceding year.
- Do not maintain another employer-sponsored retirement plan.

Contributions to a SIMPLE IRA *may not* be designated as a Roth IRA, and contributions to a SIMPLE

IRA will not affect the amount that an individual can contribute to a Roth IRA.

More information. For details about SIMPLE retirement plans, see Publication 560.

Keogh plan. A Keogh plan is a written plan that allows you to make contributions toward your own and your employees' retirement. But the rules for this plan are more complex than those for a SEP and a SIMPLE plan. Contributions are not taxed to your employees until plan benefits are distributed to them. You generally can deduct contributions to the plan. You deduct contributions for yourself on line 29 of Form 1040. You deduct contributions for your employees on line 19 of Schedule C.

For details about Keogh plans, see Publication 560.

Individual retirement arrangements (IRAs). You can set up and make contributions to a traditional individual retirement arrangement (IRA) if you receive taxable ***compensation*** (including self-employment earnings) during the year and do not reach age 70½ by the end of the year. You can have an IRA whether or not you are covered by any other retirement plan. However, your deduction for the IRA contributions may be reduced or eliminated if you or your spouse is covered by an employer's retirement plan (including any Keogh, SEP, or SIMPLE plan for your business).

Starting in 1998, there are two new kinds of IRAs, Roth IRAs and Education IRAs, to which some different rules apply. For more information about IRAs, see Publication 590, *Individual Retirement Arrangements (IRAs).*

Rent Expense

Rent is any amount you pay for the use of property that you do not own. In general, you can deduct rent on Schedule C or C–EZ only if the rent is for property that you use in your business. If you have or will receive equity in or title to the property, you cannot deduct the rent.

For more information about rent, see chapter 7 in Publication 535. That chapter explains the following items.

- The kinds of payments you can deduct as rent.
- How to deduct the cost of acquiring a lease.
- How to deduct the cost of improvements you make to leased property.

Taxes

You can deduct as business expenses various federal, state, and local taxes directly attributable to your business.

Income taxes. You can deduct as a business expense on Schedule C or C–EZ a state tax on ***gross income*** (as distinguished from net income) directly attributable to your business. You can deduct any other state and local income taxes if you itemize deductions on Schedule A (Form 1040). Do not deduct federal income tax.

Employment taxes. You can deduct the social security, Medicare, and federal unemployment (FUTA) taxes you paid out of your own funds as an employer. These taxes are explained in chapter 1. You can also deduct payments you made as an employer to a state unemployment compensation fund or to a state disability benefit fund. Deduct these payments as taxes.

Self-employment tax. You can deduct half of your self-employment tax on line 27 of Form 1040. Self-employment tax is explained in chapter 1.

Personal property tax. You can deduct as a business expense any tax imposed by a state or local government on personal property used in your business.

Registration fees for the right to use property within a state or local area are also deductible as a business expense.

Example. May and Julius Winter drove their car 7,000 business miles out of a total of 10,000 miles. They had to pay $25 for their state license tags and $20 for their city registration sticker. They also paid $235 in city personal property tax on the car, for a total of $280. They are claiming their actual car expenses. Because they used the car 70% for business, they can deduct 70% of the $280, or $196, as a business expense.

Real estate taxes. You can deduct as a business expense the real estate taxes you pay on your business property. Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxes must be based on the assessed value of the real estate and must be charged uniformly against all property under the jurisdiction of the taxing authority.

For more information about real estate taxes, see chapter 9 in Publication 535. That chapter explains special rules for deducting the following items.

- Taxes for local benefits, such as those for sidewalks, streets, water and sewerage systems.
- Real estate taxes when you buy or sell property during the year.
- Real estate taxes if you use an accrual method of accounting.

Sales tax. Sales tax you pay on a service or on the purchase or use of property is treated as part of the cost of the service or property. If the service or the cost or use of the property is a deductible business expense, you can deduct the tax as part of that service or cost. If the property is merchandise bought for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, the sales tax is added to the basis for depreciation. See Publication 551 for information on the basis of property.

Do not deduct state and local sales taxes imposed on the buyer that you were required to collect and pay over to the state or local government. Do not include these taxes in gross receipts or sales.

Excise taxes. You can deduct as a business expense on Schedule C or C–EZ all excise taxes that are ordinary and necessary expenses of carrying on your business. Excise taxes are discussed briefly in chapter 1.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that you use in your business usually are included as part of the cost of the fuel itself. Do not deduct these taxes as a separate item.

Travel, Meals, and Entertainment

This section briefly explains the kinds of travel and entertainment expenses you can deduct on Schedule C or C–EZ.

Travel expenses. These are expenses you have while traveling away from home for your business. You are traveling away from home if both the following conditions are met.

- Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work.
- You need to get sleep or rest to meet the demands of your work while away from home.

Generally, your ***tax home*** is your regular place of business, regardless of where you maintain your family home. It includes the entire city or general area in which your business is located.

The following is a brief summary of the expenses you can deduct.

Transportation. You can deduct the cost of airplane, train, or bus travel between your home and your business destination.

Taxi, commuter bus, and limousine. You can deduct fares for these and other types of transportation between the airport or station and your hotel, or between the hotel and your work location away from home.

Baggage and shipping. You can deduct the cost of sending baggage and sample or display material between your regular and temporary work locations.

Car or truck. You can deduct the costs of operating your vehicle when traveling away from home on business. You may deduct actual expenses or the standard mileage rate (discussed earlier under *Car and Truck Expenses),* including business-related tolls and parking. If you lease a car while away from home on business, you can deduct business-related expenses only.

Lodging. You can deduct the cost of lodging if your business trip is overnight or long enough to require you to get substantial sleep or rest to properly perform your duties.

Meals. You can deduct the cost of food, beverages, taxes, and related tips only if your business trip is overnight or long enough to require you to stop to get substantial sleep or rest. In most cases, you can deduct only 50% of these expenses.

Cleaning. You can deduct dry cleaning and laundry expenses while away from home overnight.

Telephone. You can deduct the cost of business calls while on your business trip, including business communication by fax machine or other communication devices.

Tips. You can deduct the tips you pay for any expenses listed above.

More information. For more information about travel expenses, see Publication 463. That publication also explains the following items.

- How much you can deduct for travel outside the United States.
- How much you can deduct for luxury water travel.
- How much you can deduct for attending a convention.
- What records to keep.

Entertainment expenses. You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee. In most cases, you can deduct only 50% of these expenses.

Examples of entertainment expenses are those for the following.

- Entertaining guests at nightclubs, athletic clubs, theaters, or sporting events.
- Providing meals, a hotel suite, or a car to business customers or their families.

To be deductible, the expenses must meet the rules listed in *Table 8–1.* For details about these rules, see Publication 463.

Reimbursing your employees for expenses. You generally can deduct the amount you reimburse your employees for travel and entertainment expenses. The reimbursement you deduct and the manner in which you deduct it depend in part on whether you reimburse the expenses under an accountable plan or a nonaccountable plan. For details, see chapter 16 in Publication 535. That chapter explains accountable and nonaccountable plans and tells you whether to report the reimbursement on your employee's Form W–2, *Wage and Tax Statement.*

Employees' Pay

You can generally deduct salaries, wages, and fringe benefits you pay to your employees for their services on Schedule C. You can also deduct amounts you pay for your employees to employee benefit programs.

You can deduct salaries or wages if they meet all the following requirements.

- Ordinary and necessary.
- Reasonable.
- For services performed.

Table 8-1. **When Are Entertainment Expenses Deductible?**

(The following is a summary of the rules for deducting entertainment expenses. For more details about these rules, see Publication 463.)

General Rule	You can deduct ordinary and necessary expenses to entertain a client, customer, or employee if the expenses meet the directly related test or the associated test.
Definitions	• Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation, and includes meals provided to a customer or client. • An ordinary expense is one that is common and accepted in your field of business, trade, or profession. • A necessary expense is one that is helpful and appropriate, although not necessarily indispensable, for your business.
Tests to be met	**Directly related test** • Entertainment took place in a clear business setting, ***or*** • Main purpose of entertainment was the active conduct of business, **and** You did engage in business with the person during the entertainment period, **and** You had more than a general expectation of getting income or some other specific business benefit.
	Associated test • Entertainment is associated with your trade or business, ***and*** • Entertainment directly precedes or follows a substantial business discussion.
Other rules	• You cannot deduct the cost of your meal as an entertainment expense if you are claiming the meal as a travel expense. • You can deduct expenses only to the extent they are not lavish or extravagant under the circumstances. • You generally can deduct only 50% of your unreimbursed entertainment expenses.

- Paid or incurred.

Chapter 2 in Publication 535 explains and defines these requirements.

You cannot deduct your own salary or any personal withdrawals you make from your business. You are not an employee of the business.

CAUTION *If you had employees during the year, you must use Schedule C. You cannot use Schedule C–EZ.*

Some of the payments you may be able to deduct are listed below. For an explanation of each of these items, see chapter 2 in Publication 535.

- Bonuses.
- Gifts of nominal value, such as turkeys and hams.
- Employee achievement awards that meet certain requirements.
- Loans or advances that you do not expect the employee to repay if they are for personal services actually performed.
- Vacation pay.
- Compensation for sickness and injury.
- Cost of furnishing meals and lodging to employees.
- Reimbursements for employee business expenses.
- Educational expenses.
- Moving expenses.
- A capital asset or business asset that you transfer to one of your employees as payment for services.

Fringe benefits. A fringe benefit is a form of pay provided to any person for the performance of services by that person. You can deduct the cost of fringe benefits you provide. However, you must include in your employees' pay the value of fringe benefits you provide unless the benefits are specifically excluded from income by law or the employee pays for them. The following are examples of fringe benefits.

- The use of a car.
- A flight on an airplane.
- A vacation.
- A discount on property or services.
- A membership in a country club or other social club.
- A ticket to an entertainment or sporting event.

For information on the rules that apply to fringe benefits, see chapter 4 in Publication 535. That chapter explains how to value fringe benefits and determine whether fringe benefits are excludable from your employees' incomes.

Employee benefit programs. You can generally deduct amounts you spend on employee benefit programs as a business expense. You can also generally exclude from an employee's income the value of part or all of the benefits you provide. Employee benefit programs include the following.

- Adoption assistance.
- Cafeteria plans.
- Dependent care assistance.
- Educational assistance.
- Group-term life insurance.
- Accident and health plans (including medical savings accounts).
- Welfare benefit funds.

More information. For more information about employee benefit programs, see chapter 5 in Publication 535. That chapter explains what costs you can deduct and which part of the benefits you can exclude from an employee's income.

Business Use of Your Home

You may be able to deduct the expenses for the part of your home you use for business. The business use of your home ***must meet strict requirements*** before you can deduct any of these expenses. You can take a deduction for the business use of your home only if you use a specific part of it both ***exclusively*** and ***regularly*** in any of the following ways.

- As your principal place of business.
- As a place where you meet or deal with customers or clients in the normal course of your business.
- In connection with your business, if the part is a structure that is not attached to your home.

You do not have to meet the exclusive use test if you use part of your home in either of the following ways.

- For the storage of inventory or product samples.
- As a day-care facility.

For an explanation of these exceptions, see Publication 587, *Business Use of Your Home (Including Use by Day-Care Providers).*

Deduction limit. If your gross income from the business use of your home equals or exceeds your total business expenses (including depreciation), you can deduct all of your expenses for the business use of your home. But if your gross income from that use is less than your total business expenses, your deduction for certain expenses for the business use of your home is limited. See Publication 587 to find out how to figure the deduction limit.

Use Form 8829, *Expenses for Business Use of Your Home,* to figure your deduction.

Beginning in 1999, new rules allow your home office to qualify as your principal place of business if the following tests are met.

- You use it exclusively and regularly for administrative or management activities of your trade or business.
- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

If your expenses qualify, deduct them on your 1999 tax return, which is due April 17, 2000.

Other Expenses You Can Deduct

You may also be able to deduct the following expenses. See Publication 535 to find out if you can deduct them.

- Advertising.
- Black lung benefit trust fund contributions.
- Clean-fuel vehicles and refueling property.
- Donations to professional organizations.
- Educational expenses.
- Environmental cleanup costs.
- Interview expense allowances.
- Impairment-related expenses.
- Licenses and regulatory fees.
- Moving machinery.
- Outplacement services.
- Penalties and fines you pay for late performance or nonperformance of a contract.
- Repairs that keep your property in a normal efficient operating condition.
- Repayments of income (claim of right).
- Subscriptions to trade or professional publications.
- Supplies and materials.
- Utilities.

Expenses You Cannot Deduct

You usually cannot deduct the following as business expenses. For more information, see Publication 535.

- Bribes and kickbacks.
- Business start-up costs.
- Charitable contributions.
- Demolition expenses or losses.
- Dues to business, social, athletic, luncheon, sporting, airline, and hotel clubs.
- Lobbying expenses.
- Penalties and fines you pay to a governmental agency or instrumentality because you broke the law.
- Political contributions.
- Repairs that add to the value of your property or significantly increase its life.

9. Figuring Net Profit or Loss

After figuring your business income and expenses, you are ready to figure the net profit or net loss from your business. You do this by subtracting business expenses from business income. If your expenses are less than your income, the difference is net profit and becomes part of your income on page 1 of Form 1040. If your expenses are more than your income, the difference is a net loss. You usually can deduct it from gross income on page 1 of Form 1040. But in some situations your loss is limited. This chapter briefly explains two of those situations. Other situations that may limit your loss are explained in the instructions for line 32 of Schedule C.

CAUTION *If you have more than one business, you must figure your net profit or loss for each business on a separate Schedule C.*

Net Operating Losses (NOLs)

If a negative figure appears on line 37 of Form 1040, you may have a net operating loss (NOL). You can use an NOL by deducting it from your income in another year or years.

To have an NOL, your loss must be caused by one of the following kinds of deductions.

- Deductions from a trade or business.
- Deductions from your work as an employee.
- Deductions for casualty and theft losses.

A loss from operating a business is the most common reason for an NOL.

For details about NOLs, get Publication 536. It explains how to figure an NOL, when to use it, how to claim an NOL deduction, and how to figure an NOL carryover.

Not-for-Profit Activities

If you do not carry on your business or investment activity to make a profit, there is a limit on the deductions you can take for that activity. You cannot use a loss from the activity to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

For details about not-for-profit activities, see chapter 1 in Publication 535. That chapter explains how to determine whether your activity is carried on to make a profit and how to figure the amount of loss you can deduct.

10. Sample Returns

This chapter shows how two sole proprietors fill out their income tax returns. Susan J. Brown reports her net profit from her business on Schedule C. She cannot use Schedule C–EZ. Stanley Price reports his net profit from his business on Schedule C–EZ.

Preparing the Return for Susan J. Brown

Susan J. Brown owns and operates Family Fashions, a ready-to-wear clothing shop. She uses an accrual method of accounting and files her return on a calendar year basis.

Five employees worked in her shop during the year. She filed all the necessary employment tax forms and made the required tax deposits. See *Employment Taxes* in chapter 1.

Schedule C

First, Susan fills in the information required at the top of Schedule C. She starts by entering her name and social security number. Then she completes lines A through H.

Line A. She enters her principal business.

Line B. She enters 448140, which is the 6-digit business code for a family clothing shop. She found the code on page C–9 of the instructions for Schedule C. Susan locates the major business category that describes her business. She reads down the items under “Retail Trade” to find 448140—“Family clothing stores.”

Line C. Susan enters the name of her business—“Family Fashions.”

Line D. She enters her employer identification number (EIN). She has to have an EIN because she has employees. For information about EINs, see *Identification Numbers* in chapter 1.

Line E. She enters her business address.

Line F. She checks box 2 for accrual method of accounting.

Line G. Susan checks “Yes” because she materially participated in her business during the year. The material participation rules are explained in the *Instructions for Schedule C.*

Line H. She leaves the box blank because she did not start or acquire her business during the year.

Part I—Income and Part III—Cost of Goods Sold

Susan enters items of income in Part I.

Line 1. Susan enters her total sales of $397,742 for the year.

Line 2. She enters the refunds she gave on merchandise her customers returned, as well as other adjustments she made to customers' purchases. They total $1,442.

Line 4. Susan uses Part III on page 2 of Schedule C to figure her cost of goods sold.

Part III, line 35. Her inventory at the beginning of the year, $42,843, is the same as her inventory at the end of last year. This figure matches the amount on Part III, line 41 of her last year's Schedule C.

Part III, line 36. The total cost of goods she bought to sell to customers, minus the cost of the goods she returned to her suppliers, was $241,026. From this stock, she withdrew clothing and accessories for her own use that cost $774. She subtracts the cost of these items from her total purchases to figure net purchases of $240,252.

Part III, line 40. She adds her net purchases to her beginning inventory. This sum is the total goods Susan had available for sale during the year.

Part III, line 41. Susan's inventory at the end of the year was $43,746.

Part III, line 42. Susan subtracts her inventory at the end of the year (line 41) from the goods that were available for sale (line 40) to get the cost of goods sold during the year. For more information on inventories and cost of goods sold, see chapter 6.

Line 5. Susan's gross profit, $156,951, is the difference between her net sales (line 3) and the cost of goods sold (line 4).

Line 7. Because Susan did not have any income to report on line 6, the gross income is the same as the gross profit (line 5).

Part II — Expenses

Susan enters her expense items in Part II.

Line 8. Susan paid $3,500 for ads.

Line 9. During the year, Susan determined that she would not be able to collect $479 from bad checks and deducted this amount as bad debts. See chapter 8.

Line 10. She used her van 75% for business during the year. She spent a total of $3,000 for gas and oil. She can deduct 75% of $3,000 or $2,250 for gas and oil. Other van expenses include $713 (75% of $950) for insurance, $812 (75% of $1,083) for repairs and upkeep, and $75 (75% of $100) for tags. She enters the total, $3,850, on line 10.

Line 13. Susan enters the $4,277 depreciation from Form 4562, discussed later.

Line 15. Susan's $238 deduction is for insurance on her business property (van insurance is included in line 10). The deduction is only for premiums that give her coverage for the year.

Line 16b. Susan had borrowed money to use in her business. The interest on these loans was $2,633 for the year.

Line 18. The $216 Susan paid for postage during the year is her only office expense.

Line 20b. Her rent for the store was $1,000 a month, or $12,000 for the year.

Line 21. She had her store counters refinished and other painting was done at a total cost of $964.

Line 22. She spent $1,203 on supplies.

Line 23. Susan renewed her business license and paid property tax on her store fixtures. She also paid the employer's share of social security and Medicare taxes for her employees, and paid state and federal unemployment taxes. She enters the total of all these taxes, $5,727, on this line. See *Taxes* in chapter 8.

Line 25. Susan's total expense for heat, light, and telephone for the year is $3,570.

Line 26. Susan paid her employees a total of $59,050 for the year. She does not include in wages any amounts she paid to herself or withdrew from the business for her own use.

Line 27. Susan enters the total of her other business expenses on this line. These expenses are not included on lines 8–26. She lists the type and amount of the expenses separately in Part V of page 2, and carries the total entered on line 48 to line 27. See chapter 8 for expenses you can or cannot deduct.

Line 28. Susan adds all her deductions listed in Part II and enters the total on this line.

Line 29. She subtracts her total deductions (line 28) from her gross income (line 7). Susan has a tentative profit of $51,166.

Line 30. Susan did not use any part of her home for business, so she does not make an entry here.

Line 31. Susan has a net profit of $51,166 (line 29 minus line 30). She enters her net profit here, on line 12 of Form 1040, and on line 2, Section A of Schedule SE (Form 1040).

Line 32. Susan does not have a loss, so she skips this line. If she had a loss and she was not "at risk" for all of her investment in the business, the amount of loss she could enter on line 12 of Form 1040 might be limited. For an explanation of an investment "at risk," see the Schedule C instructions for line 32.

Form 4562—Depreciation and Amortization

Susan figures her depreciation for the year on Form 4562.

Lines 1 through 13. On May 19, Susan bought a $200 adding machine and placed it in service on that same day. She chose to deduct its cost as a section 179 deduction. See Publication 946 for information about the section 179 deduction.

Line 15b. On May 19, Susan also bought and placed in service some clothing racks. They cost $800. She uses the Modified Accelerated Cost Recovery System (MACRS) to figure depreciation. The racks are 5-year property. Susan figures depreciation using the half-year convention and the 200% declining balance method. See Publication 946 for information about MACRS.

Line 19. Susan enters $1,117 for depreciation on assets she purchased before 1987. For items bought after 1980 and before 1987, she uses the regular Accelerated Cost Recovery System (ACRS) percentages. For items bought before 1981, she uses the straight-line method. See Publication 534 for information about ACRS.

Line 20. Susan enters the depreciation on listed property from line 26 (explained next).

Lines 24 and 26. On March 20, Susan bought a van that she placed in service in her business. The van weighs over 6,000 pounds; therefore, it is not a passenger automobile for the special deduction limits. The van is 5-year property. She figures depreciation using the 200% declining balance method and applying the half-year convention under MACRS. The van cost $18,667. Her basis for depreciation is 75% of $18,667, or $14,000, because only 75% of the total miles she drove during the year were business miles. Susan does not choose to deduct any part of the cost of the van as a section 179 deduction.

Lines 28 through 34. Because Susan is a sole proprietor, she must complete lines 28 through 34.

Schedule SE—Self-Employment Tax

After Susan prepares Schedule C, she fills out Schedule SE. She starts by entering her name and social security number at the top of the schedule. Then she reads the chart on page 1 of the schedule which tells her she can use *Section A—Short Schedule SE* to figure her self-employment tax. She fills out the following lines in Section A.

Lines 2 and 3. She enters $51,166. This is her net profit from line 31 of Schedule C.

Line 4. She multiplies $51,166 by .9235 to get her net earnings from self-employment ($47,252). This is the amount of her net profit subject to self-employment tax.

Line 5. Because the amount on line 4 is less than $68,400, Susan multiplies the amount on line 4 ($47,252) by .153 to get her self-employment tax of $7,230. She enters that amount here and on line 50 of Form 1040.

Line 6. She multiplies the amount on line 5 by .5 to get her deduction for one-half of self-employment tax of $3,615. She enters that amount here and on line 27 of Form 1040.

Form 1040

Susan fills out Form 1040 as follows:

Name, address, and social security number. Susan fills in her name, home address, and social security number.

Presidential election campaign fund. Susan chooses to have $3 go to this fund. She checks the box under "Yes."

Line 1. Susan checks the box on this line because she is filing as single.

Lines 6a and 6d. Susan claims an exemption for herself. She checks the box next to “Yourself” and enters “1” in the far right-hand entry space. She also enters “1” in the box on line 6d.

Line 8a. Susan enters $388 of taxable interest that was credited to her personal savings account for the year.

Line 9. Susan enters $100 of dividends she received from CBA Corporation.

Line 12. She enters her business net profit from line 31 of Schedule C.

Line 22. Susan adds the amounts on lines 7 through 21 and enters the total, $51,654.

Line 27. Susan enters one-half of her self-employment tax. She got this amount from line 6 in Section A of Schedule SE.

Line 28. Susan enters $1,440 as her deduction for one-half of her health insurance. This is 45% of her $3,200 in health insurance premiums for the year.

Line 29. Susan enters her simplified employee pension (SEP) deduction of $2,264. She figures her deduction by using Publication 560, *Retirement Plans for Small Business.*

Line 32. Susan adds the amounts on lines 23 through 31a and enters the total, $7,319.

Line 33. Susan subtracts the amount on line 32 from the amount on line 22 to arrive at her adjusted gross income, $44,335. She also enters this amount on line 34.

Line 36. She enters $4,250. This is the standard deduction for a single filer.

Line 37. Susan subtracts line 36 from line 34 to get $40,085.

Line 38. She multiplies $2,700 by the number of exemptions claimed on line 6d to get her total exemptions, $2,700.

Line 39. Susan subtracts line 38 from line 37 to get her taxable income, $37,385.

Line 40. Susan uses the Tax Table in the Form 1040 instructions to figure her income tax. In the Tax Table she looks for the income bracket that includes $37,385. She finds the bracket for incomes of at least $37,350, but less than $37,400 and sees that the tax for a person filing as single is $7,170. She enters this amount here.

Lines 48 and 49. Because Susan does not have any of the credits listed on lines 41 through 47, she enters -0- on line 48, subtracts it from line 40, and enters $7,170 on line 49.

Line 50. She enters $7,230 from line 5 in Section A of Schedule SE.

Line 56. Susan adds the amounts on lines 49 through 55 and enters the total, $14,400.

Line 58. She enters $14,267 estimated tax payments she made for the year.

Line 64. She enters $14,267.

Line 68. Susan subtracts line 64 from line 56 to get the amount of tax she owes, $133. She writes a check payable to the United States Treasury for $133. On the check she writes her social security number, her daytime telephone number, and “1998 Form 1040.” Her name and address are printed on the check. She sends her payment with Form 1040–V, *Payment Voucher* (not illustrated). She fills out that form and sends it to the IRS with her check and tax return.

Signing and assembling the return. She signs her name and enters the date signed and her occupation. She makes a copy of the return, schedules, and form for her records. Then she assembles her original Form 1040, Schedules C and SE, and Form 4562 in that order. (See “Attachment Sequence Number” in the upper right corner of each schedule or form.) Finally, she mails it to the IRS.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1998** IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1998, or other tax year beginning , 1998, ending , 19 OMB No. 1545-0074

Label

(See instructions on page 18.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE

Your first name and initial	Last name	Your social security number
SUSAN J	BROWN	111 00 1111
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 18.	Apt. no.	
1313 EMPIRE BLVD		
City, town or post office, state, and ZIP code. If you have a foreign address, see page 18.		
FRANKLIN NY 18725		

IMPORTANT! You **must** enter your SSN(s) above.

Presidential Election Campaign (See page 18.)

	Yes	No
Do you want $3 to go to this fund?	✓	
If a joint return, does your spouse want $3 to go to this fund?		

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Filing Status

Check only one box.

1 ☑ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 18.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 18.)

Exemptions

6a ☑ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a

b ☐ **Spouse**

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
			☐
			☐
			☐
			☐
			☐
			☐

If more than six dependents, see page 19.

d Total number of exemptions claimed

No. of boxes checked on 6a and 6b: 1
No. of your children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 19)

Dependents on 6c not entered above

Add numbers entered on lines above ▶ 1

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 20.

Enclose, but do not staple, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7		
8a	**Taxable** interest. Attach Schedule B if required		8a	388	00
b	**Tax-exempt** interest. DO NOT include on line 8a	8b			
9	Ordinary dividends. Attach Schedule B if required		9	100	00
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 21)		10		
11	Alimony received		11		
12	Business income or (loss). Attach Schedule C or C-EZ		12	51,166	00
13	Capital gain or (loss). Attach Schedule D		13		
14	Other gains or (losses). Attach Form 4797		14		
15a	Total IRA distributions	15a	**b** Taxable amount (see page 22) 15b		
16a	Total pensions and annuities	16a	**b** Taxable amount (see page 22) 16b		
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17		
18	Farm income or (loss). Attach Schedule F		18		
19	Unemployment compensation		19		
20a	Social security benefits	20a	**b** Taxable amount (see page 24) 20b		
21	Other income. List type and amount—see page 24		21		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22	51,654	00

Adjusted Gross Income

If line 33 is under $30,095 (under $10,030 if a child did not live with you), see EIC inst. on page 36.

23	IRA deduction (see page 25)	23					
24	Student loan interest deduction (see page 27)	24					
25	Medical savings account deduction. Attach Form 8853	25					
26	Moving expenses. Attach Form 3903	26					
27	One-half of self-employment tax. Attach Schedule SE	27	3,615	00			
28	Self-employed health insurance deduction (see page 28)	28	1,440	00			
29	Keogh and self-employed SEP and SIMPLE plans	29	2,264	00			
30	Penalty on early withdrawal of savings	30					
31a	Alimony paid **b** Recipient's SSN ▶	31a					
32	Add lines 23 through 31a				32	7,319	00
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶				33	44,335	00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 51. Cat. No. 11320B Form **1040** (1998)

Tax and Credits

34	Amount from line 33 (adjusted gross income)	34	44,335 00
35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a ☐		
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here ▶ 35b ☐		
36	Enter the **larger** of your **itemized deductions** from Schedule A, line 28, **OR standard deduction** shown on the left. **But** see page 30 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent	36	4,250 00
37	Subtract line 36 from line 34	37	40,085 00
38	If line 34 is $93,400 or less, multiply $2,700 by the total number of exemptions claimed on line 6d. If line 34 is over $93,400, see the worksheet on page 30 for the amount to enter	38	2,700 00
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	37,385 00
40	**Tax.** See page 30. Check if any tax from **a** ☐ Form(s) 8814 **b** ☐ Form 4972 ▶	40	7,170 00
41	Credit for child and dependent care expenses. Attach Form 2441	41	
42	Credit for the elderly or the disabled. Attach Schedule R	42	
43	Child tax credit (see page 31)	43	
44	Education credits. Attach Form 8863	44	
45	Adoption credit. Attach Form 8839	45	
46	Foreign tax credit. Attach Form 1116 if required	46	
47	Other. Check if from **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify) ______	47	
48	Add lines 41 through 47. These are your **total credits**	48	- 0 -
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶	49	7,170 00

Standard Deduction for Most People
Single: $4,250
Head of household: $6,250
Married filing jointly or Qualifying widow(er): $7,100
Married filing separately: $3,550

Other Taxes

50	Self-employment tax. Attach Schedule SE	50	7,230 00
51	Alternative minimum tax. Attach Form 6251	51	
52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	52	
53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required	53	
54	Advance earned income credit payments from Form(s) W-2	54	
55	Household employment taxes. Attach Schedule H	55	
56	Add lines 49 through 55. This is your **total tax** ▶	56	14,400 00

Payments

Attach Forms W-2 and W-2G on the front. Also attach Form 1099-R if tax was withheld.

57	Federal income tax withheld from Forms W-2 and 1099	57	
58	1998 estimated tax payments and amount applied from 1997 return	58	14,267 00
59a	**Earned income credit.** Attach Schedule EIC if you have a qualifying child **b** Nontaxable earned income: amount ▶ ______ and type ▶ ______	59a	
60	Additional child tax credit. Attach Form 8812	60	
61	Amount paid with Form 4868 (request for extension)	61	
62	Excess social security and RRTA tax withheld (see page 43)	62	
63	Other payments. Check if from **a** ☐ Form 2439 **b** ☐ Form 4136	63	
64	Add lines 57, 58, 59a, and 60 through 63. These are your **total payments** ▶	64	14,267 00

Refund

Have it directly deposited! See page 44 and fill in 66b, 66c, and 66d.

65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you **OVERPAID**	65	
66a	Amount of line 65 you want **REFUNDED TO YOU** ▶	66a	
▶ b	Routing number ______ ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number ______		
67	Amount of line 65 you want **APPLIED TO YOUR 1999 ESTIMATED TAX** ▶	67	

Amount You Owe

68	If line 56 is more than line 64, subtract line 64 from line 56. This is the **AMOUNT YOU OWE**. For details on how to pay, see page 44 ▶	68	133 00
69	Estimated tax penalty. Also include on line 68	69	

Sign Here

Joint return? See page 18. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime telephone number (optional)
Susan J. Brown	3/27/99	Retail shop owner	( )
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address			EIN
			ZIP code

SCHEDULE C (Form 1040)

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.

► Attach to Form 1040 or Form 1041. ► See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

1998

Attachment Sequence No. **09**

Name of proprietor: Susan J. Brown	**Social security number (SSN)**: 111 00 1111
A Principal business or profession, including product or service (see page C-1): Retail, Family clothing	**B Enter NEW code from pages C-8 & 9** ► 4 4 8 1 4 0
C Business name. If no separate business name, leave blank.: Family Fashions	**D Employer ID number (EIN), if any**: 10 1234567

E Business address (including suite or room no.) ► 725 Big Sur Drive
City, town or post office, state, and ZIP code: Franklin, NY 18725

F Accounting method: **(1)** ☐ Cash **(2)** ☑ Accrual **(3)** ☐ Other (specify) ►

G Did you "materially participate" in the operation of this business during 1998? If "No," see page C-2 for limit on losses ☑ **Yes** ☐ **No**

H If you started or acquired this business during 1998, check here ► ☐

Part I Income

1	Gross receipts or sales. **Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here* ► ☐	1	397,742	00
2	Returns and allowances	2	1,442	00
3	Subtract line 2 from line 1	3	396,300	00
4	Cost of goods sold (from line 42 on page 2)	4	239,349	00
5	**Gross profit.** Subtract line 4 from line 3	5	156,951	00
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6		
7	**Gross income.** Add lines 5 and 6 ►	7	156,951	00

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

8	Advertising	8	3,500	00	19	Pension and profit-sharing plans	19		
9	Bad debts from sales or services (see page C-3)	9	479	00	20	Rent or lease (see page C-5):			
					a	Vehicles, machinery, and equipment	20a		
10	Car and truck expenses (see page C-3)	10	3,850	00	b	Other business property	20b	12,000	00
					21	Repairs and maintenance	21	964	00
11	Commissions and fees	11			22	Supplies (not included in Part III)	22	1,203	00
12	Depletion	12			23	Taxes and licenses	23	5,727	00
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13	4,277	00	24	Travel, meals, and entertainment:			
					a	Travel	24a		
14	Employee benefit programs (other than on line 19)	14			b	Meals and entertainment			
15	Insurance (other than health)	15	238	00	c	Enter 50% of line 24b subject to limitations (see page C-6)			
16	Interest:								
a	Mortgage (paid to banks, etc.)	16a			d	Subtract line 24c from line 24b	24d		
b	Other	16b	2,633	00	25	Utilities	25	3,570	00
17	Legal and professional services	17			26	Wages (less employment credits)	26	59,050	00
18	Office expense	18	216	00	27	Other expenses (from line 48 on page 2)	27	8,078	00

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 in columns ►	28	105,785	00
29	Tentative profit (loss). Subtract line 28 from line 7	29	51,166	00
30	Expenses for business use of your home. Attach **Form 8829**	30		
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you MUST go on to line 32.	31	51,166	00

32 If you have a loss, check the box that describes your investment in this activity (see page C-6).
• If you checked 32a, enter the loss on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2** (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3.
• If you checked 32b, you MUST attach **Form 6198.**

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11334P **Schedule C (Form 1040) 1998**

Part III Cost of Goods Sold (see page C-7)

33 Method(s) used to value closing inventory: a ☑ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☑ No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	42,843	00
36 Purchases less cost of items withdrawn for personal use	36	240,252	00
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38		
39 Other costs	39		
40 Add lines 35 through 39	40	283,095	00
41 Inventory at end of year	41	43,746	00
42 **Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	239,349	00

Part IV Information on Your Vehicle. Complete this part ONLY if you are claiming car or truck expenses on line 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file.

43 When did you place your vehicle in service for business purposes? (month, day, year) ► ____/____/____

44 Of the total number of miles you drove your vehicle during 1998, enter the number of miles you used your vehicle for:

a Business ________ b Commuting ________ c Other ________

45 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

46 Was your vehicle available for use during off-duty hours? ☐ Yes ☐ No

47a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

Bank service charges		180	00
Chamber of Commerce		60	00
Free Credit Card Co.		6,000	00
Trash removal		1,600	00
Window washing		238	00
48 **Total other expenses.** Enter here and on page 1, line 27	48	8,078	00

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service	**Self-Employment Tax** ► See Instructions for Schedule SE (Form 1040). ► Attach to Form 1040.	OMB No. 1545-0074 **1998** Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ►
Susan J. Brown	111 00 1111

Who Must File Schedule SE

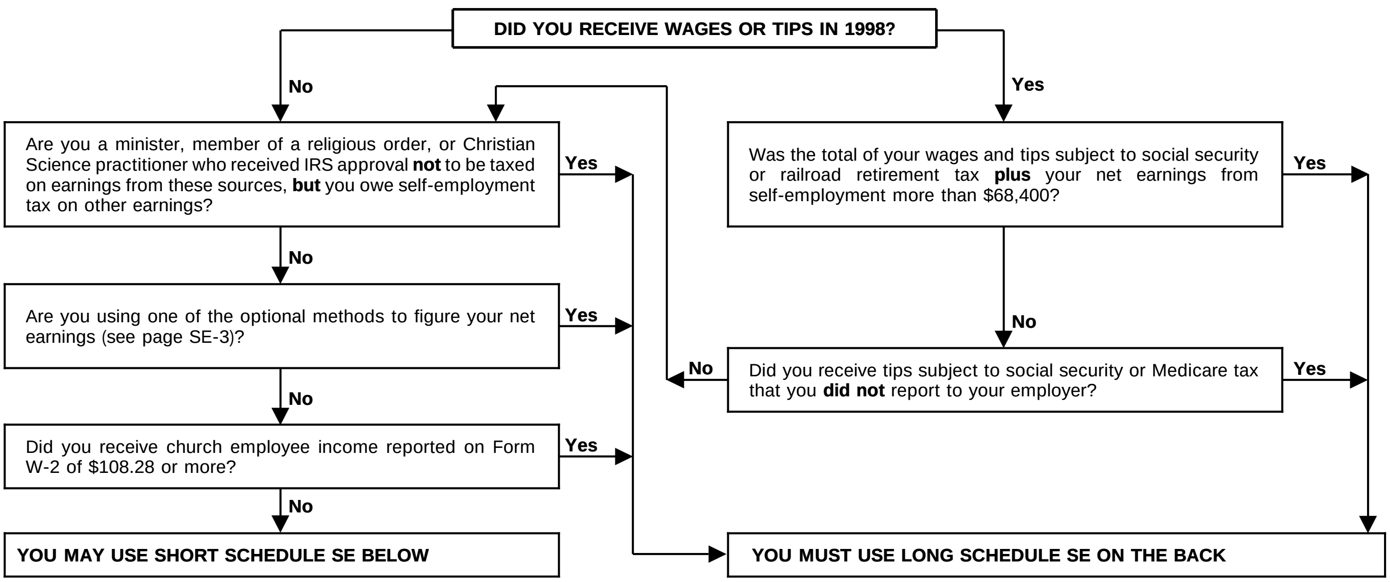
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 50.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	51,166	00
3	Combine lines 1 and 2	3	51,166	00
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ►	4	47,252	00
5	**Self-employment tax.** If the amount on line 4 is: • $68,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 50.** • More than $68,400, multiply line 4 by 2.9% (.029). Then, add $8,481.60 to the result. Enter the total here and on **Form 1040, line 50.**	5	7,230	00
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** — line 6: 3,615 00			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1998**

Form **4562**

Department of the Treasury
Internal Revenue Service

Depreciation and Amortization
(Including Information on Listed Property)

► See separate instructions. ► Attach this form to your return.

OMB No. 1545-0172

1998

Attachment Sequence No. 67

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Susan J. Brown	Family Fashions	111 - 00 - 1111

Part I **Election To Expense Certain Tangible Property (Section 179) (Note:** *If you have any "listed property," complete Part V before you complete Part I.***)**

1	Maximum dollar limitation. If an enterprise zone business, see page 2 of the instructions	1	$18,500
2	Total cost of section 179 property placed in service. See page 2 of the instructions	2	15,000
3	Threshold cost of section 179 property before reduction in limitation	3	$200,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	- 0 -
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see page 2 of the instructions	5	18,500

	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
6	Adding machine	200	200
7	Listed property. Enter amount from line 27	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	200
9	Tentative deduction. Enter the smaller of line 5 or line 8	9	200
10	Carryover of disallowed deduction from 1997. See page 3 of the instructions	10	- 0 -
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	18,000
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	200
13	Carryover of disallowed deduction to 1999. Add lines 9 and 10, less line 12 ►	13	

Note: *Do not use Part II or Part III below for listed property (automobiles, certain other vehicles, cellular telephones, certain computers, or property used for entertainment, recreation, or amusement). Instead, use Part V for listed property.*

Part II **MACRS Depreciation For Assets Placed in Service ONLY During Your 1998 Tax Year (Do Not Include Listed Property.)**

Section A—General Asset Account Election

14 If you are making the election under section 168(i)(4) to group any assets placed in service during the tax year into one or more general asset accounts, check this box. See page 3 of the instructions ► ☐

Section B—General Depreciation System (GDS) (See page 3 of the instructions.)

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
15a 3-year property						
b 5-year property		800	5	HY	200 DB	160
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Alternative Depreciation System (ADS) (See page 5 of the instructions.)

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
16a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part III **Other Depreciation (Do Not Include Listed Property.)** (See page 6 of the instructions.)

17	GDS and ADS deductions for assets placed in service in tax years beginning before 1998	17	
18	Property subject to section 168(f)(1) election	18	
19	ACRS and other depreciation	19	1,117

Part IV **Summary** (See page 6 of the instructions.)

20	Listed property. Enter amount from line 26	20	2,800
21	**Total.** Add deductions on line 12, lines 15 and 16 in column (g), and lines 17 through 20. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	21	4,277
22	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	22	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 12906N Form **4562** (1998)

Part V **Listed Property—Automobiles, Certain Other Vehicles, Cellular Telephones, Certain Computers, and Property Used for Entertainment, Recreation, or Amusement**

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete **only** 23a, 23b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See page 8 of the instructions for limits for passenger automobiles.***)**

23a Do you have evidence to support the business/investment use claimed? ☑ **Yes** ☐ **No** **23b** If "Yes," is the evidence written? ☑ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	(b) Date placed in service	(c) Business/ investment use percentage	(d) Cost or other basis	(e) Basis for depreciation (business/investment use only)	(f) Recovery period	(g) Method/ Convention	(h) Depreciation deduction	(i) Elected section 179 cost
24 Property used more than 50% in a qualified business use (See page 7 of the instructions.):								
USA 280 VAN	3-20-98	75 %	18,667	14,000	5 yr	200 DB/HY	2,800	- 0 -
		%						
		%						
25 Property used 50% or less in a qualified business use (See page 7 of the instructions.):								
		%				S/L –		
		%				S/L –		
		%				S/L –		

26 Add amounts in column (h). Enter the total here and on line 20, page 1 . . . . . . **26** 2,800

27 Add amounts in column (i). Enter the total here and on line 7, page 1 . . . . **27** - 0 -

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person.

If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		(b) Vehicle 2		(c) Vehicle 3		(d) Vehicle 4		(e) Vehicle 5		(f) Vehicle 6	
28 Total business/investment miles driven during the year (DO NOT include commuting miles)	7,500											
29 Total commuting miles driven during the year	2,025											
30 Total other personal (noncommuting) miles driven	475											
31 Total miles driven during the year. Add lines 28 through 30	10,000											
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
32 Was the vehicle available for personal use during off-duty hours?	✓											
33 Was the vehicle used primarily by a more than 5% owner or related person?	✓											
34 Is another vehicle available for personal use?	✓											

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

*Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **are not** more than 5% owners or related persons.*

	Yes	No
35 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
36 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See page 9 of the instructions for vehicles used by corporate officers, directors, or 1% or more owners		
37 Do you treat all use of vehicles by employees as personal use?		
38 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
39 Do you meet the requirements concerning qualified automobile demonstration use? See page 9 of the instructions . .		

Note: *If your answer to 35, 36, 37, 38, or 39 is "Yes," you need not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	(b) Date amortization begins	(c) Amortizable amount	(d) Code section	(e) Amortization period or percentage	(f) Amortization for this year
40 Amortization of costs that begins during your 1998 tax year:					
41 Amortization of costs that began before 1998				**41**	
42 **Total.** Enter here and on "Other Deductions" or "Other Expenses" line of your return . . .				**42**	

Preparing the Return for Stanley Price

Stanley Price owns and operates Stan's Barber Shop. He has been in business for 32 years. Stanley uses the cash method of accounting and files his return on a calendar year basis.

Schedule C–EZ

Stanley uses Schedule C–EZ to report the net profit from his business because he meets all of the requirements listed in Part I of the schedule. Stanley enters his name and social security number at the top of the schedule.

Part I–General Information

Stanley fills out Part I as follows:

Line A. Stanley enters his principal business.

Line B. He enters 812111, which is the 6-digit business code for a barber shop. This code is on page C–9 of the instructions for Schedule C. Stanley locates the major business category that describes his business. He reads down the items under “Personal and Laundry Services” (part of “Other Services” to find 812111—Barber shops.

Line C. He enters the name of his business—“Stan's Barber Shop.”

Line D. Stanley leaves this line blank. He does not have an employer identification number (EIN) because he is not required to have one. For information about EINs, see *Identification Numbers* in chapter 1.

Line E. He enters his business address.

Part II–Figure Your Net Profit

Stanley fills out Part II as follows:

Line 1–Gross receipts. Stanley enters his gross receipts from cutting hair. They include the amounts he charged for haircuts and all the tips received from his customers. The total for the year was $27,000.

Line 2–Total expenses. Stanley enters his expenses for the year. They total $1,302 and consist of the following:

- Advertising in the local newspaper—$145
- Supplies—$475
- Business licenses—$150
- Utilities (electricity and water)—$532

Line 3–Net profit. Stanley subtracts his total expenses ($1,302) from his gross receipts ($27,000) to get his net profit of $25,698. He enters his net profit here, on line 12 of Form 1040, and on line 2, Section A of Schedule SE (Form 1040).

Part III–Information on Your Vehicle

Stanley leaves this part blank because he is not deducting car or truck expenses.

Schedule SE—Self-Employment Tax

After Stanley prepares Schedule C–EZ, he fills out Schedule SE. He starts by entering his name and social security number at the top of the schedule. Then he reads the chart on page 1 of the schedule which tells him he can use *Section A—Short Schedule SE* to figure his self-employment tax. He fills out the following lines in Section A.

Lines 2 and 3. He enters $25,698. This is his net profit from line 3 of Schedule C–EZ.

Line 4. He multiplies $25,698 by .9235 to get his net earnings from self-employment ($23,732). This is the amount of his net profit subject to self-employment tax.

Line 5. Because the amount on line 4 is less than $68,400, he multiplies the amount on line 4 ($23,732) by .153 to get his self-employment tax of $3,631. He enters that amount here and on line 50 of Form 1040.

Line 6. He multiplies the amount on line 5 by .5 to get his deduction for one-half of self-employment tax of $1,816. He enters that amount here and on line 27 of Form 1040.

Form 1040

Stanley Price fills out Form 1040 as follows:

Name, address, and social security number. Stanley enters his name, home address, and social security number.

Presidential election campaign fund. Stanley chooses to have $3 go to this fund. He checks the box under “Yes.”

Line 1. Stanley checks the box on this line because he is filing as single.

Lines 6a and 6d. Stanley claims an exemption for himself. He checks the box next to “Yourself” and enters “1” in the far right-hand entry space. He also enters “1” in the box on line 6d.

Line 8a. Stanley enters $295 of taxable interest that was credited to his personal savings account for the year.

Line 9. Stanley enters $145 of dividends he received from ABC Corporation.

Line 12. He enters his business net profit from line 3 of Schedule C–EZ.

Line 22. Stanley adds the amounts on lines 7 through 21 and enters the total income, $26,138.

Line 23. Stanley enters the $2,000 contribution he made for the year to his individual retirement account (IRA). According to the Form 1040 instructions, he can deduct this amount.

Line 27. Stanley enters one-half of his self-employment tax. He got this amount from line 6 in Section A of Schedule SE.

Line 32. Stanley adds the amounts on lines 23 through 31a and enters the total, $3,816.

Line 33. Stanley subtracts the amount on line 32 from the amount on line 22 to arrive at his adjusted gross income, $22,322. He also enters this amount on line 34.

Line 36. He enters $4,250. This is the standard deduction for a single filer.

Line 37. Stanley subtracts line 36 from line 34 to get $18,072.

Line 38. He multiplies $2,700 by the number of exemptions claimed on line 6d to get his total exemptions, $2,700.

Line 39. Stanley subtracts line 38 from line 37 to get his taxable income, $15,372.

Line 40. Stanley uses the Tax Table in the Form 1040 instructions to figure his income tax. In the Tax Table he looks for the income bracket that includes $15,372. He finds the bracket for incomes of at least $15,350, but less than $15,400 and sees that the tax for a person filing as single is $2,306. He enters this amount here.

Lines 48 and 49. Because Stanley does not have any of the credits listed on lines 41 through 47, he enters -0- on line 48, subtracts it from line 40, and enters $2,306 on line 49.

Line 50. He enters $3,631 from line 5 in Section A of Schedule SE.

Line 56. Stanley adds the amounts on lines 49 through 55 and enters the total, $5,937.

Line 58. He enters $6,000 estimated tax payments he made for the year.

Line 64. He enters $6,000.

Lines 65 and 66a. Stanley subtracts line 56 from line 64 to arrive at the amount he overpaid, $63. He wants this amount refunded to him and also enters it on line 66a. The IRS will send him a check for this amount provided he owes no other taxes. If Stanley wanted the refund deposited directly into his checking or savings account, he would have had to complete lines 66b, c, and d.

Signing and assembling the return. He signs his name and enters the date signed and his occupation. He makes a copy of the return and schedules for his records. Then he assembles his original Form 1040, Schedules C–EZ and SE in that order. (See “Attachment Sequence Number” in the upper right corner of each schedule or form.) Finally, he mails it to the IRS.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **1998**

IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 1998, or other tax year beginning , 1998, ending , 19 OMB No. 1545-0074

Label (See instructions on page 18.) **Use the IRS label.** Otherwise, please print or type.

LABEL HERE

Your first name and initial: STANLEY	Last name: PRICE		Your social security number: 000 00 0000
If a joint return, spouse's first name and initial	Last name		Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 18.: 99 OAK ST		Apt. no.	**IMPORTANT!** You **must** enter your SSN(s) above.
City, town or post office, state, and ZIP code. If you have a foreign address, see page 18.: ANYTOWN TX 70000			

Presidential Election Campaign (See page 18.)

	Yes	No
Do you want $3 to go to this fund?	✓	
If a joint return, does your spouse want $3 to go to this fund?		

Note: *Checking "Yes" will not change your tax or reduce your refund.*

Filing Status

Check only one box.

1 ☑ Single
2 ☐ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 18.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶ 19). (See page 18.)

Exemptions

If more than six dependents, see page 19.

6a ☑ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a.
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 19)
			☐
			☐
			☐
			☐
			☐
			☐

d Total number of exemptions claimed

No. of boxes checked on 6a and 6b: 1
No. of your children on 6c who:
• lived with you
• did not live with you due to divorce or separation (see page 19)
Dependents on 6c not entered above
Add numbers entered on lines above ▶ 1

Income

Attach Copy B of your Forms W-2, W-2G, and 1099-R here.

If you did not get a W-2, see page 20.

Enclose, but do not staple, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	**Taxable** interest. Attach Schedule B if required	8a	295 00
b	**Tax-exempt** interest. DO NOT include on line 8a — 8b		
9	Ordinary dividends. Attach Schedule B if required	9	145 00
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 21)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	25,698 00
13	Capital gain or (loss). Attach Schedule D	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	Total IRA distributions 15a — **b** Taxable amount (see page 22)	15b	
16a	Total pensions and annuities 16a — **b** Taxable amount (see page 22)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits 20a — **b** Taxable amount (see page 24)	20b	
21	Other income. List type and amount—see page 24	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	26,138 00

Adjusted Gross Income

If line 33 is under $30,095 (under $10,030 if a child did not live with you), see EIC inst. on page 36.

23	IRA deduction (see page 25)	23	2,000 00		
24	Student loan interest deduction (see page 27)	24			
25	Medical savings account deduction. Attach Form 8853	25			
26	Moving expenses. Attach Form 3903	26			
27	One-half of self-employment tax. Attach Schedule SE	27	1,816 00		
28	Self-employed health insurance deduction (see page 28)	28			
29	Keogh and self-employed SEP and SIMPLE plans	29			
30	Penalty on early withdrawal of savings	30			
31a	Alimony paid **b** Recipient's SSN ▶	31a			
32	Add lines 23 through 31a			32	3,816 00
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶			33	22,322 00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 51. Cat. No. 11320B Form **1040** (1998)

Tax and Credits

34	Amount from line 33 (adjusted gross income)	34	22,322	00
35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ **35a** ☐			
b	If you are married filing separately and your spouse itemizes deductions or you were a dual-status alien, see page 29 and check here ▶ **35b** ☐			
36	Enter the **larger** of your **itemized deductions** from Schedule A, line 28, **OR standard deduction** shown on the left. **But** see page 30 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent	36	4,250	00
37	Subtract line 36 from line 34	37	18,072	00
38	If line 34 is $93,400 or less, multiply $2,700 by the total number of exemptions claimed on line 6d. If line 34 is over $93,400, see the worksheet on page 30 for the amount to enter	38	2,700	00
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	15,372	00
40	**Tax.** See page 30. Check if any tax from **a** ☐ Form(s) 8814 **b** ☐ Form 4972 ▶	40	2,306	00
41	Credit for child and dependent care expenses. Attach Form 2441 — **41**			
42	Credit for the elderly or the disabled. Attach Schedule R — **42**			
43	Child tax credit (see page 31) — **43**			
44	Education credits. Attach Form 8863 — **44**			
45	Adoption credit. Attach Form 8839 — **45**			
46	Foreign tax credit. Attach Form 1116 if required — **46**			
47	Other. Check if from **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify) ______ — **47**			
48	Add lines 41 through 47. These are your **total credits**	48	- 0 -	
49	Subtract line 48 from line 40. If line 48 is more than line 40, enter -0- ▶	49	2,306	00

Standard Deduction for Most People

Single: $4,250

Head of household: $6,250

Married filing jointly or Qualifying widow(er): $7,100

Married filing separately: $3,550

Other Taxes

50	Self-employment tax. Attach Schedule SE	50	3,631	00
51	Alternative minimum tax. Attach Form 6251	51		
52	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	52		
53	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required	53		
54	Advance earned income credit payments from Form(s) W-2	54		
55	Household employment taxes. Attach Schedule H	55		
56	Add lines 49 through 55. This is your **total tax** ▶	56	5,937	00

Payments

Attach Forms W-2 and W-2G on the front. Also attach Form 1099-R if tax was withheld.

57	Federal income tax withheld from Forms W-2 and 1099	57		
58	1998 estimated tax payments and amount applied from 1997 return	58	6,000	00
59a	**Earned income credit.** Attach Schedule EIC if you have a qualifying child **b** Nontaxable earned income: amount ▶ ______ and type ▶ ______	59a		
60	Additional child tax credit. Attach Form 8812	60		
61	Amount paid with Form 4868 (request for extension)	61		
62	Excess social security and RRTA tax withheld (see page 43)	62		
63	Other payments. Check if from **a** ☐ Form 2439 **b** ☐ Form 4136	63		
64	Add lines 57, 58, 59a, and 60 through 63. These are your **total payments** ▶	64	6,000	00

Refund

Have it directly deposited! See page 44 and fill in 66b, 66c, and 66d.

65	If line 64 is more than line 56, subtract line 56 from line 64. This is the amount you **OVERPAID**	65	63	00
66a	Amount of line 65 you want **REFUNDED TO YOU** ▶	66a	63	00
▶ b	Routing number ☐☐☐☐☐☐☐☐☐ ▶ **c** Type: ☐ Checking ☐ Savings			
▶ d	Account number ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐			
67	Amount of line 65 you want **APPLIED TO YOUR 1999 ESTIMATED TAX** ▶ — **67**			

Amount You Owe

68	If line 56 is more than line 64, subtract line 64 from line 56. This is the **AMOUNT YOU OWE**. For details on how to pay, see page 44 ▶	68		
69	Estimated tax penalty. Also include on line 68 — **69**			

Sign Here

Joint return? See page 18. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime telephone number (optional)
Stanley Price	3/15/99	Barber	
Spouse's signature. If a joint return, BOTH must sign.	Date	Spouse's occupation	( )

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's social security no.
Firm's name (or yours if self-employed) and address ▶			EIN
			ZIP code

SCHEDULE C-EZ (Form 1040)

Department of the Treasury
Internal Revenue Service

Net Profit From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.

► Attach to Form 1040 or Form 1041. ► See instructions on back.

OMB No. 1545-0074

1998

Attachment Sequence No. **09A**

Name of proprietor: Stanley Price

Social security number (SSN): 000 00 0000

Part I General Information

You May Use Schedule C-EZ Instead of Schedule C Only If You:

- Had business expenses of $2,500 or less.
- Use the cash method of accounting.
- Did not have an inventory at any time during the year.
- Did not have a net loss from your business.
- Had only one business as a sole proprietor.

And You:

- Had no employees during the year.
- Are not required to file **Form 4562,** Depreciation and Amortization, for this business. See the instructions for Schedule C, line 13, on page C-4 to find out if you must file.
- Do not deduct expenses for business use of your home.
- Do not have prior year unallowed passive activity losses from this business.

A Principal business or profession, including product or service: Barber Shop

B Enter NEW code from pages C-8 & 9 ► 812111

C Business name. If no separate business name, leave blank. Stan's Barber Shop

D Employer ID number (EIN), if any

E Business address (including suite or room no.). Address not required if same as on Form 1040, page 1. 1001 Maple Ave.

City, town or post office, state, and ZIP code: Anytown, TX 70000

Part II Figure Your Net Profit

1	**Gross receipts. Caution:** *If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see **Statutory Employees** in the instructions for Schedule C, line 1, on page C-3 and check here* . . . ► ☐	1	27,000	00
2	**Total expenses.** If more than $2,500, you **must** use Schedule C. See instructions . . .	2	1,302	00
3	**Net profit.** Subtract line 2 from line 1. If less than zero, you **must** use Schedule C. Enter on **Form 1040, line 12,** and ALSO on **Schedule SE, line 2.** (Statutory employees **do not** report this amount on Schedule SE, line 2. Estates and trusts, enter on Form 1041, line 3.) . . .	3	25,698	00

Part III Information on Your Vehicle. Complete this part ONLY if you are claiming car or truck expenses on line 2.

4 When did you place your vehicle in service for business purposes? (month, day, year) ► ____/____/____

5 Of the total number of miles you drove your vehicle during 1998, enter the number of miles you used your vehicle for:

a Business ________ **b** Commuting ________ **c** Other ________

6 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ **Yes** ☐ **No**

7 Was your vehicle available for use during off-duty hours? . . . ☐ **Yes** ☐ **No**

8a Do you have evidence to support your deduction? . . . ☐ **Yes** ☐ **No**

b If "Yes," is the evidence written? . . . ☐ **Yes** ☐ **No**

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 14374D **Schedule C-EZ (Form 1040) 1998**

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service	**Self-Employment Tax** ► See Instructions for Schedule SE (Form 1040). ► Attach to Form 1040.	OMB No. 1545-0074 **1998** Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ►
Stanley Price	000 00 0000

Who Must File Schedule SE

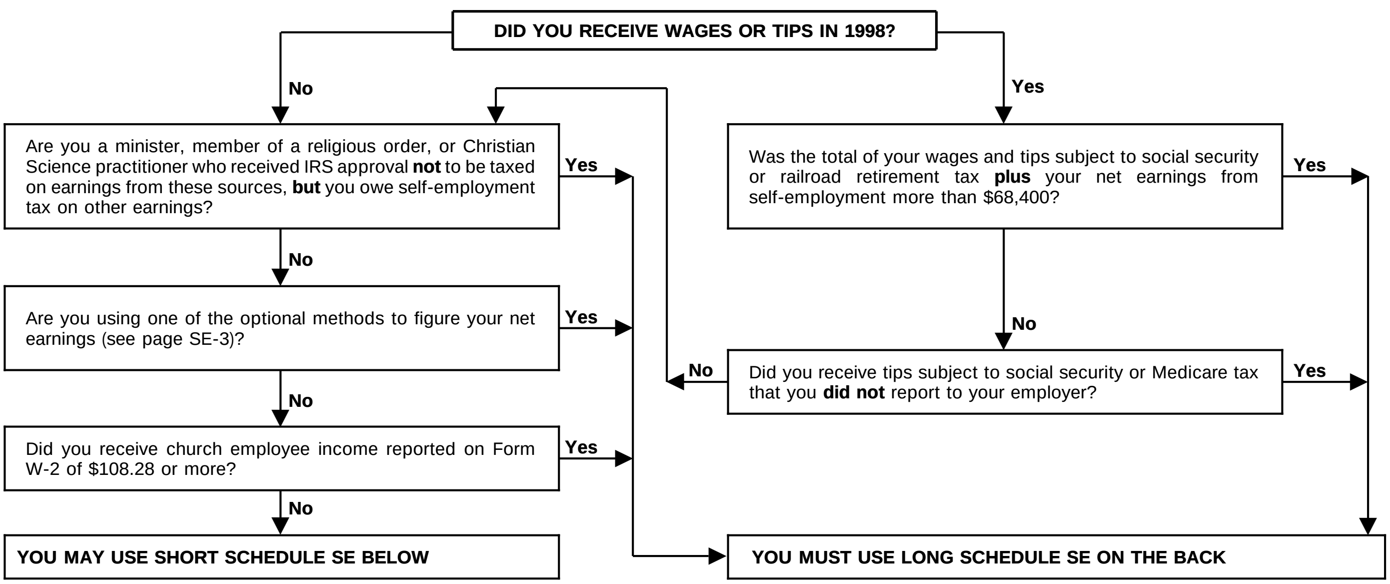
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **OR**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note: *Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.*

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt–Form 4361" on Form 1040, line 50.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Section A—Short Schedule SE. Caution: *Read above to see if you can use Short Schedule SE.*

1	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	25,698	00
3	Combine lines 1 and 2	3	25,698	00
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax ►	4	23,732	00
5	**Self-employment tax.** If the amount on line 4 is: • $68,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 50.** • More than $68,400, multiply line 4 by 2.9% (.029). Then, add $8,481.60 to the result. Enter the total here and on **Form 1040, line 50.**	5	3,631	00
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.5). Enter the result here and on **Form 1040, line 27** **6** 1,816 00			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 1998**

11.

Your Rights as a Taxpayer

The first part of this chapter explains some of your most important rights as a taxpayer. The second part explains the examination, appeal, collection, and refund processes.

Declaration of Taxpayer Rights

I. Protection of your rights. IRS employees will explain and protect your rights as a taxpayer throughout your contact with us.

II. Privacy and confidentiality. The IRS will not disclose to anyone the information you give us, except as authorized by law. You have the right to know why we are asking you for information, how we will use it, and what happens if you do not provide requested information.

III. Professional and courteous service. If you believe that an IRS employee has not treated you in a professional manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to your IRS District Director or Service Center Director.

IV. Representation. You may either represent yourself, or with proper written authorization, have someone else represent you in your place. You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination or collection personnel, provided you tell us in writing 10 days before the meeting.

V. Payment of only the correct amount of tax. You are responsible for paying only the correct amount of tax due under the law—no more, no less.

VI. Help with unresolved tax issues. Most problems can be solved with one contact by calling, writing, or visiting an IRS office. But if you have tried unsuccessfully to resolve a problem with the IRS, you should contact the Taxpayer Advocate's Problem Resolution Program (PRP). Someone at PRP will assign you a personal advocate who is in the best position to try to resolve your problem. The Taxpayer Advocate can also offer you special help if you have a significant hardship as a result of a tax problem.

You should contact the Taxpayer Advocate if:

- You have tried unsuccessfully to resolve your problem with the IRS and have not been contacted by the date promised, or
- You are on your second attempt to resolve your problem.

You may contact a Taxpayer Advocate by calling a new assistance number, 1–877–777–4778. Persons who have access to TTY/TDD equipment can call 1–800–829–4059 and ask for the Taxpayer Advocate. If you prefer, you can write to the Taxpayer Advocate at the office that last contacted you.

While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review. Taxpayer Advocates are working to put service first. For more information about PRP, get Publication 1546, *The Problem Resolution Program of the Internal Revenue Service.*

VII. Appeals and judicial review. If you disagree with us about the amount of your tax liability or certain collection actions, you have the right to ask the IRS Appeals Office to review your case. You may also ask a court to review your case.

VIII. Relief from certain penalties. The IRS will waive penalties when allowed by law if you can show you acted reasonably and in good faith or relied on the incorrect advice of an IRS employee.

Examinations, Appeals, Collections, and Refunds

Examinations (audits). We accept most taxpayers' returns as filed. If we inquire about your return or select it for examination, it does not suggest that you are dishonest. The inquiry or examination may or may not result in more tax. We may close your case without change; or, you may receive a refund.

By mail. We handle many examinations and inquiries by mail. We will send you a letter with either a request for more information or a reason why we believe a change to your return may be needed. If you give us the requested information or provide an explanation, we may or may not agree with you, and we will explain the reasons for any changes. Please do not hesitate to write us about anything you do not understand. If you cannot resolve a question through the mail, you can request a personal interview with an examiner.

By interview. If we notify you that we will conduct your examination through a personal interview, or you request such an interview, you have the right to ask that the examination take place at a reasonable time and place that is convenient for both you and the IRS. At the end of your examination, the examiner will give you a report if there are any proposed changes to your tax return. If you do not agree with the report, you may meet with the examiner's supervisor.

Repeat examinations. If we examined your tax return for the same items in either of the 2 previous years and proposed no change to your tax liability, please contact us as soon as possible so we can determine if we should discontinue the repeat examination. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* will give you more information about the rules and procedures of an IRS examination.

Appeals. If you do not agree with the examiner's findings, you can appeal them to our Appeals Office. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases.* If you do not wish to use our Appeals Office or disagree with its findings, you can take your case to the U.S. Tax Court, U.S. Court of Federal Claims, or the U.S. District Court where you live. If the court agrees with you on most issues in your case, and finds that our position was largely unjustified, you may be able to recover some of your administrative and litigation costs. You will not be eligible to recover these costs unless you tried to resolve your case administratively, including going through our appeals system, and you gave us all the information necessary to resolve the case.

Collections. Publication 594, *Understanding The Collection Process,* explains your rights and responsibilities regarding payment of federal taxes. It is divided into several sections that explain the procedures in plain language. The sections include:

1) *When you have not paid enough tax.* This section describes tax bills and explains what to do if you think your bill is wrong.
2) *Making arrangements to pay your bill.* This covers making installment payments, delaying collection action, and submitting an offer in compromise.
3) *What happens when you take no action to pay.* This covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property. Your appeal rights are explained in detail in Publication 1660, *Collection Appeal Rights for Liens, Levies, Seizures & Installment Agreement Terminations.*

Innocent spouse relief. Generally, both you and your spouse are responsible, jointly and individually, for paying any tax, interest, or penalties due on your joint return. However, you may not have to pay the tax, interest, and penalties you believe should be paid only by your spouse (or former spouse).

For more information, see Publication 971, *Innocent Spouse Relief,* and Form 8857, *Request for Innocent Spouse Relief.*

Refunds. You may file a claim for refund if you think you paid too much tax. You must generally file the claim within 3 years after the date you filed your return or 2 years after the date you paid the tax, whichever is later. The law generally provides for interest on your refund if it is not paid within 45 days of the date you filed your return or claim for refund. Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* has more information on refunds.

Your comments on IRS enforcement actions. The Small Business and Agriculture Regulatory Enforcement Ombudsman and 10 Regional Fairness Boards were established to receive comments from small business about federal agency enforcement actions. The Ombudsman will annually evaluate the enforcement activities and rate each agency's responsiveness to small business. If you wish to comment on the enforcement actions of IRS, call 1–888–REG–FAIR (1–888–734–3247).

How To Get More Information

This section describes the help that the IRS and other federal agencies offer to taxpayers who operate their own businesses.

Internal Revenue Service

The following describes assistance provided by the IRS. You can order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help. See *Free tax services,* later.

Small Business Tax Education Program. Small business owners and other self-employed individuals can learn about business taxes through a unique partnership between the IRS and local organizations. Through workshops or in-depth tax courses, instructors provide training on starting a business, recordkeeping, preparing business tax returns, self-employment tax issues, and employment taxes.

Some courses are offered free as a community service. Courses given by an educational facility may include costs for materials and tuition. Other courses may have a nominal fee to offset administrative costs of sponsoring organizations.

For more information about this program, call the IRS Monday through Friday during regular business hours and ask for your Taxpayer Education Coordinator. Check your telephone book for the local number of the IRS office closest to you or you can call **1–800–829–1040.**

Your Business Tax Kit. *Your Business Tax Kit* is an assortment of IRS forms and publications to help taxpayers who operate their own businesses. To order the kit, see *Free tax services,* later. The kit consists of the following items.

Forms:

- SS–4, *Application for Employer Identification Number*
- 1040–ES, *Estimated Tax for Individuals*
- 9779, *EFTPS Business Enrollment Form*

Publications:

- 509, *Tax Calendars for 1999*
- 583, *Starting a Business and Keeping Records*
- 594, *Understanding the Collection Process*
- 910, *Guide to Free Tax Services*
- 1544, *Reporting Cash Payments of Over $10,000 (Received in a Trade or Business)*

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Personal computer. With your personal computer and modem, you can access the IRS on the Internet at ***www.irs.ustreas.gov.*** While visiting our Web Site, you can select:

- *Frequently Asked Tax Questions* to find answers to questions you may have.
- *Fill-in Forms* to complete tax forms on-line.
- *Forms and Publications* to download forms and publications or search publications by topic or keyword.
- *Comments & Help* to e-mail us with comments about the site or with tax questions.
- *Digital Dispatch* and *IRS Local News Net* to receive our electronic newsletters on hot tax issues and news.

You can also reach us with your computer using any of the following.

- Telnet at **iris.irs.ustreas.gov**
- File Transfer Protocol at **ftp.irs.ustreas.gov**
- Direct dial (by modem) **703–321–8020**

TaxFax Service. Using the phone attached to your fax machine, you can receive forms, instructions, and tax information by calling **703–368–9694.** Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS

assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.

- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Walk-in. You can pick up certain forms, instructions, and publications at many post offices, libraries, and IRS offices. Some libraries and IRS offices have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response 7 to 15 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA
  95743–0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702–8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261–5074

CD-ROM. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms, instructions, and publications.
- Popular tax forms which may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) for $25.00 by calling 1–877–233–6767 or for $18.00 on the Internet at **www.irs.ustreas.gov/cdorders.** The first release is available in mid-December and the final release is available in late January.

Help with unresolved tax issues. Most problems can be solved with one contact by calling, writing, or visiting an IRS office. But if you have tried unsuccessfully to resolve a problem with the IRS, you should contact the Taxpayer Advocate's Problem Resolution Program (PRP). Someone at PRP will assign you a personal advocate who is in the best position to try to resolve your problem. The Taxpayer Advocate can also offer you special help if you have a significant hardship as a result of a tax problem.

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Small Business Administration

The Small Business Administration (SBA) is a federal agency that offers training and educational programs, counseling services, financial programs, and contract assistance to small business owners. The SBA also has publications and videos on a wide range of business topics. If you want help from the SBA, look in your telephone directory under “U.S. Government” for the number of your local SBA office or call the Small Business Answer Desk at **1–800–8–ASK–SBA.**

Other Federal Agencies

Other federal agencies also publish publications and pamphlets to assist small businesses. For a list of federal publications that are for sale write to:

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250–7954

Index

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Tax Publications for Business Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

General Guides

- **1** Your Rights as a Taxpayer
- **17** Your Federal Income Tax (For Individuals)
- **225** Farmer's Tax Guide
- **334** Tax Guide for Small Business
- **509** Tax Calendars for 1999
- **553** Highlights of 1998 Tax Changes
- **595** Tax Highlights for Commercial Fishermen
- **910** Guide to Free Tax Services

Employer's Guides

- **15** Employer's Tax Guide (Circular E)
- **15-A** Employer's Supplemental Tax Guide
- **51** Agricultural Employer's Tax Guide (Circular A)
- **80** Federal Tax Guide For Employers in the U.S. Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands (Circular SS)
- **179** Guía Contributiva Federal Para Patronos Puertorriqueños (Circular PR)
- **926** Household Employer's Tax Guide

Specialized Publications

- **378** Fuel Tax Credits and Refunds
- **463** Travel, Entertainment, Gift, and Car Expenses
- **505** Tax Withholding and Estimated Tax
- **510** Excise Taxes for 1999
- **515** Withholding of Tax on Nonresident Aliens and Foreign Corporations
- **517** Social Security and Other Information for Members of the Clergy and Religious Workers
- **527** Residential Rental Property
- **533** Self-Employment Tax
- **534** Depreciating Property Placed in Service Before 1987
- **535** Business Expenses
- **536** Net Operating Losses
- **537** Installment Sales
- **538** Accounting Periods and Methods
- **541** Partnerships
- **542** Corporations
- **544** Sales and Other Dispositions of Assets
- **551** Basis of Assets
- **556** Examination of Returns, Appeal Rights, and Claims for Refund
- **560** Retirement Plans for Small Business (SEP, SIMPLE, and Keogh Plans)
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- **583** Starting a Business and Keeping Records
- **587** Business Use of Your Home (Including Use by Day-Care Providers)
- **594** Understanding the Collection Process
- **597** Information on the United States-Canada Income Tax Treaty
- **598** Tax on Unrelated Business Income of Exempt Organizations
- **686** Certification for Reduced Tax Rates in Tax Treaty Countries
- **901** U.S. Tax Treaties
- **908** Bankruptcy Tax Guide
- **911** Direct Sellers
- **925** Passive Activity and At-Risk Rules
- **946** How To Depreciate Property
- **947** Practice Before the IRS and Power of Attorney
- **953** International Tax Information for Businesses
- **1544** Reporting Cash Payments of Over $10,000
- **1546** The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

- **1SP** Derechos del Contribuyente
- **579SP** Cómo Preparar la Declaración de Impuesto Federal
- **594SP** Comprendiendo el Proceso de Cobro
- **850** English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- **1544SP** Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. Items with an asterisk are available by fax. For these orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number
W-2 Wage and Tax Statement	10134
W-4 Employee's Withholding Allowance Certificate*	10220
940 Employer's Annual Federal Unemployment (FUTA) Tax Return*	11234
940EZ Employer's Annual Federal Unemployment (FUTA) Tax Return*	10983
941 Employer's Quarterly Federal Tax Return	17001
1040 U.S. Individual Income Tax Return*	11320
Sch A & B Itemized Deductions & Interest and Ordinary Dividends*	11330
Sch C Profit or Loss From Business*	11334
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Sch D Capital Gains and Losses and Built-In Gains	11516
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5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs*	13329
6252 Installment Sale Income*	13601
8283 Noncash Charitable Contributions*	62299
8300 Report of Cash Payments Over $10,000 Received in a Trade or Business*	62133
8582 Passive Activity Loss Limitations*	63704
8606 Nondeductible IRAs*	63966
8822 Change of Address*	12081
8829 Expenses for Business Use of Your Home*	13232

Tax Publications for Individual Taxpayers

See *How To Get More Information* for a variety of ways to get publications, including by computer, phone, and mail.

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Specialized Publications

3 Armed Forces' Tax Guide
378 Fuel Tax Credits and Refunds
463 Travel, Entertainment, Gift, and Car Expenses
501 Exemptions, Standard Deduction, and Filing Information
502 Medical and Dental Expenses
503 Child and Dependent Care Expenses
504 Divorced or Separated Individuals
505 Tax Withholding and Estimated Tax
508 Educational Expenses
514 Foreign Tax Credit for Individuals
516 U.S. Government Civilian Employees Stationed Abroad
517 Social Security and Other Information for Members of the Clergy and Religious Workers
519 U.S. Tax Guide for Aliens
520 Scholarships and Fellowships
521 Moving Expenses
523 Selling Your Home
524 Credit for the Elderly or the Disabled
525 Taxable and Nontaxable Income
526 Charitable Contributions
527 Residential Rental Property
529 Miscellaneous Deductions
530 Tax Information for First-Time Homeowners
531 Reporting Tip Income
533 Self-Employment Tax
534 Depreciating Property Placed in Service Before 1987
537 Installment Sales
541 Partnerships
544 Sales and Other Dispositions of Assets
547 Casualties, Disasters, and Thefts (Business and Nonbusiness)
550 Investment Income and Expenses
551 Basis of Assets
552 Recordkeeping for Individuals
554 Older Americans' Tax Guide
555 Community Property
556 Examination of Returns, Appeal Rights, and Claims for Refund
559 Survivors, Executors, and Administrators
561 Determining the Value of Donated Property
564 Mutual Fund Distributions
570 Tax Guide for Individuals With Income From U.S. Possessions
575 Pension and Annuity Income
584 Nonbusiness Disaster, Casualty, and Theft Loss Workbook
587 Business Use of Your Home (Including Use by Day-Care Providers)
590 Individual Retirement Arrangements (IRAs) (Including Roth IRAs and Education IRAs)
593 Tax Highlights for U.S. Citizens and Residents Going Abroad
594 Understanding the Collection Process
596 Earned Income Credit
721 Tax Guide to U.S. Civil Service Retirement Benefits
901 U.S. Tax Treaties
907 Tax Highlights for Persons with Disabilities
908 Bankruptcy Tax Guide
911 Direct Sellers
915 Social Security and Equivalent Railroad Retirement Benefits
919 Is My Withholding Correct for 1999?
925 Passive Activity and At-Risk Rules
926 Household Employer's Tax Guide
929 Tax Rules for Children and Dependents
936 Home Mortgage Interest Deduction
946 How To Depreciate Property
947 Practice Before the IRS and Power of Attorney
950 Introduction to Estate and Gift Taxes
967 IRS Will Figure Your Tax
968 Tax Benefits for Adoption
970 Tax Benefits for Higher Education
971 Innocent Spouse Relief
1542 Per Diem Rates
1544 Reporting Cash Payments of Over $10,000
1546 The Problem Resolution Program of the Internal Revenue Service

Spanish Language Publications

1SP Derechos del Contribuyente
579SP Cómo Preparar la Declaración de Impuesto Federal
594SP Comprendiendo el Proceso de Cobro
596SP Crédito por Ingreso del Trabajo
850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
1544SP Informe de Pagos en Efectivo en Exceso de $10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get More Information* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog numbers when ordering.

Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320
Sch A & B Itemized Deductions & Interest and Ordinary Dividends	11330
Sch C Profit or Loss From Business	11334
Sch C-EZ Net Profit From Business	14374
Sch D Capital Gains and Losses	11338
Sch E Supplemental Income and Loss	11344
Sch EIC Earned Income Credit	11339
Sch F Profit or Loss From Farming	11346
Sch H Household Employment Taxes	12187
Sch J Farm Income Averaging	25513
Sch R Credit for the Elderly or the Disabled	11359
Sch SE Self-Employment Tax	11358
1040A U.S. Individual Income Tax Return	11327
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329
1040-ES Estimated Tax for Individuals	11340
1040X Amended U.S. Individual Income Tax Return	11360
2106 Employee Business Expenses	11700
2106-EZ Unreimbursed Employee Business Expenses	20604
2210 Underpayment of Estimated Tax by Individuals, Estates and Trusts	11744
2441 Child and Dependent Care Expenses	11862
2848 Power of Attorney and Declaration of Representative	11980
3903 Moving Expenses	12490
4562 Depreciation and Amortization	12906
4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
4952 Investment Interest Expense Deduction	13177
5329 Additional Taxes Attributable to IRAs, Other Qualified Retirement Plans, Annuities, Modified Endowment Contracts, and MSAs	13329
6251 Alternative Minimum Tax–Individuals	13600
8283 Noncash Charitable Contributions	62294
8582 Passive Activity Loss Limitations	63704
8606 Nondeductible IRAs	63966
8812 Additional Child Tax Credit	10644
8822 Change of Address	12081
8829 Expenses for Business Use of Your Home	13232
8863 Education Credits	25379