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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For use in preparing

2001
Returns

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Introduction

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

A ***sole proprietor*** is someone who owns an unincorporated business, including a limited liability company, by himself or herself. A ***statutory employee*** has a checkmark in box 13 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.

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 chapter 12 for information on ordering these forms.

Husband-wife business. If you and your spouse jointly own and operate a business and share in the profits and losses, you are partners in a partnership, whether or not you have a formal partnership agreement. Do ***not*** use Schedule C or C-EZ. You must file Form 1065. For more information on partnerships, see Publication 541, *Partnerships.*

This publication does not cover the topics listed in the following table.

If you need information about:	You should see:
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* (shown later) 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.

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.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Important Changes for 2001

The following are some of the tax changes for 2001. For information on other changes, see Publication 553, *Highlights of 2001 Tax Changes.*

Self-employment tax. The maximum net self-employment earnings subject to the social security part (12.4%) of the self-employment tax increased to $80,400 for 2001. 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 2001 is 34½ cents a mile for all business miles. See *Car and Truck Expenses* in chapter 8.

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?	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 chapter 12.

Third party designee. Beginning with your tax return for 2001, you can check the “Yes” box in the “Third Party Designee” area of your return to authorize the IRS to discuss your return with a friend, family member, or any other person you choose. This allows the IRS to call the person you identified as your designee to ask any questions that may arise during the processing of your return. It also allows your designee to perform certain actions. See your income tax package for details.

Important Changes for 2002

The following are some of the tax changes for 2002. For information on other changes, see Publication 553, *Highlights of 2001 Tax Changes.*

New tax credit for employer provided child-care facilities. For tax years beginning after 2001, you can receive a tax credit of 25% of the qualified expenses you paid for employee child care and 10% of qualified expenses you paid for child care resource and referral services. This credit is limited to $150,000 each year. For more information, see Publication 553.

New tax credit for small business pension plan startup costs. For tax years beginning after 2001, if you begin a new qualified defined benefit or defined contribution plan (including a 401(k) plan), SIMPLE plan, or simplified employee pension, you can receive a tax credit of 50% of the first $1,000 of qualified startup costs. For more information, see Publication 553.

Health insurance deduction for the self-employed. For 2002, this deduction is 70% 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 self-employment earnings subject to the social security part of the self-employment tax increases to $84,900 for 2002.

Important Reminders

Accounting methods. Certain small business taxpayers may be eligible to adopt or change to the cash method of accounting and may not be required to account for inventories. For more information, see *Inventories* in chapter 2.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1–800–THE–LOST (1–800–843–5678)** if you recognize a child.

1.

Filing and Paying Business Taxes

Introduction

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 lists the federal taxes you may have to pay, their due dates, and the forms you use to report them.

Table 1–2 provides checklists that highlight the typical forms and schedules you may need to file if you ever go out of business.

TIP *You may want to get Publication 509,* Tax Calendars for 2002. *It has tax calendars that tell you when to file returns and make tax payments.*

Useful Items

You may want to see:

Publication

- ❏ **505** Tax Withholding and Estimated Tax

Form (and Instructions)

- ❏ **1040** U.S. Individual Income Tax Return
- ❏ **1040–ES** Estimated Tax for Individuals
- ❏ **Sch C (Form 1040)** Profit or Loss From Business
- ❏ **Sch C–EZ (Form 1040)** Net Profit From Business
- ❏ **Sch SE (Form 1040)** Self-Employment Tax

See chapter 12 for information about getting publications and forms.

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). 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.** It is also available from the SSA's Internet web site at **www.ssa.gov.**

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 it 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.*

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 either the SSA or the IRS.

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

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 *General 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 2001 if your net earnings from self-employment were $400 or more. If your net earnings from self-employment were less than $400, you still have to file an income tax return if you meet any other filing requirement listed in the Form 1040 instructions.

How Do I File?

File your income tax return on ***Form 1040*** and attach ***Schedule C*** or ***Schedule C–EZ.*** Enter the 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 using IRS *e-file* (electronic filing). This includes the following options.

1) Using a tax professional who is an authorized IRS *e-file* provider.
2) Using your personal computer.
3) Using a telephone (TeleFile).

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

When is my tax return due? Form 1040 for calendar year 2001 is due by April 15, 2002. 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,*** *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return,* to request an automatic 4-month extension.

How Do I Pay Income Tax?

Federal income tax is a pay-as-you-go tax. You must pay it 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.

Penalty for underpayment of tax. If you did not pay enough income tax and self-employment tax for 2001 by withholding or by making estimated tax payments, you may have to pay a penalty on the amount not paid. The IRS will figure the penalty for you and send you a bill. Or you can use ***Form 2210,*** *Underpayment of Estimated 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 a social security and Medicare tax primarily for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners.

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

Social security coverage. Your payments of SE tax contribute to your coverage under the social security system if you are covered. Social security coverage provides you with retirement benefits, disability benefits, survivor benefits, and hospital insurance (Medicare) benefits. Social security benefits are available to self-employed persons just as they are to wage earners.

CAUTION *By not reporting all of your self-employment income, you could cause your social security benefits to be lower when you retire.*

How to become insured under social security. You must be insured under the social security system before you begin receiving social security benefits. You are insured if you have the required number of credits (also called quarters of coverage), discussed next.

Earning credits in 2001 and 2002. For 2001, you received one credit, up to a maximum of four credits, for each $830 ($870 for 2002) of income subject to social security. Therefore, for 2001, if you had income (self-employment and wages) of $3,320 that was subject to social security taxes, you received four credits ($3,320 ÷ $830).

For an explanation of the number of credits you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

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[4] 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[4] Last day of February (March 31 if filing electronically)[4]
Federal unemployment (FUTA) tax	940 or 940-EZ 8109 (to make deposits)[3]	January 31[4] 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 (March 31 if filing electronically) Other forms—See the *General 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, see Publication 509, *Tax Calendars for 2002.*

[2]File a separate schedule for each business.

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

[4]See the form instructions if you go out of business, change the form of your business, or stop paying wages.

CAUTION *Making false statements to get or to increase social security benefits may subject you to penalties.*

The Social Security Administration (SSA) time limit for posting self-employment income. Generally, the SSA will give you credit only for self-employment income reported on a tax return filed within 3 years, 3 months, and 15 days after the tax year you earned the income. If you file your tax return or report a change in your self-employment income after this time limit, the SSA may change its records, but only to remove or reduce the amount. The SSA will not change its records to increase your self-employment income.

Who must pay self-employment tax. You must pay SE tax and file Schedule SE if either of the following applies.

1) Your net earnings from self-employment (excluding church employee income) were $400 or more.
2) You had church employee income of $108.28 or more.

CAUTION *The SE tax rules apply even if you are fully insured under social security or have started receiving benefits.*

Methods for figuring net earnings. There are three ways to figure net earnings from self-employment.

- The regular method
- The nonfarm optional method
- The farm optional method

You must use the regular method unless you are eligible to use one or both of the optional methods. Multiply your total earnings subject to SE tax by 92.35% (.9235) to get your net earnings under the regular method.

Why use the optional methods? You use the optional methods when you have a loss or a small net profit and any one of the following applies.

- You want to receive credit for social security benefit coverage.

- You incurred child or dependent care expenses for which you could claim a credit. (An optional method may increase your earned income, which could increase your credit.)
- You are entitled to the earned income credit. (An optional method may increase your earned income, which could increase your credit.)

SE tax rate. The SE tax rate on net earnings is 15.3% (12.4% social security tax plus 2.9% Medicare tax).

Maximum earnings subject to SE tax. Only the first $80,400 of your combined wages, tips, and net earnings in 2001 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All your combined wages, tips, and net earnings in 2001 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1) tax, or both, and total at least $80,400, do not pay the 12.4% social security part of the SE tax on any of your net earnings. However, ***you must pay the 2.9% Medicare part*** of the SE tax on all your net earnings.

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

More information. For more information on the SE tax, see Publication 533, *Self-Employment Tax.*

Employment Taxes

If you have employees, you will need to file forms to report employment taxes. Employment taxes include the following items.

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

For more information, see Publication 15, *Circular E, Employer's Tax Guide.* That publication explains your tax responsibilities as an employer.

To help you determine whether the people working for you are your employees, see Publication 15–A, *Employer's Supplemental Tax Guide.* That publication has information to help you determine whether an individual is an independent contractor or an employee.

CAUTION *If you incorrectly classify an employee as an independent contractor, you can be held liable for employment taxes for that worker plus a penalty.*

An ***independent contractor*** is someone who is self-employed. You do not generally have to withhold or pay any taxes on payments to an independent contractor.

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.
- Receive payment for certain services.

For more information on excise taxes, see Publication 510, *Excise Taxes for 2002.*

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

- Environmental taxes on the sale or use of ozone-depleting chemicals and imported products containing or manufactured with these chemicals.
- Communications and air transportation taxes.
- Fuel taxes.
- Tax on the first retail sale of heavy trucks, trailers, and tractors.
- Luxury tax on the first retail sale of passenger vehicles.
- Manufacturers taxes on the sale or use of a variety of different articles.

Form 2290. There is a federal excise tax on the use of certain trucks, truck tractors, and buses 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 Highway 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 be-

Table 1–2. **Going Out of Business Checklists**

(**Note:** *The following checklists highlight the typical final forms and schedules you may need to file if you ever go out of business. For more information, see the instructions for the listed forms.*)

If You Are Liable For:	You May Need To:
Income Tax	☐ File Schedule C or C-EZ with your Form 1040 for the year in which you go out of business. ☐ File Form 4797 with your Form 1040 for each year in which you sell or exchange property used in your business or in which the business use of certain section 179 or listed property drops to 50% or less. ☐ File Form 8594 with your Form 1040 if you sold your business.
Self-Employment Tax	☐ File Schedule SE with your Form 1040 for the year in which you go out of business.
Employment Taxes	☐ File Form 941 for the calendar quarter in which you make final wage payments. **Note:** Do not forget to check the box above line 1, *If you do not have to file returns in the future...,* and enter the date final wages were paid. ☐ File Form 940 or 940-EZ for the calendar year in which final wages were paid. **Note:** Do not forget to check the box, *If you will not have to file returns in the future...,* under Question C box.
Information Returns	☐ Provide Forms W-2 to your employees for the calendar year in which you make final wage payments. **Note:** These forms are generally due by the due date of your final Form 941. ☐ File Form W-3 to file Forms W-2. **Note:** These forms are generally due within 1 month after the due date of your final Form 941. ☐ Provide Forms 1099-MISC to each person to whom you have paid at least $600 for services (including parts and materials) during the calendar year in which you go out of business. ☐ File Form 1096 to file Forms 1099-MISC.

low, 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. 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.

You also use Form 1099–MISC to report your sales 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 payments. For more information on what to report on Form W–2, see the *Instructions for Forms 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 *General Instructions for Forms 1099, 1098, 5498, and W–2G.*

- ***Failure to file information returns.*** This 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.*** This 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. This 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. Cash does not include a check drawn on an individual's personal account (personal check). 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, filing (or causing the filing of) a false or fraudulent Form 8300, or structuring a transaction to evade reporting requirements.

2. Accounting Periods and Methods

Introduction

You must figure your taxable income and file an income tax return for an annual accounting period called a "tax year." Also, you must consistently use an accounting method that clearly shows your income and expenses for the tax year.

Useful Items

You may want to see:

Publication

❏ **538** Accounting Periods and Methods

See chapter 12 for information about getting publications and forms.

Accounting Periods

When preparing a statement of income and expenses (generally your income tax return), you must use your books and records for a specific interval of time called an accounting period. The annual accounting period for your income tax return is called a ***tax year.*** You can use one of the following tax years.

- 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 income tax 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 it. See *Change in tax year,* later.

If you adopt the calendar tax year, 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.

Fiscal tax year. A fiscal tax year is 12 consecutive months ending on the last day of any month except December. A 52–53 week tax year is a fiscal tax year that varies from 52 to 53 weeks but does not have to end on the last day of a month.

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

For more information on a fiscal tax year, including a 52–53 week tax year, see Publication 538.

Change in tax year. Once you have chosen your tax year, you must, with certain exceptions, 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 the form instructions.

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 an accounting method for your business when you file your first income tax return that includes a Schedule C for the business. After that, if you want to change your accounting method, you must generally get IRS approval. See *Change in Accounting Method,* later.

Kinds of methods. Generally, you can use any of the following accounting methods.

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

You must use the same accounting method to figure your taxable income and to keep your books. Also, you must use an accounting method that clearly shows your income.

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

Two or more businesses. If you have two or more separate and distinct businesses, you can use a different accounting method for each if the method clearly reflects the income of each business. They are separate and distinct only if you maintain complete and separate books and records for each business.

Cash Method

Most individuals and many sole proprietors with no inventory use the cash method because they find it easier to keep cash method records. However, if an inventory is necessary to account for your income, you must generally use an accrual method of accounting for sales and purchases. See *Inventories,* later.

Income

Under the cash method, include in your gross income all items of income you actually or constructively receive during your tax year. If you receive property or services, you must include their fair market value in income.

Example. On December 30, 2000, Mrs. Sycamore sent you a check for interior decorating services you provided to her. You received the check on January 2, 2001. You must include the amount of the check in income for 2001.

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. Interest is credited to your bank account in December 2001. You do not withdraw it or enter it into your passbook until 2002. You must include it in your gross income for 2001.

Delaying receipt of income. You cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. You must report the income in the year the property is received or 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 2001. She was told in December that her payment was available. At her request, she was not paid until January 2002. She must include this payment in her 2001 income because it was constructively received in 2001.

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, 2001, from a patient. She could not deposit the check in her business account until January 2, 2002. She must include this fee in her income for 2001.

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* in chapter 13 of Publication 535, *Business Expenses.*

Expenses

Under the cash method, you generally deduct expenses in the tax year in which you actually pay them. This includes business expenses for which you contest liability. However, you may not be able to deduct an expense paid in advance or you may be required to capitalize certain costs, as explained later under *Uniform Capitalization Rules.*

Expenses paid in advance. You can deduct an expense you pay in advance only in the year to which it applies.

Example. You are a calendar year taxpayer and you pay $1,000 in 2001 for a business insurance policy effective for one year, beginning July 1. You can deduct $500 in 2001 and $500 in 2002.

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 income and expenses in the correct year.

Income—General Rule

Under an accrual method, you generally include an amount in your gross income for the tax year in which all events that fix your right to receive the income have occurred and you can determine the amount with reasonable accuracy.

Example. You are a calendar year, accrual method taxpayer. You sold a computer on December 28, 2001. You billed the customer in the first week of January 2002, but you did not receive payment until February 2002. You must include the amount received for the computer in your 2001 income.

Income—Special Rules

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

Estimated income. If you include a reasonably estimated amount in gross income, and later determine the exact amount is different, take the difference into account in the tax year in which you make the determination.

Change in payment schedule for services. If you perform services for a basic rate specified in a contract, you must accrue the income at the basic rate, even if you agree to receive payments at a lower rate until you complete the services and then receive the difference.

Advance payments for services. Generally, you report an advance payment for services to be performed in a later tax year as income in the year you receive the payment. However, if you receive an advance payment for services you agree to perform by the end of the next tax year, you can choose to postpone including the advance payment in income until the next tax year. However, you cannot postpone including any payment beyond that tax year.

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 payments for service agreements.
- Advance payments under guarantee or warranty contracts.
- Prepaid interest.
- Prepaid rent.

Advance payments for sales. Special rules apply to including income from advance payments on agreements for future sales or other dispositions of goods you hold primarily for sale to your customers in the ordinary course of your business. 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 an advance payment in income for the tax year in which you receive it. However, you can use an alternative method. For information about the alternative method, see Publication 538.

Expenses

Under an accrual method of accounting, you generally deduct or capitalize a business expense when both the following apply.

1) The all-events test has been met. The test has been met when:
   a) All events have occurred that fix the fact of liability, and
   b) The liability can be determined with reasonable accuracy.
2) Economic performance has occurred.

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

Example. You are a calendar year taxpayer and use an accrual method of accounting. You buy office supplies in December 2001. You receive the supplies and the bill in December, but you pay the bill in January 2002. You can deduct the expense in 2001 because all events that fix the fact of liability have occurred, the amount of the liability could be reasonably determined, and economic performance occurred in that year.

Your office supplies may qualify as a recurring expense. In that case, you can deduct them in 2001, even if the supplies are not delivered until 2002 (when economic performance occurs).

Keeping inventories. When the production, purchase, or sale of merchandise is an income-producing factor in your business, you must generally take inventories into account at the beginning and the end of your tax year. If you must account for an inventory, you must generally use an accrual method of accounting for your purchases and sales. For more information, see *Inventories,* later.

Special rule 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 related person's gross income. 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 expense or interest is includible in the gross income of that person.

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

Combination Method

You can generally use any combination of cash, accrual, and special methods of accounting if the combination clearly shows your income and expenses and you use it consistently. However, the following restrictions apply.

- If an inventory is necessary to account for your income, you must generally use an accrual method for purchases and sales. (See, however, *Inventories,* later.) You can use the cash method for all other items of income and expenses.
- 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 reporting your expenses, you must use an accrual method for figuring your income.
- If you use a combination method that includes the cash method, treat that combination method as the cash method.

Inventories

Generally, if you produce, purchase, or sell merchandise in your business, you must keep an inventory and use the accrual method for purchases and sales of merchandise. However, if you are a qualifying taxpayer, you can choose to do the following, even if you produce, purchase, or sell merchandise in your business.

- Use the cash method of accounting.
- Not keep an inventory, even if you do not change to the cash method.

You are a qualifying taxpayer only if you meet the gross receipts test for ***each*** tax year ending after December 16, 1998. Your average annual gross receipts must be $1,000,000 or less for the 3 tax years ending with the prior tax year. You must test 1998, 1999, and 2000 to see if you qualify to use the cash method and to not keep an inventory for 2001. You qualify if your average annual gross receipts for 1996, 1997, and 1998 are $1,000,000 or less (1998 test), your average annual gross receipts for 1997, 1998, and 1999 are $1,000,000 or less (1999 test), and your average annual gross receipts for 1998, 1999, and 2000 are $1,000,000 or less (2000 test). A tax shelter cannot be a qualifying taxpayer.

For more information, see *Cash Method of Accounting for Qualifying Taxpayers* under *Cash Method* in Publication 538.

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

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

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

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

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

Uniform Capitalization Rules

Under the uniform capitalization rules, you must capitalize the direct costs and part of the indirect costs for production or resale activities. Include these costs in the basis of property you produce or acquire for resale, rather than claiming them as a current deduction. You recover the costs through depreciation, amortization, or cost of goods sold when you use, sell, or otherwise dispose of the property.

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

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

Exceptions. These rules do not apply to the following property.

1) Personal property you acquire for resale if your average annual gross receipts are $10 million or less.
2) Property you produce if you meet either of the following conditions.

a) Your indirect costs of producing the property are $200,000 or less.

b) You use the cash method of accounting and do not account for inventories. For more information, see *Inventories,* earlier.

Special Methods

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

- Amortization, discussed in chapter 9 of Publication 535, *Business Expenses.*
- Bad debts, discussed in chapter 11 of Publication 535.
- Depletion, discussed in chapter 10 of Publication 535.
- Depreciation, discussed in Publication 946, *How To Depreciate Property.*
- Installment sales, discussed in Publication 537, *Installment Sales.*

Change in Accounting Method

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

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

To get approval, you must file ***Form 3115,*** *Application for Change in Accounting Method.* You may have to pay a fee. For more information, see the form instructions.

3. Dispositions of Business Property

Introduction

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 discusses whether you have a disposition, how to figure the gain or loss, and where to report the gain or loss.

Useful Items

You may want to see:

Publication

❑ **544** Sales and Other Dispositions of Assets

Form (and Instructions)

❑ **4797** Sales of Business Property

❑ **Sch D (Form 1040)** Capital Gains and Losses

See chapter 12 for information about getting publications and forms.

What Is a Disposition of Property?

A disposition of property includes the following transactions.

- You sell property for cash or other property.
- You exchange property for other property.
- You receive money as a tenant for the cancellation of a lease.
- You receive money for granting the exclusive use of a copyright throughout its life in a particular medium.
- You transfer property to satisfy a debt.
- You abandon property.
- Your bank or other financial institution forecloses on your mortgage or repossesses your property.
- Your property is damaged, destroyed, or stolen, and you receive property or money in payment.
- Your property is condemned, or disposed of under the threat of condemnation, and you receive property or money in payment.

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

Nontaxable exchanges. Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized and you cannot deduct any loss. Your gain or loss will not be recognized until you sell or otherwise dispose of the property you receive.

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

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

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

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

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

Both the buyer and seller involved in the sale of a business must report to the IRS the allocation of the sales price among the business assets. Use ***Form 8594,*** *Asset Acquisition Statement Under Sections 338 and 1060,* to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.

For more information about the sale of a business, see chapter 2 of Publication 544.

How Do I Figure a Gain or Loss?

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

IF your...	THEN you have a...
Adjusted basis is more than the amount realized,	Loss.
Amount realized is more than the adjusted basis,	Gain.

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

Basis. The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition. However, if you acquired the property by gift, 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 property is your original cost or other basis plus certain additions, and minus certain deductions such as depreciation and casualty losses. In determining gain or loss, the costs of transferring property to a new owner, such as selling expenses, are added to the adjusted basis of the property.

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

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

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

Is My Gain or Loss Ordinary or Capital?

You must classify your gains and losses as either ordinary or capital gains or losses. You must do this to figure your net capital gain or loss. Generally, you will have a capital gain or loss if you dispose of a capital asset. For the most part, everything you own and use for personal purposes or investment is a capital asset.

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

For more information about ordinary and capital gains and losses, see chapters 2 and 3 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.*** 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

Introduction

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

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 *How To Claim the Credit* later because you may also have to fill out Form 3800, *General Business Credit,* in certain situations.

Useful Items

You may want to see:

Publication

- ❏ **954** Tax Incentives for Empowerment Zones and Other Distressed Communities

Form (and Instructions)

- ❏ **3800** General Business Credit
- ❏ **6251** Alternative Minimum Tax—Individuals

See chapter 12 for information about getting publications and forms.

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 certain contributions made to a selected community development corporation before June 30, 1999. For more information, see Form 8847.

Credit for social security 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 and Publication 954.

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

Indian employment credit (Form 8845). This credit applies to the 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 and Publication 954.

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

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

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.

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 9 in Publication 535, *Business Expenses.*

Rehabilitation credit. This credit applies to expenses you incur to rehabilitate certain buildings. 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.” For more information, see Form 8820.

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. However, the credit does not apply to expenses you pay or incur after June 30, 2004. For more information, see Form 6765.

Welfare-to-work credit (Form 8861). The welfare-to-work credit provides businesses with an incentive to hire long-term family assistance recipients. However, the credit does not apply to wages you pay or incur for qualified long-term family assistance recipients who begin work for you after December 31, 2001. For more information, see Form 8861 and Publication 954.

Work opportunity credit (Form 5884). The work opportunity credit provides businesses with an incentive to hire individuals from targeted groups that have a particularly high unemployment rate or other special employment needs. However, the credit does not apply to wages you pay or incur for qualified targeted group members who begin work for you after December 31, 2001. For more information, see Form 5884 and Publication 954.

How To Claim the 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 credit(s).
- The credit (other than the low-income housing credit) is not from a passive activity. See ***Form 8582–CR,*** *Passive Activity Credit Limitations,* for information about passive activity credits.

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

CAUTION

Although the empowerment zone employment credit (Form 8844) is part of the general business credit, ***do not*** *report it on Form 3800.*

Alternative minimum tax (AMT). Although you may not owe AMT, you must still figure your tentative minimum tax on ***Form 6251*** if you claim a general business credit. After you fill in Form 6251, attach it to your tax return.

5. Business Income

Introduction

This chapter primarily explains 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.

TIP

Nonemployee compensation. *Business income includes amounts you received in your business that were properly shown on Forms 1099–MISC. This includes amounts reported as nonemployee compensation in box 7 of the form. You can find more information* *in the instructions on the back of the Form 1099–MISC you received.*

Kinds of Income

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

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

Bartering for Property or Services

Bartering is an exchange of property or services. You must include in your gross receipts, at the time received, the fair market value of property or services you receive in 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 Publication 15, *Circular E, Employer's Tax Guide.*

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 *General 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 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 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 receive 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 *Bad Debts* in chapter 8.

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

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

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

Canceled Debt

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

General Rule

Generally, if your debt is canceled or forgiven, other than as a gift or bequest to you, you must include the canceled amount in your gross income for tax purposes. Report the canceled amount on line 6 of Schedule C if you incurred the debt in your business. If the debt is a nonbusiness debt, report the canceled amount on line 21 of Form 1040.

Exceptions

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

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

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

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

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

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

Exclusions

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

1) The cancellation takes place in a bankruptcy case under title 11 of the U.S. Code (relating to bankruptcy). See Publication 908, *Bankruptcy Tax Guide.*

2) The cancellation takes place when you are insolvent. You can exclude the canceled debt to the extent you are insolvent. See Publication 908.

3) The canceled debt is a qualified farm debt owed to a qualified person. See chapter 4 in Publication 225, *Farmer's Tax Guide.*

4) The canceled debt is a qualified real property business debt. This situation is explained later.

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

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

Qualified real property business debt. You can 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 timely filed your return for the year without making the choice, you can still make the choice by filing an amended return within 6 months of the due date of the return (excluding extensions). For more information, see *When to file* in the form instructions.

Other Income

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

Restricted property. Restricted property is property that has certain restrictions that affect its value. If you receive restricted stock or other property for services performed, the fair market value of the property in excess of your cost is included in your income on Schedule C 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, *Taxable and Nontaxable Income.*

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 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, a capital expenditure, or cost of goods sold.

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

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 2 personal exemptions of $5,800. He would not pay income tax even if he did not deduct the bad debt. Therefore, he will not 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 you include in income part or all of the depreciation you deducted in previous years.

Listed property. If your business use of listed property (explained in chapter 8 under *Depreciation*) falls to 50% or less in a tax year after the tax year you placed the property in service, you may have to recapture part of the depreciation deduction. You do this by including in income on Schedule C part of the depreciation you deducted in previous years. Use Part IV of ***Form 4797***, *Sales of Business Property,* to figure the amount to include on Schedule C. See *Do the Business-Use Limits Apply?* in chapter 4 of Publication 946, *How To Depreciate Property.* That chapter explains how to determine whether property is used more than 50% in your business.

Section 179 property. If you take a section 179 deduction (explained in chapter 8 under *Depreciation*) for an asset and before the end of the asset's recovery period the percentage of business use drops to 50% or less, you must recapture part of the section 179 deduction. You do this by including in income on Schedule C part of the deduction you took. Use Part IV of Form 4797 to figure the amount to include on Schedule C. See chapter 2 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 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 like-kind 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 *Nontaxable exchanges* in chapter 3.

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

Do not include merchandise you receive on consignment in your inventory. Include your profit or commission on merchandise consigned to you in your income when you sell the merchandise or when you receive your profit or commission, depending upon the method of accounting you use.

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

- Under a ***short-term lease*** of ***retail space.***

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

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

Short-term lease. A short-term lease is a lease (or other agreement for occupancy or use) of retail space for 15 years or less. The following rules apply in determining whether the lease is for 15 years or less.

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

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

Qualified long-term real property. Qualified long-term real property is nonresidential real property that is part of, or otherwise present at, your retail space and that reverts to the landlord when the lease ends.

Accounting for Your Income

Accounting for your income for income tax purposes differs at times from accounting for financial purposes. This section discusses some of the more common differences that may affect business transactions.

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

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

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

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

1) Deduct the cash discount from purchases (see *Line 36 Purchases less cost of items withdrawn for personal use* in chapter 6).
2) Credit the cash discount to a discount income account.

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

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

Trade discounts. These are reductions from list or catalog prices and 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.

Sales returns and allowances. Credits you allow customers for returned merchandise and any other allowances you make on sales are deductions from gross sales in figuring net sales.

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

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

For information on casualty or theft losses, see Publication 547, *Casualties, Disasters, and Thefts.*

6. How To Figure Cost of Goods Sold

Introduction

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

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

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

Figuring Cost of Goods Sold – Schedule C Lines 35 – 42

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* in chapter 2).

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

Donation of inventory. If you 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 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 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 2001, you contributed property from inventory to a church. It had a fair market value of $600. The closing inventory at the end of 2000 properly included $400 of costs due to the acquisition of the property, and in 2000, you properly deducted $50 of administrative and other expenses attributable to the property as business expenses. The charitable contribution allowed for 2001 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 2001 must not include the $400. You remove that amount from opening inventory for 2001.

Example 2. If, in Example 1, you acquired the contributed property in 2001 at a cost of $400, you would include the $400 cost of the property in figuring the cost of goods sold for 2001 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 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 file ***Form 3115,*** *Application for Change in Accounting Method.* For more information, see *Change in Accounting Method* in chapter 2.

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

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

Merchandise withdrawn from sale. If you withdraw merchandise for your personal or family use, you must exclude this cost from the total amount of merchandise you bought for sale. Do this by crediting the purchases or sales account with the cost of merchandise you withdraw for personal use. You 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 are usually an element of cost of goods sold only in a manufacturing or mining business. Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold. In a manufacturing business, labor costs properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, saleable product.

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

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

Other labor. Other labor costs not properly chargeable to the cost of goods sold may be deducted as selling or administrative expenses. Generally, the only kinds of labor costs properly chargeable to your cost of goods sold are the direct or indirect labor costs and certain other costs treated as overhead expenses properly charged to the manufacturing process, as discussed later under *Line 39 Other Costs.*

Line 38
Materials and Supplies

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

Line 39
Other Costs

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

Containers. Containers and packages that are an integral part of the product manufactured are a part of your cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.

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

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

Line 40
Add Lines 35 through 39

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

Line 41
Inventory at End of Year

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

Line 42
Cost of Goods Sold

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

7.

Figuring Gross Profit

Introduction

After you have figured the gross receipts from your business (chapter 5) and the cost of goods sold (chapter 6), you are ready to figure your gross profit. You must determine gross profit before you can deduct any business expenses. These expenses are discussed in chapter 8.

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.*

Businesses that sell products. If you are filing Schedule C, figure your gross profit by first figuring your net receipts. Figure net receipts 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.

Businesses that sell services. 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, 2001

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 usually 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 ensure all items have been included in inventory and proper pricing techniques have been used.

Use inventory forms and 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 discussed in chapter 2.

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 $33\frac{1}{3}$% on its sales. The net receipts (gross receipts minus returns and allowances) shown on his income statement 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 33 1/3% confirms his markup percentage of 33 1/3%.

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 include income from an interest-bearing checking account, income from scrap sales, and amounts recovered from bad debts.

8.

Business Expenses

Introduction

You can deduct the costs of running your business. These costs 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 helpful and appropriate for your business. An expense does not have to be indispensable to be considered necessary.

For more information about the general rules for deducting business expenses, see chapter 1 in Publication 535, *Business Expenses.*

CAUTION *If you have an expense that is partly for business and partly personal, separate the personal part from the business part.*

Useful Items

You may want to see:

Publication

❏ **535** Business Expenses

See chapter 12 for information about getting publications and forms.

Bad Debts

If someone owes you money you cannot collect, you have a bad debt. There are two kinds of bad debts—business bad debts and nonbusiness bad debts.

A business bad debt is generally one that comes from operating your trade or business. You can deduct business bad debts as an expense on your business tax return.

Business bad debt. A business bad debt is a loss from the worthlessness of a debt that was either of the following.

1) Created or acquired in your business.
2) 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 to customers. They can also be the result of loans to suppliers, clients, employees, or distributors. Goods and services customers have not paid for are shown in your books as either accounts receivable or notes receivable. If you are unable to collect any part of these accounts or notes receivable, the uncollectible part is a business bad debt.

CAUTION *You can take a bad debt deduction for these accounts and notes receivable only if the amount owed you was included in your gross income either for the year the deduction is claimed or for a prior year.*

Accrual method. If you use an accrual method of accounting, you normally report income as you earn it. You can take a bad debt deduction for an uncollectible receivable if you have included the uncollectible amount in income.

Cash method. If you use the cash method of accounting, you normally report income when you receive payment. You cannot take a bad debt deduction for amounts owed to you that you have not received and cannot collect if you never included those amounts in income.

More information. For more information about business bad debts, see chapter 11 in Publication 535.

Nonbusiness bad debts. All other bad debts are nonbusiness bad debts and deductible as short-term capital losses on Schedule D (Form 1040). For more information on 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 may be able to deduct the costs of operating and maintaining your vehicle. You also may be able to deduct other costs of local transportation and traveling away from home overnight on business.

*You may be entitled to a tax credit for an **electric vehicle** or a deduction from gross income for a part of the cost of a **clean-fuel vehicle** you place in service during the year. The vehicle must meet certain requirements and you do not have to use it in your business to qualify for the credit or the deduction. For more information, see chapter 12 in Publication 535.*

Local transportation expenses. Local transportation expenses include the ordinary and necessary costs of all the following.

- Getting from one workplace to another in the course of your business or profession when you are traveling within the city or general area that is your tax home. Tax home is defined later.
- Visiting clients or customers.
- Going to a business meeting away from your regular workplace.
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Local business transportation does ***not*** include expenses you have while traveling away from home overnight. Those expenses are deductible as travel expenses and are discussed later under *Travel, Meals, and Entertainment.* However, if you use your car while traveling away from home overnight, use the rules in this section to figure your car expense deduction.

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 or work 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.*

Office in the home. Your workplace can be your home if you have an office in your home that qualifies as your ***principal place of business.*** See *Business Use of Your Home,* later.

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.

Methods for Deducting Car and Truck Expenses

For local transportation or overnight travel by car or truck, you generally can use one of the following methods to figure your expenses.

- Standard mileage rate.
- Actual expenses.

Standard mileage rate. 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. For 2001, the standard mileage rate is $34\frac{1}{2}$ cents a mile for all business miles.

CAUTION *If you choose to use the standard mileage rate for a year, you **cannot** deduct your actual expenses for that year except for business-related parking fees and tolls.*

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car or truck you own, you must choose to use it in the first year the car is available for use in your business. In later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must choose to use it for the entire lease period (including renewals).

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

1) Use the car for hire (such as a taxi),
2) Operate two or more cars at the same time,
3) Claimed a depreciation deduction using ACRS or MACRS in an earlier year,
4) Claimed a section 179 deduction on the car,
5) Claimed actual car expenses for a car you leased, or
6) Are a rural mail carrier who received a qualified reimbursement.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual expenses. If you do not choose to use the standard mileage rate, you may be able to deduct your actual car or truck expenses.

TIP *If you qualify to use both methods, figure your deduction both ways to see which gives you a larger deduction.*

Actual car expenses include the costs of the following items.

Depreciation	Lease payments	Registration 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. You can divide based on the miles driven for each purpose.

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.

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

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 13 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 is expected to last 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 Publication 946, *How To Depreciate Property.*

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

- It must be property you own.
- It must be used in business or held to produce income.
- It must have a useful life that extends substantially beyond the year it is placed in service.
- It must be something that wears out, decays, gets used up, becomes obsolete, or loses its 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 2).
- 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 or line 2 of Schedule C–EZ.

Depreciation method. The method for depreciating most business and investment property placed in service after 1986 is called the Modified Accelerated Cost Recovery System (MACRS). MACRS is discussed in detail in Publication 946.

Section 179 deduction. You can choose to deduct a limited amount of the cost of certain depreciable property in the year you place the property in service. This deduction is known as the "section 179 deduction." For more information, see Publication 946. It explains what property qualifies for the deduction, what limits apply to the deduction, and when and how to recapture the deduction.

Listed property. Listed property is any of the following.

- Most passenger automobiles.
- Most other property used for transportation.
- 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).

You must follow special rules and recordkeeping requirements when depreciating listed property. For more information about listed property, see Publication 946.

Form 4562. Use Form 4562, *Depreciation and Amortization,* if you are claiming any of the following.

- Depreciation on property placed in service during the current 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. You cannot use Schedule C–EZ.*

Employees' Pay

You can generally deduct on Schedule C the pay you give your employees for the services they perform for your business. The pay may be in cash, property, or services.

To be deductible, your employees' pay must be an ordinary and necessary expense and you must pay or incur it in the tax year. In addition, the pay must meet both the following tests.

- The pay must be reasonable.
- The pay must be for services performed.

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.*

Kinds of pay. Some of the ways you may provide pay to your employees are listed below. For an explanation of each of these items, see chapter 2 in Publication 535.

- Awards.
- Bonuses.
- Education expenses.
- Fringe benefits (discussed later).
- Loans or advances you do not expect the employee to repay if they are for personal services actually performed.
- Property you transfer to an employee as payment for services.
- Reimbursements for employee business expenses.
- Sick pay.
- Vacation pay.

Fringe benefits. A fringe benefit is a form of pay provided to any person for the performance of services by that person. The following are examples of fringe benefits.

- Benefits under qualified employee benefit programs.
- Meals and lodging.
- The use of a car.
- Flights on airplanes.
- Discounts on property or services.
- Memberships in country clubs or other social clubs.
- Tickets to entertainment or sporting events.

Employee benefit programs include the following.

- Accident and health plans.
- Adoption assistance.
- Cafeteria plans.
- Dependent care assistance.
- Educational assistance.
- Group-term life insurance coverage.
- Welfare benefit funds.

You can generally deduct the cost of fringe benefits you provide on your Schedule C in whatever category the cost falls. For example, if you allow an employee to use a car or other property you lease, deduct the cost of the lease as a rent or lease expense. If you own the property, include your deduction for its cost or other basis as a section 179 deduction or a depreciation deduction.

TIP *You may be able to exclude all or part of the fringe benefits you provide from your employees' wages. For more information about fringe benefits and the exclusion of benefits, see Publication 15–B,* Employer's Tax Guide to Fringe Benefits.

Insurance

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

1) Fire, theft, flood, or similar insurance.
2) Credit insurance on losses from unpaid debts.
3) Group hospitalization and medical insurance for employees, including long-term care insurance.
4) Liability insurance.
5) Malpractice insurance that covers your personal liability for professional negligence resulting in injury or damage to patients or clients.
6) 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.
7) Contributions to a state unemployment insurance fund. Contributions are deductible as taxes if they are considered taxes under state law.
8) Overhead insurance that pays you for business overhead expenses you have during long periods of disability caused by your injury or sickness.
9) Car and other vehicle insurance that covers vehicles used in your business for liability, damages, and other losses. If you operate a vehicle partly for personal use, you can deduct only the part of your insurance premiums that applies to the business use of the vehicle. If you use the standard mileage rate to figure your car expenses, you cannot deduct any car insurance premiums.

10) Life insurance covering your employees if you are not directly or indirectly the beneficiary under the contract.
11) Business interruption insurance that pays you for lost profits if your business is shut down due to a fire or other cause.

Nondeductible premiums. You cannot deduct premiums on the following kinds of insurance.

1) 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. See Publication 547, *Casualties, Disasters, and Thefts.*
2) Loss of earnings. You cannot deduct premiums for a policy that pays for your lost earnings due to sickness or disability. However, see item (8) in the previous list.
3) Certain life insurance and annuities.
   a) For contracts issued before June 9, 1997, you cannot deduct the premiums on a life insurance policy covering yourself, an employee, or any person with a financial interest in your business if you are directly or indirectly a beneficiary of the policy. You are included among possible beneficiaries of the policy if the policy owner is obligated to repay a loan from you using the proceeds of the policy. A person has a financial interest in your business if the person is an owner or part owner of the business or has lent money to the business.
   b) For contracts issued after June 8, 1997, you generally cannot deduct the premiums on any life insurance policy, endowment contract, or annuity contract if you are directly or indirectly a beneficiary. The disallowance applies without regard to whom the policy covers.
4) Insurance to secure a loan. If you take out a policy on your life or on the life of another person with a financial interest in your business to get or protect a business loan, you cannot deduct the premiums as a business expense. Nor can you deduct the premiums as interest on business loans or as an expense of financing loans.

Self-employed insurance deduction. You may be able to deduct up to 60% of the amount you paid during 2001 for medical insurance and qualified long-term care insurance for you and your family.

How to figure the deduction. Generally, you can use the worksheet in the Form 1040 instructions to figure your deduction. However, if any of the following apply, you must use the worksheet in chapter 7 of Publication 535.

- You have more than one source of income subject to self-employment tax.
- You file Form 2555 or Form 2555–EZ (relating to foreign earned income).
- You are using amounts paid for long-term care insurance to figure the deduction.

Prepayment. You cannot deduct expenses in advance, even if you pay them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year.

Example. In 2001, you signed a 3-year insurance contract. Even though you paid the premiums for 2001, 2002, and 2003 when you signed the contract, you can only deduct the premium for 2001 on your 2001 tax return. You can deduct in 2002 and 2003 the premium allocable to those years.

More information. For more information about deducting insurance, see chapter 7 in Publication 535.

Interest

You can generally deduct on Schedule C or C–EZ all interest you pay or accrue during the tax year on debts related to your business. Interest relates to your business if you use the proceeds of the loan for a business expense. It does not matter what type of property secures the loan. You can deduct interest on a debt only if you meet all of the following requirements.

- You are legally liable for that debt.
- Both you and the lender intend that the debt be repaid.
- You and the lender have a true debtor-creditor relationship.

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 2001, you paid $600 interest on a car loan. During 2001, 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% × $600) for 2001 on Schedule C or C–EZ. The remaining interest of $240 is a nondeductible personal expense.

More information. For more information about deducting interest, see chapter 5 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 can take a business deduction only for the part of the fee related to your business. The personal part 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. For more information, see Publication 529, *Miscellaneous Deductions.*

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 the amount you pay or incur in resolving asserted tax deficiencies for your business as a sole proprietor or statutory employee.

Pension Plans

You can set up and maintain the following small business retirement plans for yourself and your employees.

- SEP (Simplified Employee Pension) plans.
- SIMPLE (Savings Incentive Match Plan for Employees) plans.
- Qualified plans (including Keogh or H.R. 10 plans).

SEP, SIMPLE, and qualified plans offer you and your employees a tax favored way to save for retirement. You can deduct contributions you make to the plan for your employees on line 19 of Schedule C. If you are a sole proprietor, you can deduct contributions you make to the plan for yourself on line 29 of Form 1040. You can also deduct trustees' fees if contributions to the plan do not cover them. Earnings on the contributions are generally tax free until you or your employees receive distributions from the plan in later years.

Under some plans, employees can have you contribute limited amounts of their before-tax pay to a plan. These amounts (and earnings on them) are generally tax free until your employees receive distributions from the plan in later years.

For more information on retirement plans for small business, see Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*

TIP *Publication 590,* Individual Retirement Arrangements (IRAs), *discusses other tax favored ways to save for retirement.*

Rent Expense

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

Unreasonable rent. You cannot take a rental deduction for unreasonable rents. Ordinarily, the issue of reasonableness arises only if you and the lessor are related. Rent paid to a related person is reasonable if it is the same amount you would pay to a stranger for use of the same property. Rent is not unreasonable just because it is figured as a percentage of gross receipts.

Related persons include members of your immediate family, including only brothers and sisters (either whole or half), your spouse, ancestors, and lineal descendants. For a list of the other related persons, see Publication 538, *Accounting Periods and Methods.*

Rent on your home. If you rent your home and use part of it as your place of business, you may be able to deduct the rent you pay for that part. You must meet the requirements for business use of your home. For more information, see *Business Use of Your Home,* later.

Rent paid in advance. Generally, rent paid in your business is deductible in the year paid or accrued. If you pay rent in advance, you can deduct only the amount that applies to your use of the rented property during the tax year. You can deduct the rest of your payment only over the period to which it applies.

More information. For more information about rent, see chapter 4 in Publication 535.

Taxes

You can deduct on Schedule C or C–EZ various federal, state, local, and foreign taxes directly attributable to your business.

Income taxes. You can deduct 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 other state and local income taxes on Schedule A (Form 1040) if you itemize your deductions. 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. Employment taxes are discussed briefly 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 one-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 on Schedule C or C–EZ any tax imposed by a state or local government on personal property used in your business.

You can also deduct registration fees for the right to use property within a state or local area.

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 on Schedule C or C–EZ 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 6 in Publication 535. That chapter explains special rules for deducting the following items.

- Taxes for local benefits, such as those for sidewalks, streets, and 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. Treat any sales tax you pay on a service or on the purchase or use of property 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, add the sales tax to the basis for depreciation. For information on the basis of property, see Publication 551, *Basis of Assets.*

CAUTION *Do not deduct state and local sales taxes imposed on the buyer that you must 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 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 you use in your business are usually included as part of the cost of the fuel. Do not deduct these taxes as a separate item.

You may be entitled to a credit or refund for federal excise tax you paid on fuels used for certain purposes. For more information, see Publication 378, *Fuel Tax Credits and Refunds.*

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 the ordinary and necessary expenses of traveling away from home for your business. You are traveling away from home if both the following conditions are met.

a) 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.

b) 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 travel by airplane, train, bus, or car 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 and maintaining your vehicle when traveling away from home on business. You can deduct actual expenses or the standard mileage rate (discussed earlier under *Car and Truck Expenses),* as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.

Meals and lodging. You can deduct the cost of meals and lodging if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. In most cases, you can deduct only 50% of your meal expenses.

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 emplyee if the expenses meet the directly-related test or the associated test.
Definitions	• **Entertainment** includes any activity generally considered to provide entertainment, amuement, 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 indipensable, 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 cannot deduct expenses that are lavish or extravagent under the circumstances. • You generally can deduct only 50% of your unreimbursed entertainment expenses.

Cleaning. You can deduct the costs of dry cleaning and laundry while on your business trip.

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 expense in this list.

More information. For more information about travel expenses, see Publication 463, *Travel, Entertainment, Gift, and Car Expenses.*

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

The following are examples of entertainment expenses.

- 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 13 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.*

Business Use of Your Home

To deduct expenses related to the part of your home used for business, you must meet specific requirements. Even then, your deduction may be limited.

To qualify to claim expenses for business use of your home, you must meet the following tests.

a) Your use of the business part of your home must be:

   i) Exclusive (however, see *Exceptions to exclusive use,* later),

   ii) Regular,

   iii) For your business, AND

b) The business part of your home must be ***one*** of the following:

   i) Your principal place of business (defined later),

   ii) A place where you meet or deal with patients, clients, or customers in the normal course of your business, or

   iii) A separate structure (not attached to your home) you use in connection with your business.

Exclusive use. To qualify under the exclusive use test, you must use a specific area of your home ***only*** for your business. The area used for business can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition.

You do ***not*** meet the requirements of the exclusive use test if you use the area in question both for business and for personal purposes.

Example. You are an attorney and use a den in your home to write legal briefs and prepare clients' tax returns. Your family also uses the den for recreation. Since the den is not used exclusively in your profession, you ***cannot*** claim a business deduction for its use.

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

a) For the storage of inventory or product samples.

b) 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).*

Regular use. To qualify under the regular use test, you must use a specific area of your home for business on a continuing basis. You do not meet the test if your business use of the area is only occasional or incidental, even if you do not use that area for any other purpose.

Principal place of business. You can have more than one business location, including your home, for a single business. To qualify to deduct the expenses for the business use of your home under the principal place of business test, your home must be your principal place of business for that business. To determine your principal place of business, you must consider all the facts and circumstances.

Your home office will qualify as your principal place of business for deducting expenses for its use if you meet the following requirements.

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

Alternatively, if you do business at more than one location, and your home office does not qualify as your principal place of business based on the previous rules, you determine your principal place of business based on the following factors.

a) The relative importance of the activities performed at each location.

b) If the relative importance factor does not determine your principal place of business, you can also consider the time spent at each location.

If, after considering your business locations, your home cannot be identified as your principal place of business, you cannot deduct home office expenses. However, for other ways to qualify to deduct home office expenses, see Publication 587.

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 your business expenses related to the use of your home. If your gross income from the business use is less than your total business expenses, your deduction for certain expenses for the business use of your home is limited.

Your deduction of otherwise nondeductible expenses, such as insurance, utilities, and depreciation (with depreciation taken last), allocable to the business is limited to the gross income from the business use of your home minus the sum of the following.

a) The business part of expenses you could deduct even if you did not use your home for business (such as mortgage interest, real estate taxes, and casualty and theft losses).

b) The business expenses that relate to the business activity in the home (for example, salaries or supplies), but not to the use of the home itself.

Do not include in (2) above your deduction for one-half of your self-employment tax.

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

More information. For more information on deducting expenses for the business use of your home, see Publication 587.

Other Expenses You Can Deduct

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

- Advertising.
- Clean-fuel vehicles and refueling property.
- Donations to business organizations.
- Educational expenses.
- Environmental cleanup costs.
- Impairment-related expenses.
- Interview expense allowances.
- 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.
- 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.
- 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

Introduction

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 G and 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 your deductions for the year are more than your income for the year (line 37 of your Form 1040 is a negative number), you may have a net operating loss (NOL). You can use an NOL by deducting it from your income in another year or years.

Examples of typical losses that may produce an NOL include, but are not limited to, losses incurred from the following.

- Your trade or business.
- Your work as an employee (unreimbursed employee business expenses).
- A casualty or theft.
- Moving expenses.
- Rental property.

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

For details about NOLs, see Publication 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.* 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 to make a profit, there is a limit on the deductions you can take. 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.

For details about not-for-profit activities, see chapter 1 in Publication 535, *Business Expenses.* 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 Publication 15, *Circular E, Employer's Tax Guide.*

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–8 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. She 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, see chapter 2. For more information on 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 *Bad Debts* in 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. See *Car and Truck Expenses* in chapter 8.

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. See *Insurance* in chapter 8.

Line 16b. Susan had borrowed money to use in her business. The interest on these loans was $2,633 for the year. See *Interest* in chapter 8.

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. See *Rent Expense* in chapter 8.

Line 21. She had her store counters refinished and other painting 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. See *Employees' Pay* in chapter 8.

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. For information about business use of the home, see *Business Use of Your Home* in chapter 8.

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 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 *Depreciation* in chapter 8.

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, *Depreciating Property Placed in Service Before 1987,* 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.

Line 21. Susan has a total depreciation deduction of $4,277. She enters her deduction here and on line 13 of Schedule C.

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 her net profit subject to self-employment tax.

Line 5. Because the amount on line 4 is less than $80,400, 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 53 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 enters 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 $398 of taxable interest credited to her personal savings account for the year.

Line 9. Susan enters $390 of dividends she received from CBA Corporation.

Line 12. She enters her business net profit of $51,166 from line 31 of Schedule C.

Line 22. Susan adds the amounts on lines 7 through 21 and enters the total, $51,954.

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 her health insurance. This is 60% of her $2,400 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 (SEP, SIMPLE, and Qualified Plans).*

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, $44,635. She also enters this amount on line 34.

Line 36. She enters $4,550. 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 $2,900 by the number of exemptions claimed on line 6d to get her total exemptions, $2,900.

Line 39. Susan subtracts line 38 from line 37 to get her taxable income, $37,185.

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 $37,185. She finds the bracket for incomes of at least $37,150 but less than $37,200 and sees that the tax for a person filing as single is $6,842. She enters this amount here.

Lines 41 and 42. Because she does not owe alternative minimum tax, she enters -0- on line 41 and $6,842 on line 42.

Line 47. Because Susan received the advance payment of her 2001 taxes, she is not entitled to claim the rate reduction credit.

Lines 51 and 52. Because Susan does not have any of the credits listed on lines 43 through 50, she enters -0- on line 51 and $6,842 on line 52.

Line 53. She enters $7,230 from line 5 in Section A of Schedule SE.

Line 58. Susan adds the amounts on lines 52 through 57 and enters the total, $14,072.

Line 60. She enters $14,000 of estimated tax payments she made for the year.

Line 66. She enters $14,000.

Line 70. Susan subtracts line 66 from line 58 to get the amount of tax she owes, $72. She writes a check payable to the United States Treasury for $72. On the check she writes her social security number, her daytime telephone number, and "2001 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, her occupation, and a daytime telephone number. 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.) Then she makes a copy of the return for her records. Finally, she mails it to the IRS.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2001**

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

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 OMB No. 1545-0074

Label

(See instructions on page 19.)

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

LABEL HERE

Your first name and initial: SUSAN J	Last name: BROWN	**Your social security number**: 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 19.: 1313 EMPIRE BLVD	Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.: FRANKLIN, NY 18725		

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

Presidential Election Campaign (See page 19.)

Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☑ Yes ☐ No Spouse ☐ Yes ☐ No

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 19.) 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 ▶). (See page 19.)

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 — No. of boxes checked on 6a and 6b: 1

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 20)
			☐
			☐
			☐
			☐
			☐
			☐

If more than six dependents, see page 20.

No. of your children on 6c who:
- lived with you
- did not live with you due to divorce or separation (see page 20)

Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers entered on lines above ▶ 1

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, 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	398 00
b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
9	Ordinary dividends. Attach Schedule B if required	9	390 00
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	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 if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	Total IRA distributions — 15a — b Taxable amount (see page 23)	15b	
16a	Total pensions and annuities — 16a — b Taxable amount (see page 23)	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 25)	20b	
21	Other income. List type and amount (see page 27)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	51,954 00

Adjusted Gross Income

23	IRA deduction (see page 27)	23			
24	Student loan interest deduction (see page 28)	24			
25	Archer MSA 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 30)	28	1,440 00		
29	Self-employed SEP, SIMPLE, and qualified 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	44,635 00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2001)

Tax and Credits

Standard Deduction for—
- People who checked any box on line 35a or 35b **or** who can be claimed as a dependent, see page 31.
- All others:

Single, $4,550
Head of household, $6,650
Married filing jointly or Qualifying widow(er), $7,600
Married filing separately, $3,800

34	Amount from line 33 (adjusted gross income)	34	44,635 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 31 and check here ▶ 35b ☐		
36	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	36	4,550 00
37	Subtract line 36 from line 34	37	40,085 00
38	If line 34 is $99,725 or less, multiply $2,900 by the total number of exemptions claimed on line 6d. If line 34 is over $99,725, see the worksheet on page 32	38	2,900 00
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	37,185 00
40	**Tax** (see page 33). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972	40	6,842 00
41	**Alternative minimum tax** (see page 34). Attach Form 6251	41	- 0 -
42	Add lines 40 and 41 ▶	42	6,842 00
43	Foreign tax credit. Attach Form 1116 if required	43	
44	Credit for child and dependent care expenses. Attach Form 2441	44	
45	Credit for the elderly or the disabled. Attach Schedule R	45	
46	Education credits. Attach Form 8863	46	
47	Rate reduction credit. See the worksheet on page 36	47	
48	Child tax credit (see page 37)	48	
49	Adoption credit. Attach Form 8839	49	
50	Other credits from: **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify) ______	50	
51	Add lines 43 through 50. These are your **total credits**	51	- 0 -
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0- ▶	52	6,842 00

Other Taxes

53	Self-employment tax. Attach Schedule SE	53	7,230 00
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	
58	Add lines 52 through 57. This is your **total tax** ▶	58	14,072 00

Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59	
60	2001 estimated tax payments and amount applied from 2000 return	60	14,000 00
61a	**Earned income credit (EIC)**	61a	
b	Nontaxable earned income 61b		
62	Excess social security and RRTA tax withheld (see page 51)	62	
63	Additional child tax credit. Attach Form 8812	63	
64	Amount paid with request for extension to file (see page 51)	64	
65	Other payments. Check if from **a** ☐ Form 2439 **b** ☐ Form 4136	65	
66	Add lines 59, 60, 61a, and 62 through 65. These are your **total payments** ▶	66	14,000 00

Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

67	If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you **overpaid**	67	
68a	Amount of line 67 you want **refunded to you** ▶	68a	
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
69	Amount of line 67 you want **applied to your 2002 estimated tax** ▶ 69		

Amount You Owe

70	**Amount you owe.** Subtract line 66 from line 58. For details on how to pay, see page 52 ▶	70	72 00
71	Estimated tax penalty. Also include on line 70 71		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 19.
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 phone number
Susan J. Brown	3/27/02	Retail shop owner	(555) 735-0001
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 SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no.	( )

Form **1040** (2001)

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

2001

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 of the instructions): Retail, Family clothing

B Enter code from pages C-7 & 8 ▶ 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 2001? If "No," see page C-2 for limit on losses . ☑ **Yes** ☐ **No**

H If you started or acquired this business during 2001, 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-2 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-4):			
					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-3)	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 nondeductible amount included on line 24b (see page C-5)			
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-5). Estates and trusts, enter on Form 1041, line 3. • If a loss, you **must** go 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-5). 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) 2001**

Part III Cost of Goods Sold (see page C-6)

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-3 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 2001, 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 personal 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 C (Form 1040) 2001

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 **2001** Attachment Sequence No. **17**

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

Who Must File Schedule SE

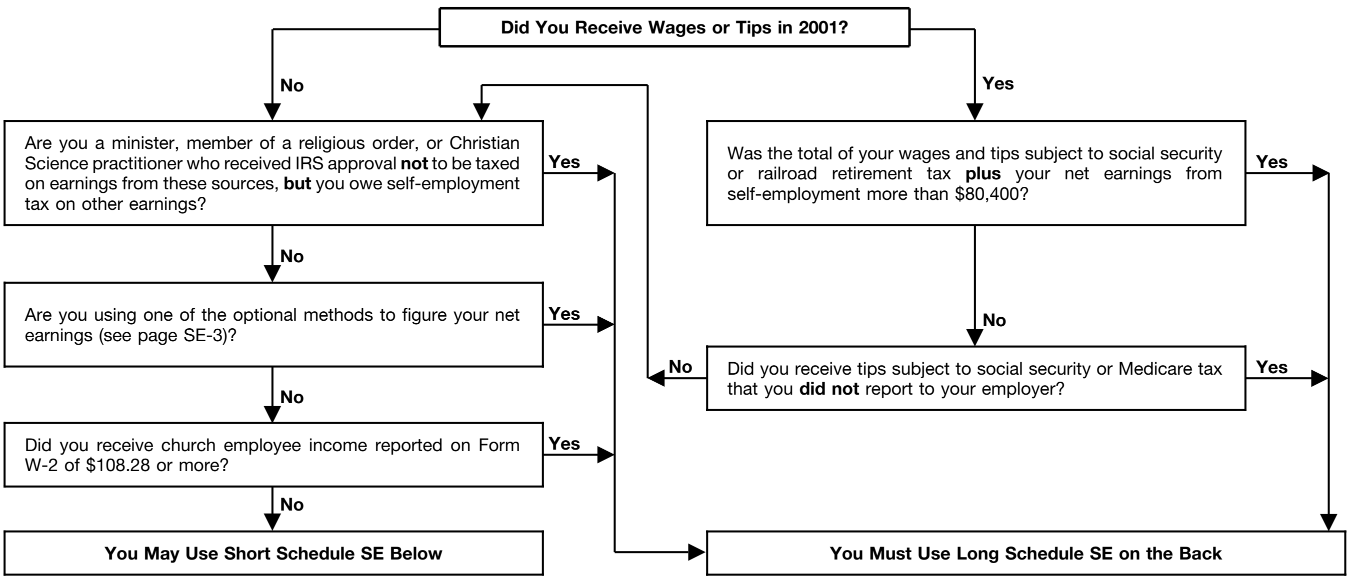
You must file Schedule SE if:

- 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 53.

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: • $80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 53.** • More than $80,400, multiply line 4 by 2.9% (.029). Then, add $9,969.60 to the result. Enter the total here and on **Form 1040, line 53.**	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** . . . 6 — 3,615 00			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2001**

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

2001

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 Under 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	$24,000
2	Total cost of section 179 property placed in service (see page 2 of the instructions)	2	200
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	24,000

	(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 2000 (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	24,000
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 2002. 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 2001 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)	(c)	(d)	(e)	(f)	(g)
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 instructions beginning on page 5.)

17	GDS and ADS deductions for assets placed in service in tax years beginning before 2001	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 from 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 page 9 of the instructions. Cat. No. 12906N Form **4562** (2001)

Part V **Listed Property** (Include 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 7 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 6 of the instructions):								
USA 280 VAN	3-20-01	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 6 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—see page 2 of the instructions) . . .	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 (see page 8 of the instructions).

	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 8 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 8 of the instructions.) .		

Note: *If your answer to 35, 36, 37, 38, or 39 is "Yes," do 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 2001 tax year (see instructions beginning on page 8):					

41 Amortization of costs that began before your 2001 tax year **41**

42 **Total.** Add amounts in column (f). See page 9 of the instructions for where to report . . . **42**

Form **4562** (2001)

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. He enters his principal business.

Line B. He enters 812111, which is the 6-digit business code for a barber shop. He found the code on page C–8 of the instructions for Schedule C. Stanley locates the major business category that describes his business. He reads down the items under "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 $2,330 and consist of the following:

- Advertising in the local newspaper—$145
- Supplies—$475
- Business licenses—$150
- Utilities (electricity and water)—$360
- Rent—$1,200

Line 3–Net profit. Stanley subtracts his total expenses ($2,330) from his gross receipts ($27,000) to get his net profit of $24,670. 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 $24,670. This is his net profit from line 3 of Schedule C–EZ.

Line 4. He multiplies $24,670 by .9235 to get his net earnings from self-employment ($22,783). This is his net profit subject to self-employment tax.

Line 5. Because the amount on line 4 is less than $80,400, Stanley multiplies the amount on line 4 ($22,783) by .153 to get his self-employment tax of $3,486. He enters that amount here and on line 53 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 $1,743. He enters that amount here and on line 27 of Form 1040.

Form 1040

Stanley 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 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 of $24,670 from line 3 of Schedule C–EZ.

Line 22. Stanley adds the amounts on lines 7 through 21 and enters the total, $25,110.

Line 23. Stanley enters the $2,000 contribution he made for the year to his individual retirement arrangement (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, $3,743.

Line 33. Stanley subtracts the amount on line 32 from the amount on line 22 to arrive at his adjusted gross income, $21,367. He also enters this amount on line 34.

Line 36. He enters $4,550. This is the standard deduction for a single filer.

Line 37. Stanley subtracts line 36 from line 34 to get $16,817.

Line 38. He multiplies $2,900 by the number of exemptions claimed on line 6d to get his total exemptions, $2,900.

Line 39. Stanley subtracts line 38 from line 37 to get his taxable income, $13,917.

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 $13,917. He finds the bracket for incomes of at least $13,900, but less than $13,950 and sees that the tax for a person filing as single is $2,089. He enters this amount here.

Lines 41 and 42. Because he does not owe alternative minimum tax, he enters -0- on line 41 and $2,089 on line 42.

Line 47. Because Stanley received the advance payment of his 2001 taxes, he is not entitled to claim the rate reduction credit.

Lines 51 and 52. Because Stanley does not have any of the credits listed on lines 43 through 50, he enters -0- on line 51 and $2,089 on line 52.

Line 53. He enters $3,486 from line 5 in Section A of Schedule SE.

Line 58. Stanley adds the amounts on lines 52 through 57 and enters the total, $5,575.

Line 60. He enters $6,000 of estimated tax payments he made for the year.

Line 66. He enters $6,000.

Lines 67 and 68a. Stanley subtracts line 58 from line 66 to arrive at the amount he overpaid, $425. He wants this amount refunded to him so he enters it on line 68a. The IRS will send him a check for this amount provided he owes no other taxes, child support, spousal support, or certain other federal nontax debt. If Stanley wanted the refund deposited directly into his checking or savings account, he would have had to complete lines 68b, c, and d.

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

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2001 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 OMB No. 1545-0074

Label

(See instructions on page 19.)
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 19.: 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 19.: ANYTOWN, TX 70000		

Presidential Election Campaign (See page 19.)
Note. Checking "Yes" will not change your tax or reduce your refund.
Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☑ Yes ☐ No Spouse ☐ Yes ☐ No

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 19.) 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 ▶). (See page 19.)

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 — No. of boxes checked on 6a and 6b: 1
b ☐ **Spouse** — No. of your children on 6c who:
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 20)
			☐
			☐
			☐
			☐
			☐
			☐

If more than six dependents, see page 20.

• lived with you
• did not live with you due to divorce or separation (see page 20)
Dependents on 6c not entered above
Add numbers entered on lines above ▶ 1

d Total number of exemptions claimed

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, 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 22)			10		
11	Alimony received			11		
12	Business income or (loss). Attach Schedule C or C-EZ			12	24,670	00
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13		
14	Other gains or (losses). Attach Form 4797			14		
15a	Total IRA distributions	15a	b Taxable amount (see page 23)	15b		
16a	Total pensions and annuities	16a	b Taxable amount (see page 23)	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 25)	20b		
21	Other income. List type and amount (see page 27)			21		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶			22	25,110	00

Adjusted Gross Income

23	IRA deduction (see page 27)	23	2,000	00			
24	Student loan interest deduction (see page 28)	24					
25	Archer MSA deduction. Attach Form 8853	25					
26	Moving expenses. Attach Form 3903	26					
27	One-half of self-employment tax. Attach Schedule SE	27	1,743	00			
28	Self-employed health insurance deduction (see page 30)	28					
29	Self-employed SEP, SIMPLE, and qualified 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	3,743	00
33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶				33	21,367	00

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 72. Cat. No. 11320B Form **1040** (2001)

Tax and Credits

Standard Deduction for—
- People who checked any box on line 35a or 35b **or** who can be claimed as a dependent, see page 31.
- All others:

Single, $4,550
Head of household, $6,650
Married filing jointly or Qualifying widow(er), $7,600
Married filing separately, $3,800

34	Amount from line 33 (adjusted gross income)	34	21,367 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 31 and check here ▶ 35b ☐		
36	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	36	4,550 00
37	Subtract line 36 from line 34	37	16,817 00
38	If line 34 is $99,725 or less, multiply $2,900 by the total number of exemptions claimed on line 6d. If line 34 is over $99,725, see the worksheet on page 32	38	2,900 00
39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-	39	13,917 00
40	**Tax** (see page 33). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972	40	2,089 00
41	**Alternative minimum tax** (see page 34). Attach Form 6251	41	- 0 -
42	Add lines 40 and 41 ▶	42	2,089 00
43	Foreign tax credit. Attach Form 1116 if required	43	
44	Credit for child and dependent care expenses. Attach Form 2441	44	
45	Credit for the elderly or the disabled. Attach Schedule R	45	
46	Education credits. Attach Form 8863	46	
47	Rate reduction credit. See the worksheet on page 36	47	
48	Child tax credit (see page 37)	48	
49	Adoption credit. Attach Form 8839	49	
50	Other credits from: **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify) ________	50	
51	Add lines 43 through 50. These are your **total credits**	51	- 0 -
52	Subtract line 51 from line 42. If line 51 is more than line 42, enter -0- ▶	52	2,089 00

Other Taxes

53	Self-employment tax. Attach Schedule SE	53	3,486 00
54	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	54	
55	Tax on qualified plans, including IRAs, and other tax-favored accounts. Attach Form 5329 if required	55	
56	Advance earned income credit payments from Form(s) W-2	56	
57	Household employment taxes. Attach Schedule H	57	
58	Add lines 52 through 57. This is your **total tax** ▶	58	5,575 00

Payments

If you have a qualifying child, attach Schedule EIC.

59	Federal income tax withheld from Forms W-2 and 1099	59	
60	2001 estimated tax payments and amount applied from 2000 return	60	6,000 00
61a	**Earned income credit (EIC)**	61a	
b	Nontaxable earned income 61b		
62	Excess social security and RRTA tax withheld (see page 51)	62	
63	Additional child tax credit. Attach Form 8812	63	
64	Amount paid with request for extension to file (see page 51)	64	
65	Other payments. Check if from **a** ☐ Form 2439 **b** ☐ Form 4136	65	
66	Add lines 59, 60, 61a, and 62 through 65. These are your **total payments** ▶	66	6,000 00

Refund

Direct deposit? See page 51 and fill in 68b, 68c, and 68d.

67	If line 66 is more than line 58, subtract line 58 from line 66. This is the amount you **overpaid**	67	425 00
68a	Amount of line 67 you want **refunded to you** ▶	68a	425 00
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
69	Amount of line 67 you want **applied to your 2002 estimated tax** ▶ 69		

Amount You Owe

70	**Amount you owe.** Subtract line 66 from line 58. For details on how to pay, see page 52 ▶	70	
71	Estimated tax penalty. Also include on line 70 71		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 53)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ ( ) Personal identification number (PIN) ▶

Sign Here

Joint return? See page 19.
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 phone number
Stanley Price	3/15/02	Barber	(555) 735-0002
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 SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code		EIN	
		Phone no. ( )	

Form **1040** (2001)

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 1041.** ▶ **See instructions on back.**

OMB No. 1545-0074

2001

Attachment Sequence No. **09A**

Name of proprietor	Social security number (SSN)
Stanley Price	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-3 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 code from pages C-7 & 8** ▶ 8 1 2 1 1 1
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-2 and check here . . . . ▶ ☐	**1**	27,000	00
2	**Total expenses.** If more than $2,500, you **must** use Schedule C. See instructions	**2**	2,330	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**	24,670	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 2001, 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 personal 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) 2001**

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 2001 Attachment Sequence No. **17**
Name of person with **self-employment** income (as shown on Form 1040) Stanley Price	Social security number of person with **self-employment** income ►	000 00 0000

Who Must File Schedule SE

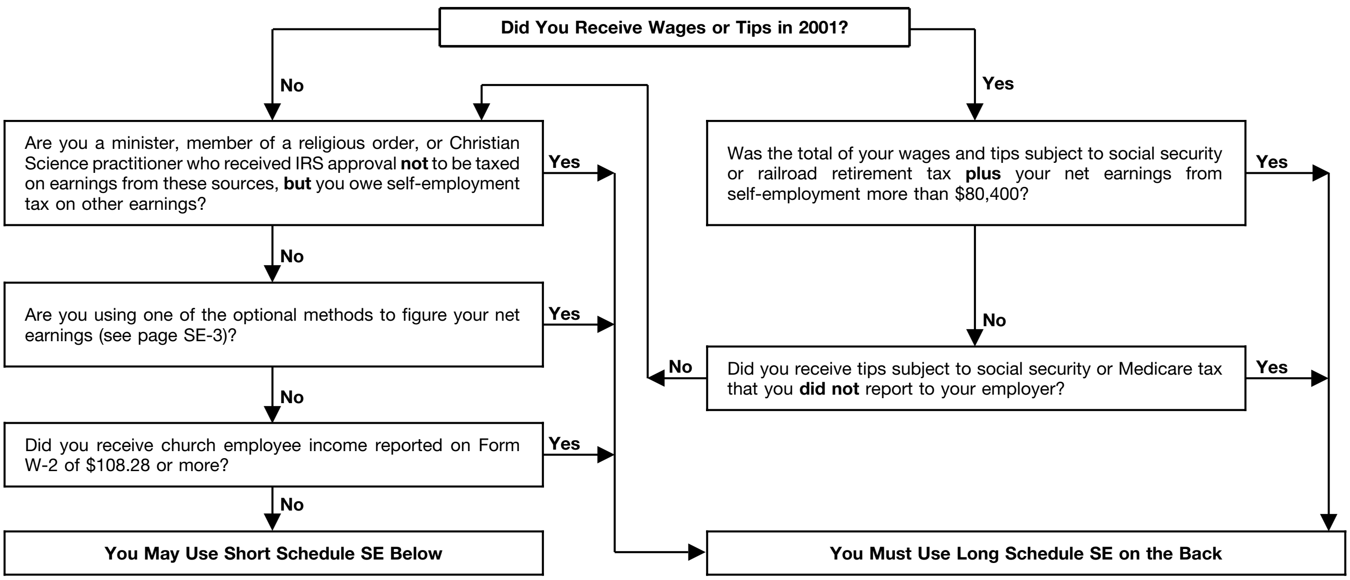
You must file Schedule SE if:

- 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 53.

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**	24,670	00
3	Combine lines 1 and 2	**3**	24,670	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**	22,783	00
5	**Self-employment tax.** If the amount on line 4 is: • $80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 53.** • More than $80,400, multiply line 4 by 2.9% (.029). Then, add $9,969.60 to the result. Enter the total here and on **Form 1040, line 53.**	**5**	3,486	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** — 1,743 00			

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2001**

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

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

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.

Professional and courteous service. If you believe that an IRS employee has not treated you in a professional, fair, and courteous manner, you should tell that employee's supervisor. If the supervisor's response is not satisfactory, you should write to the IRS director for your area or the center where you filed your return.

Representation. You may either represent yourself or, with proper written authorization, have someone else represent you in your place. Your representative must be a person allowed to practice before the IRS, such as an attorney, certified public accountant, or enrolled agent. If you are in an interview and ask to consult such a person, then we must stop and reschedule the interview in most cases.

You can have someone accompany you at an interview. You may make sound recordings of any meetings with our examination, appeal, or collection personnel, provided you tell us in writing 10 days before the meeting.

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. If you cannot pay all of your tax when it is due, you may be able to make monthly installment payments.

Help with unresolved tax problems. The Taxpayer Advocate Service can help you if you have tried unsuccessfully to resolve a problem with the IRS. Your local Taxpayer Advocate can offer you special help if you have a significant hardship as a result of a tax problem. For more information, call toll free **1–877–777–4778** (**1–800–829–4059** for TTY/TDD) or write to the Taxpayer Advocate at the IRS office that last contacted you.

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 Appeals Office to review your case. You may also ask a court to review your case.

Relief from certain penalties and interest. 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. We will waive interest that is the result of certain errors or delays caused by 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.

The process of selecting a return for examination usually begins in one of two ways. First, we use computer programs to identify returns that may have incorrect amounts. These programs may be based on information returns, such as Forms 1099 and W–2, on studies of past examinations, or on certain issues identified by compliance projects. Second, we use information from outside sources that indicates that a return may have incorrect amounts. These sources may include the media, public records, and individuals. If we determine that the information is accurate and reliable, we may use it to select a return for examination.

Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund,* explains the rules and procedures that we follow in examinations. The following sections give an overview of how we conduct examinations.

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. You can respond by mail or you can request a personal interview with an examiner. If you mail 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 to us about anything you do not understand.

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. If our examiner proposes any changes to your return, he or she will explain the reasons for the changes. If you do not agree with these changes, you can meet with the examiner's supervisor.

Repeat examinations. If we examined your 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 see if we should discontinue the examination.

Appeals. If you do not agree with the examiner's proposed changes, you can appeal them to the Appeals Office of IRS. Most differences can be settled without expensive and time-consuming court trials. Your appeal rights are explained in detail in both Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree,* and Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund.*

If you do not wish to use the Appeals Office or disagree with its findings, you may be able to 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 you take your case to court, the IRS will have the burden of proving certain facts if you kept adequate records to show your tax liability, cooperated with the IRS, and meet certain other conditions. If the court agrees with you on most issues in your case and finds that the IRS' 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 the appeals system, and you gave us the information necessary to resolve the case.

Collections. Publication 594, *The IRS Collection Process,* explains your rights and responsibilities regarding payment of federal taxes. It describes:

- What to do when you owe taxes. It describes what to do if you get a tax bill and what to do if you think your bill is wrong. It also covers making installment payments, delaying collection action, and submitting an offer in compromise.
- IRS collection actions. It covers liens, releasing a lien, levies, releasing a levy, seizures and sales, and release of property.

Your collection appeal rights are explained in detail in Publication 1660, *Collection Appeal Rights.*

Innocent spouse relief. Generally, both you and your spouse are responsible, jointly and individually, for paying the full amount of any tax, interest, or penalties due on your joint return. However, if you qualify for innocent spouse relief, you may not have to pay the tax, interest, and penalties related to your spouse (or former spouse). For information on innocent spouse relief and two other ways to get relief, see Publication 971, *Innocent Spouse Relief,* and ***Form 8857,*** *Request for Innocent Spouse Relief (And Separation of Liability and Equitable 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 from the date you filed your original return or 2 years from 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.

If you were due a refund but you did not file a return, you must file within 3 years from the date the return was originally due to get that refund.

12. 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.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. 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.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1–877–777–4778.**
- Call the IRS at **1–800–829–1040.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

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 2002*
- 583, *Starting a Business and Keeping Records*
- 594, *The IRS 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.gov**. While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov.**

TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions 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.

For help with transmission problems, call the FedWorld Help Desk at **703–487–4608.**

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 walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 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 and instructions.
- Popular tax forms that 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) by calling **1–877–233–6767** or on the Internet at **www.irs.gov.** The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide,* is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1–800–829–3676** or visiting the IRS web site at **www.irs.gov.**

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 of each agency and rate its responsiveness to small business. If you wish to comment on the enforcement actions of the IRS, you can:

- Call **1–888–REG–FAIR (1–888–734–3247)**,
- Send an e-mail to **ombudsman@sba.gov**, or
- Download the appraisal form at **www.sba.gov/regfair**.

Small Business Administration

The Small Business Administration (SBA) offers training and educational programs, counseling services, financial programs, and contract assistance for small business owners. The SBA also has publications and videos on a variety of business topics. The following briefly describes assistance provided by the SBA.

Small Business Development Centers (SBDCs). SBDCs provide counseling, training, and technical services to current and prospective small business owners who cannot afford the services of a private consultant. Help is available when beginning, improving, or expanding a small business.

Business Information Centers (BICs). BICs offer a small business reference library, management video tapes, and computer technology to help plan a business. BICs also offer one-on-one assistance. Individuals who are in business or are interested in starting a business can use BICs as often as they wish at no charge.

Service Corps of Retired Executives (SCORE). SCORE provides small business counseling and training to current and prospective small business owners. SCORE is made up of current and former business people who offer their expertise and knowledge to help people start, manage, and expand a small business. SCORE also offers a variety of small business workshops.

Personal computer. With your personal computer and modem, you can access the SBA on the Internet at **www.sba.gov.** While visiting the SBA web site, you can find a variety of information of interest to small business owners.

Phone. Call the SBA Answer Desk at **1–800–UASK-SBA (1–800–827–5722)** for general information about programs available to assist small business owners.

Walk-in. You can walk in to a Small Business Development Center or Business Information Center to request assistance with your small business. To find the location nearest you, access the SBA on the Internet or call the SBA Answer Desk.

Other Federal Agencies

Other federal agencies also publish publications and pamphlets to assist small businesses. Most of these are available from the Superintendant of Documents at the Government Printing Office. You can get information and order these publications and pamphlets in several ways.

Personal computer. With your personal computer and modem, you can access the GPO on the Internet at **www.access.gpo.gov**.

Phone. Call the GPO at **1–202–512–1800.** This is not a toll-free call.

Mail. Write to the GPO at the following address.

Superintendent of Documents
U.S. Government Printing Office
P.O. Box 371954
Pittsburgh, PA 15250–7954

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