5 Sole Proprietorships and Farmers

Tab 5 Contents

Business Use of Home Methods **5-1**
Common Elections **5-1**
Employer Identification Number (EIN) **5-1**
2025 Daycare Meal and Snack Rates **5-1**
Self-Employment (SE) Tax **5-2**
Per Diem Rates **5-2**
Hobby Loss Rules **5-2**
Farmers — Estimated Tax **5-2**
Features of Sole Proprietorships **5-2**
Self-Employment Tax Situations Chart **5-3**
Principal Business or Professional Activity Codes **5-4**
Schedule C—Profit or Loss From Business **5-6**
Schedule C Recordkeeping and Substantiation Rules 5-7
Self-Employed Health Insurance Deduction 5-10
Employee-Spouse Health Insurance 5-10
Excess Business Loss Limitation 5-13
Business Use of Home **5-13**
Simplified Method 5-15
Regular Method 5-16
Sole Proprietorships **5-18**
Daycare Providers—Deducting Meals 5-19
Authors, Artists, and Musicians 5-19
Name, Image, and Likeness (NIL) 5-19
Sharing (Gig) Economy 5-20
Foster Care Business 5-20
Family Businesses—Employing Family Members 5-20
Hobby Loss Rules **5-21**
Independent Contractor vs. Employee **5-22**
Erroneous Treatment of Employees as Independent Contractors—Form 1099-NEC Received 5-24
Self-Employment Tax **5-25**
Self-Employment Tax Optional Methods Election 5-25
Schedule F — Profit or Loss From Farming **5-25**
Agricultural Program Payments 5-27
Income Averaging for Farmers and Fishermen 5-28
Postponing Gain on Weather-Related Sales of Livestock 5-30

Business Use of Home Methods (page 5-13)

	Simplified Method	*Regular Method*
Regular/exclusive use tests	No differences.	No differences.
Maximum square footage allowed for business.	300 square feet.	No maximum.
Expenses allowed	$5 per square foot.	Actual expenses determined and records maintained.
Depreciation deduction.	No.	Yes.
Depreciation recapture on sale of home.	No.	Yes.
Deduction cannot exceed gross income limitation.	No differences.	No differences.
Carryover of expenses in excess of gross income limitation.	No.	Yes.*
Home-related itemized deductions (i.e. mortgage interest and real estate taxes).	Claimed in full on Schedule A (Form 1040), subject to limitation.	Allocated between Schedule A (Form 1040) and business schedule.

* Loss carryover from use of regular method in prior year may not be claimed in a year the simplified method is used. The loss is carried over until the next year the regular method is used again.

New for 2025

- **Excess business loss limitation.** The excess business loss threshold increased. See *Excess Business Loss Limitation,* page 5-13.
- **Maximum earnings subject to Social Security tax.** The amount of earnings subject to Social Security tax has increased to $176,100. See *Maximum earnings subject to self-employment tax,* page 5-25.

Common Elections

- Election by spouses to be treated as a qualified joint venture, page 5-6.
- Election to use simplified method or regular method for business use of home deduction, page 5-18.
- Election for sale of a musical composition, page 5-19.
- Election to postpone hobby or business status determination, page 5-22.
- Election to use self-employment tax optional methods, page 5-25.
- Election to use crop method of accounting for farmers, page 5-27.
- Election to postpone reporting crop insurance payments, page 5-27.
- Election to use income averaging for farmers and fishermen, page 5-28.
- Election to treat cut timber as sale or exchange, page 5-30.
- Election to treat outright sales of timber as Section 1231 gain or loss, page 5-30.

Employer Identification Number (EIN)

Third party designees. Tax practitioners who apply for EINs on behalf of their clients must first obtain a completed, signed Form SS-4, *Application for Employer Identification Number,* with the practitioner identified as "third party designee." The completed Form SS-4 must be faxed or mailed to the appropriate IRS service center.

Online (immediately): www.irs.gov, search "EIN online."
Fax (four business days) or mail (four to five weeks): Complete Form SS-4 and submit based on where the principal business is located.

One of the 50 states or the District of Columbia	Internal Revenue Service Attn: EIN Operation Cincinnati, OH 45999 **Fax:** 855-641-6935
No legal residence or principal place of business, office, or agency in any state	Internal Revenue Service Attn: EIN International Operation Cincinnati, OH 45999 **Fax:** 855-215-1627 (within U.S.) **Fax:** 304-707-9471 (outside U.S.)

Phone: 267-941-1099 (International applicants only)

Daily limit for EINs. One per responsible party per day, whether online, fax, or mail.

Responsible party. Only individuals with tax identification numbers may request an EIN as the "responsible party" on the application. Individuals named as responsible party must have either a Social Security Number (SSN) or an individual taxpayer identification number (ITIN).

2025 Daycare Meal and Snack Rates (page 5-19)

	Continental U.S.	*Alaska*	*Guam, Hawaii, Puerto Rico, Virgin Islands*
Breakfast	$1.66	$2.66	$2.14
Lunch and dinner (each)	$3.15	$5.10	$4.09
Snacks (each/up to three)	$0.93	$1.52	$1.22

Note: The applicable rates for 2025 are the Child and Adult Care Food Program reimbursement rates in effect on December 31, 2024.

Self-Employment (SE) Tax (page 5-25)

- Computation: Net profit × 0.9235 = Net SE earnings.
- File Schedule SE (Form 1040) if net SE earnings are $400 or more.
  Exception: File if church employee income is $108.28 or more.
- SE tax rate is 15.3% of net SE earnings, broken down as follows:
  – Social Security portion: Net SE earnings (up to limit) × 12.4%
  – Medicare portion: Net SE earnings × 2.9%
- Self-employment earnings limit on Social Security portion:

2025	*2024*	*2023*
$176,100	$168,600	$160,200

- Self-employment maximum tax on Social Security portion:

2025	*2024*	*2023*
$21,836	$20,906	$19,865

- Self-employment maximum tax on Medicare portion: No limit.
- Deduction for one-half of SE tax is reported on line 15, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.*
- Social Security earnings credit. One credit is earned for each of the following dollar amounts of SE earnings, up to four credits per year:

2025	*2024*	*2023*
$1,810	$1,730	$1,640

Self-employment tax optional method limits:

Optional method	*2025*	*2024*	*2023*
Farm gross income limit	$10,860	$10,380	$9,840
Farm net profits limit	$7,840	$7,493	$7,103
Nonfarm net profits limit	$7,840	$7,493	$7,103

Per Diem Rates

Effective	*10/1/25 – 9/30/26*	*10/1/24– 9/30/25*
Continental U.S. (CONUS)		
M&IE	$68	$68
Lodging	$110	$110
Transportation Industry		
M&IE (CONUS)	$80	$80
M&IE, outside continental U.S. (OCONUS)	$86	$86

Hobby Loss Rules (page 5-21)

Occasional profits from hobby activities are not subject to SE tax and hobby losses cannot offset other income because hobby expenses are limited to gross income from the activity.

Hobby income. Gross hobby income equals gross receipts minus cost of goods sold deduction. Report hobby income on line 8j, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.*

Hobby expenses. Hobby operating expenses are not deductible.

Note: Expenses related to a sole proprietor business are deductible on Schedule C (Form 1040), *Profit or Loss From Business.*

Farmers — Estimated Tax

For calendar year taxpayers, only one estimated payment is required if at least two-thirds of gross income for 2024 or 2025 is from farming or fishing. The due date of the estimated payment for tax year 2025 is January 15, 2026, and the required payment is two-thirds of the tax liability for 2025, or 100% of the tax shown on the 2024 return. Due dates for the first three installments do not apply. ***Exception:*** No estimated payment is required if the 2025 tax return is filed and the balance due paid by March 2, 2026.

Features of Sole Proprietorships*

Organization and Ownership	• One individual carrying on an unincorporated trade or business. • A qualified joint venture whose only members are spouses may elect not to be taxed as a partnership and file as two sole proprietorships. An LLC may not make this election. For an exception, see *Spousal LLC,* page 5-6. • Easiest business to organize with minimal legal restrictions. • The entity does not exist apart from the owner. Business starts and ends based on engaging in and ending engagement in business. • The owner has complete freedom over business decisions and is entitled to 100% of the after-tax profits. • The owner is limited by his or her own ability to raise capital and obtain financing. Outside investors cannot be part owners. • Transfer of ownership consists of selling the business assets. • A single-member LLC owned by an individual is taxed as a sole proprietorship unless an election is made to be taxed as a corporation.
Taxation of Profits and Losses	• The owner is self-employed and usually pays SE tax on net profits. See *Self-Employment Tax,* page 5-25. • Net profits are subject to income tax in the year earned and cannot be deferred by retaining profits. • Losses offset other income in year incurred, such as Form W-2 wages, interest, dividends, and capital gains. ***Exception:*** Losses cannot be used to offset income from activities subject to passive loss, at-risk loss, and hobby loss rules.
Accounting and Record-keeping	• Accounting is less involved than partnerships and corporations. Double-entry bookkeeping is not required as no balance sheet is needed when filing Schedule C (Form 1040), *Profit or Loss From Business,* or Schedule F (Form 1040), *Profit or Loss From Farming.* • Cannot file as a fiscal year business unless owner files Form 1040 under the fiscal year rules.
Fringe Benefits	Excludable fringe benefits are generally not allowed for owner. ***Exceptions:*** For instances where a sole proprietor may qualify for certain fringe benefits, see the following: • *Employee-spouse health insurance,* page 5-10. • *De Minimus Benefits,* page 22-3. • *Dependent Care Assistance,* page 22-4. • *Working Condition Benefits,* page 22-8.
Retirement	The owner can deduct contributions to qualified retirement plans. See *Pension Plan Characteristics – 2025* chart, page 13-4. ***Note:*** Owner contributions are deducted on Schedule 1 (Form 1040), and do not reduce self-employment income.
Liability	Owner is personally liable for all debts and lawsuits against the business. ***Exception:*** If organized as an LLC under state law, liability is usually limited to owner's investment and his or her own malpractice.

* Includes single-member LLCs and spousal businesses.

Note: For information on other types of business entities as compared to sole proprietorships, see *Business Entity Comparison Chart,* page 27-3.

Self-Employment Tax Situations Chart

This list is not intended to be all-inclusive

Type of Worker/Income	Self-Employment (SE) Tax Requirements
Employee	No SE tax, subject to FICA (Social Security and Medicare) withholding.
Hobby income	Not subject to SE tax.[1] See *Hobby Loss Rules,* page 5-21.
Partners and LLC members	Guaranteed payments and a general partner's distributive share of income are subject to SE tax. A limited partner's distributive share is not subject to SE tax [IRC §1402(a)(13)]. Distributive shares to LLC members who are active in the production of the LLC's earnings are subject to SE tax. See *Court Case* below.[2]
Partnership losses	A self-employment loss reported on Schedule K-1 (Form 1065) to a partner cannot be used to offset other self-employment income unless the partner has basis in the partnership loss. See *Basis,* page 20-13.
Deceased partner	If a general partner dies during the year, earnings from self-employment include the distributive share of partnership profits through the end of the month in which the partner died. [IRC §1402(f)]
Retired partner	Lifelong periodic payments are not subject to SE tax if the partner had no other interest in the partnership and did not perform services for the partnership during the year.
S corporation shareholder	Distributive share of earnings are not subject to SE tax. Wages paid for services performed are subject to FICA withholding.
Share crop farming	Producing crops or livestock on someone else's land for a share of the crops or livestock is subject to SE tax, as is the property owner's income if he or she materially participates in the farm activity.
Department of Agriculture	Payments for participating in a land diversion program are subject to SE tax. ***Exception:*** See *Conservation Reserve Program (CRP),* page 5-27.
Community property states	State laws that say income is earned one-half by each spouse do not apply to SE tax. The spouse who actually earns the income is subject to SE tax. See *Community Property,* page 14-4.
Covenant not-to-compete	Not subject to SE tax. (*Milligan,* 9th Cir., 1994)
Insurance agent (self-employed)	Subject to SE tax on regular, renewal, and deferred commissions, if earned prior to retirement. ***Exception:*** Covenant not-to-compete.
Rental real estate	Not subject to SE tax unless substantial services are provided, such as a hotel or tourist camp.
Newspaper and magazine sales	Under age 18, exempt from SE tax. Age 18 or older, subject to SE tax. See *Children in Business,* page 5-20.
Notary public	Exempt from SE tax. Enter "Exempt-Notary" on line 4, Schedule 2 (Form 1040), *Additional Taxes.* See *Notary Public,* Tab 3.
Interest on accounts receivable	Subject to SE tax if received in the course of trade or business.
Net operating loss (NOL)	Carryovers from other years do not reduce current year earnings for SE tax calculation purposes. See *Net Operating Loss (NOL),* page 8-20.
Fishing vessel crew members	Subject to SE tax if compensation based on share of catch and average crew size is less than 10. Crews of 10 or more are considered employees.
Corporate director fees	Subject to SE tax. See *Corporate director,* page 5-23.
Estate fiduciary fees	Not subject to SE tax unless taxpayer is a professional fiduciary or an active participant in the estate's trade or business.
Depreciation recapture	Not subject to SE tax unless due to the business use of Section 179 or section 280F listed property falling to 50% or less.
Church employees (not a minister or religious order member)	Must pay SE tax on wages exceeding $108.28 (unless minister or member of religious order) if employer has a certificate in effect electing an exemption from employee Social Security and Medicare taxes.
Ministers and members of religious order	Pay SE tax on salaries and other income for services performed as an ordained, commissioned, or licensed minister, member of a religious order, or a Christian Science practitioner. Housing allowance income may be subject to SE tax. See *Parsonage (Housing) Allowance,* page 14-6. ***Exceptions:*** • A minister or Christian Science practitioner can apply for exemption from SE tax by filing Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners.* • A member of a recognized religious group can file for an exemption from SE tax if he or she is conscientiously opposed to accepting Social Security or Medicare benefits, by filing Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits.* • Payment for services performed by a member of a religious order who has taken a vow of poverty is exempt from SE tax. [IRC §1402(c)]
U.S. citizen employed by foreign government	Subject to SE tax only if the services are performed in the United States, Puerto Rico, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the U.S. Virgin Islands.
Foreign earned income	U.S. citizens living and working outside the U.S. are subject to SE tax on SE earnings, unless the U.S. has a Social Security exemption agreement with the foreign country. The foreign earned income exclusion for income tax purposes does not apply to SE tax. See *Foreign Income,* page 14-10.
State and local government employees	Certain fee basis government employees not covered under a Social Security agreement may be subject to SE tax.

[1] **Court Case:** The courts have ruled that an activity subject to SE tax must be regular and continuous. A taxpayer was not liable for SE tax for doing a one-time window installation job where he had never performed that kind of service before, nor did he ever again at any time thereafter. (*Batok,* T.C. Memo. 1992-727)

[2] **Court Case:** LLC members reported distributive share of net profits in excess of guaranteed payments as income not subject to SE tax. The IRS argued, and the court agreed, that because each member had management power over the business, the distributive share payments were subject to SE Tax. (*Castigliola,* T.C. Memo. 2017-62)

Principal Business or Professional Activity Codes

These codes for the Principal Business or Professional Activity classify sole proprietorships by the type of activity they are engaged in to facilitate the administration of the IRC. These six-digit codes are based on the North American Industry Classification System (NAICS).

Select the category that best describes the primary business activity (for example, Real Estate). Then select the activity that best identifies the principal source of sales or receipts (for example, real estate agent). Now find the six-digit code assigned to this activity (for example, 531210, the code for offices of real estate agents and brokers) and enter it on line B, Schedule C (Form 1040).

Note: If principal source of income is from farming activities, file Schedule F (Form 1040), and enter code on line B, Schedule F (Form 1040).

Accommodation, Food Services, & Drinking Places

Accommodation

721310 Rooming & boarding houses, dormitories, & workers' camps
721210 RV (recreational vehicle) parks & recreational camps
721100 Traveler accommodation (including hotels, motels, & bed & breakfast inns)

Food Services & Drinking Places

722514 Cafeterias, grill buffets, & buffets
722410 Drinking places (alcoholic beverages)
722511 Full-service restaurants
722513 Limited-service restaurants
722515 Snack & non-alcoholic beverage bars
722300 Special food services (including food service contractors & caterers)

Administrative & Support and Waste Management & Remediation Services

Administrative & Support Services

561430 Business service centers (including private mail centers & copy shops)
561740 Carpet & upholstery cleaning services
561440 Collection agencies
561450 Credit bureaus
561410 Document preparation services
561300 Employment services
561710 Exterminating & pest control services
561210 Facilities support (management) services
561600 Investigation & security services
561720 Janitorial services
561730 Landscaping services
561110 Office administrative services
561420 Telephone call centers (including telephone answering services & telemarketing bureaus)
561500 Travel arrangement & reservation services
561490 Other business support services (including repossession services, court reporting, & stenotype services)
561790 Other services to buildings & dwellings
561900 Other support services (including packaging & labeling services, & convention & trade show organizers)

Waste Management & Remediation Services

562000 Waste management & remediation services

Agriculture, Forestry, Hunting, & Fishing

112900 Animal production (including breeding of cats and dogs)
114110 Fishing
113000 Forestry & logging (including forest nurseries & timber tracts)
114210 Hunting & trapping

Support Activities for Agriculture & Forestry

115210 Support activities for animal production (including farriers)
115110 Support activities for crop production (including cotton ginning, soil preparation, planting, & cultivating)
115310 Support activities for forestry

Arts, Entertainment, & Recreation

Amusement, Gambling, & Recreation Industries

713100 Amusement parks & arcades
713200 Gambling industries
713900 Other amusement & recreation services (including golf courses, skiing facilities, marinas, fitness centers, bowling centers, skating rinks, miniature golf courses)

Museums, Historical Sites, & Similar Institutions

712100 Museums, historical sites, & similar institutions

Performing Arts, Spectator Sports, & Related Industries

711410 Agents & managers for artists, athletes, entertainers, & other public figures
711510 Independent artists, writers, & performers
711100 Performing arts companies
711300 Promoters of performing arts, sports, & similar events
711210 Spectator sports (including professional sports clubs & racetrack operations)

Construction of Buildings

236200 Nonresidential building construction
236100 Residential building construction

Heavy and Civil Engineering Construction

237310 Highway, street, & bridge construction
237210 Land subdivision
237100 Utility system construction
237990 Other heavy & civil engineering construction

Specialty Trade Contractors

238310 Drywall & insulation contractors
238210 Electrical contractors
238350 Finish carpentry contractors
238330 Flooring contractors
238130 Framing carpentry contractors
238150 Glass & glazing contractors
238140 Masonry contractors
238320 Painting & wall covering contractors
238220 Plumbing, heating & air conditioning contractors
238110 Poured concrete foundation & structure contractors
238160 Roofing contractors
238170 Siding contractors
238910 Site preparation contractors
238120 Structural steel & precast concrete construction contractors
238340 Tile & terrazzo contractors
238290 Other building equipment contractors
238390 Other building finishing contractors
238190 Other foundation, structure, & building exterior contractors
238990 All other specialty trade contractors

Educational Services

611000 Educational services (including schools, colleges, & universities)

Farming

Crop Production

111100 Oilseed and grain farming
111210 Vegetable and melon farming
111300 Fruit and tree nut farming
111400 Greenhouse, nursery, and floriculture production
111900 Other crop farming

Animal Production

112111 Beef cattle ranching and farming
112112 Cattle feedlots
112120 Dairy cattle and milk production
112210 Hog and pig farming
112300 Poultry and egg production
112400 Sheep and goat farming
112510 Aquaculture
112900 Other animal production

Forestry and Logging

113000 Forestry and logging (including forest nurseries and timber tracts)
113110 Timber tract operations
113210 Forest nurseries and gathering of forest products
113310 Logging

Finance & Insurance

Credit Intermediation & Related Activities

522100 Depository credit intermediation (including commercial banking, savings institutions, & credit unions)
522200 Nondepository credit intermediation (including sales financing & consumer lending)
522300 Activities related to credit intermediation (including loan brokers)

Insurance Agents, Brokers, & Related Activities

524210 Insurance agencies & brokerages
524290 Other insurance related activities

Securities, Commodity Contracts, & Other Financial Investments & Related Activities

523160 Commodity contracts intermediation
523150 Investment banking & securities intermediation
523210 Securities & commodity exchanges
523900 Other financial investment activities (including investment advice)

Health Care & Social Assistance

Ambulatory Health Care Services

621610 Home health care services
621510 Medical & diagnostic laboratories
621310 Offices of chiropractors
621210 Offices of dentists
621330 Offices of mental health practitioners (except physicians)
621320 Offices of optometrists
621340 Offices of physical, occupational & speech therapists, & audiologists
621111 Offices of physicians (except mental health specialists)
621112 Offices of physicians, mental health specialists
621391 Offices of podiatrists
621399 Offices of all other miscellaneous health practitioners
621400 Outpatient care centers
621900 Other ambulatory health care services (including ambulance services, blood, & organ banks)

Hospitals

622000 Hospitals

Nursing & Residential Care Facilities

623000 Nursing & residential care facilities

Social Assistance

624410 Childcare services
624200 Community food & housing, & emergency & other relief services
624100 Individual & family services
624310 Vocational rehabilitation services

Information Publishing Industries

513000 Publishing industries

Broadcasting & Content Providers & Telecommunications

516000 Broadcasting & content providers
517000 Telecommunications including Wired, Wireless, Satellite, Cable & Other Program Distribution, Resellers, Agents, Other Telecommunications, & Internet service providers)

Data Processing, Web Search Portals, & Other Information Services

518210 Computing infrastructure providers, data processing, web hosting, & related services
519200 Web search portals, libraries, archives, & other info. services

Motion Picture & Sound Recording

512100 Motion picture & video industries (except video rental)
512200 Sound recording industries

continued on next page

Manufacturing

315000 Apparel mfg.
312000 Beverage & tobacco product mfg.
334000 Computer & electronic product mfg.
335000 Electrical equipment, appliance, & component mfg.
332000 Fabricated metal product mfg.
337000 Furniture & related product mfg.
333000 Machinery mfg.
339110 Medical equipment & supplies mfg.
322000 Paper mfg.
324100 Petroleum & coal products mfg.
326000 Plastics & rubber products mfg.
331000 Primary metal mfg.
323100 Printing & related support activities
313000 Textile mills
314000 Textile product mills
336000 Transportation equipment mfg.
321000 Wood product mfg.
339900 Other miscellaneous mfg.

Chemical Manufacturing

325100 Basic chemical mfg.
325500 Paint, coating, & adhesive mfg.
325300 Pesticide, fertilizer, & other agricultural chemical mfg.
325410 Pharmaceutical & medicine mfg.
325200 Resin, synthetic rubber, & artificial & synthetic fibers & filaments mfg.
325600 Soap, cleaning compound, & toilet preparation mfg.
325900 Other chemical product & preparation mfg.

Food Manufacturing

311110 Animal food mfg.
311800 Bakeries, tortilla, & dry pasta mfg.
311500 Dairy product mfg.
311400 Fruit & vegetable preserving & speciality food mfg.
311200 Grain & oilseed milling
311610 Animal slaughtering & processing
311710 Seafood product preparation & packaging
311300 Sugar & confectionery product mfg.
311900 Other food mfg. (including coffee, tea, flavorings, & seasonings)

Leather & Allied Product Manufacturing

316210 Footwear mfg. (including leather, rubber, & plastics)
316110 Leather & hide tanning & finishing
316990 Other leather & allied product mfg.

Nonmetallic Mineral Product Manufacturing

327300 Cement & concrete product mfg.
327100 Clay product & refractory mfg.
327210 Glass & glass product mfg.
327400 Lime & gypsum product mfg.
327900 Other nonmetallic mineral product mfg.

Mining

212110 Coal mining
211120 Crude petroleum extraction
212200 Metal ore mining
211130 Natural gas extraction
212300 Nonmetallic mineral mining & quarrying
213110 Support activities for mining

Other Services

Personal & Laundry Services

812111 Barber shops
812112 Beauty salons
812220 Cemeteries & crematories
812310 Coin-operated laundries & drycleaners
812320 Drycleaning & laundry services (except coin-operated) (including laundry & drycleaning drop-off & pickup sites)
812210 Funeral homes & funeral services
812330 Linen & uniform supply
812113 Nail salons
812930 Parking lots & garages
812910 Pet care (except veterinary) services
812920 Photofinishing
812190 Other personal care services (including diet & weight reducing centers)
812990 All other personal services

Repair & Maintenance

811120 Automotive body, paint, interior, & glass repair
811110 Automotive mechanical & electrical repair & maintenance
811190 Other automotive repair & maintenance (including oil change & lubrication shops & car washes)
811310 Commercial & industrial machinery & equipment (except automotive & electronic) repair & maintenance
811210 Electronic & precision equipment repair & maintenance
811430 Footwear & leather goods repair
811410 Home & garden equipment & appliance repair & maintenance
811420 Reupholstery & furniture repair
811490 Other personal & household goods repair & maintenance

Professional, Scientific, & Technical Services

541100 Legal services
541211 Offices of certified public accountants
541214 Payroll services
541213 Tax preparation services
541219 Other accounting services

Architectural, Engineering, & Related Services

541310 Architectural services
541350 Building inspection services
541340 Drafting services
541330 Engineering services
541360 Geophysical surveying & mapping services
541320 Landscape architecture services
541370 Surveying & mapping (except geophysical) services
541380 Testing laboratories

Computer Systems Design & Related Services

541510 Computer systems design & related services

Specialized Design Services

541400 Specialized design services (including interior, industrial, graphic, & fashion design)

Other Professional, Scientific, & Technical Services

541800 Advertising & related services
541600 Management, scientific, & technical consulting services
541910 Market research & public opinion polling
541920 Photographic services
541700 Scientific research & development services
541930 Translation & interpretation services
541940 Veterinary services
541990 All other professional, scientific, & technical services

Real Estate & Rental & Leasing

Real Estate

531100 Lessors of real estate (including miniwarehouses & self-storage units)
531210 Offices of real estate agents & brokers
531320 Offices of real estate appraisers
531310 Real estate property managers
531390 Other activities related to real estate

Rental & Leasing Services

532100 Automotive equipment rental & leasing
532400 Commercial & industrial machinery & equipment rental & leasing
532210 Consumer electronics & appliances rental
532281 Formal wear & costume rental
532310 General rental centers
532283 Home health equipment rental
532284 Recreational goods rental
532282 Video tape and disc rental
532289 Other consumer goods rental

Religious, Grantmaking, Civic, Professional, & Similar Organizations

813000 Religious, grantmaking, civic, professional, & similar organizations

Retail Trade

Building Material & Garden Equipment & Supplies Dealers

444140 Hardware retailers
444110 Home centers
444200 Lawn & garden equipment & supplies retailers
444120 Paint & wallpaper retailers
444180 Other building materials dealers

Clothing & Accessories Retailers

458110 Clothing & clothing accessories retailers
458310 Jewelry retailers
458320 Luggage & leather goods retailers
458210 Shoe retailers

Electronic & Appliance Retailers

449210 Electronics & appliance retailers (including computers)

Food & Beverage Retailers

445320 Beer, wine, & liquor retailers
445250 Fish & seafood retailers
445230 Fruit & vegetable retailers
445100 Grocer & convenience retailers
445240 Meat retailers
445290 Other specialty food retailers
445132 Vending machine operators

Furniture & Home Furnishing Retailers

449110 Furniture retailers
449120 Home furnishing retailers

Gasoline Stations & Fuel Dealers

447100 Gasoline stations (including convenience stores with gas)
457210 Fuel dealers (including heating oil & liquified petroleum)

General Merchandise Retailers

455000 General merchandise retailers

Health & Personal Care Retailers

456120 Cosmetics, beauty supplies, & perfume retailers
456130 Optical goods retailers
456110 Pharmacies & drug retailers
456190 Other health & personal care retailers

Motor Vehicle & Parts Dealers

441300 Automotive parts, accessories, & tire retailers
441222 Boat dealers
441227 Motorcycle, ATV, & all other motor vehicle dealers
441110 New car dealers
441210 Recreational vehicle dealers (including motor home & travel trailer dealers)
441120 Used car dealers

Sporting Goods, Hobby, Book, Musical Instrument & Miscellaneous Retailers

459210 Book retailers & news dealers (including newsstands)
459120 Hobby, toy, & game retailers
459140 Musical instrument & supplies retailers
459130 Sewing, needlework, & piece goods retailers
459110 Sporting goods retailers
459920 Art dealers
459310 Florists
459420 Gift, novelty, & souvenir retailers
459930 Manufactured (mobile) home dealers
459410 Office supplies & stationery retailers
459910 Pet & pet supplies retailers
459510 Used merchandise retailers
459990 All other miscellaneous retailers (including tobacco, candle, & trophy retailers)

Nonstore Retailers

Nonstore retailers sell all types of merchandise using such methods as Internet, mail-order catalogs, interactive television, or direct sales. These types of retailers should select the PBA associated with their primary line of products sold.

For example, establishments primarily selling prescription and non-prescription drugs, select PBA code 456110 Pharmacies & Drug Retailers.

Transportation & Warehousing

481000 Air transportation
485510 Charter bus industry
484110 General freight trucking, local
484120 General freight trucking, long distance
485210 Interurban & rural bus transportation
486000 Pipeline transportation
482110 Rail transportation
487000 Scenic & sightseeing transportation
485410 School & employee bus transportation
484200 Specialized freight trucking (including household moving vans)
485300 Taxi, limousine, & ridesharing service
485110 Urban transit systems
483000 Water transportation

continued on next page

485990 Other transit & ground passenger transportation
488000 Support activities for transportation (including motor vehicle towing)

Couriers & Messengers
492000 Couriers & messengers

Warehousing & Storage Facilities
493100 Warehousing & storage (except leases of miniwarehouses & self-storage units)

Utilities
221000 Utilities

Wholesale Trade

Merchant Wholesalers, Durable Goods
423200 Furniture & home furnishing
423700 Hardware, & plumbing & heating equipment & supplies
423600 Household appliances & electrical & electronic goods
423940 Jewelry, watch, precious stone, & precious metals
423300 Lumber & other construction materials
423800 Machinery, equipment, & supplies
423500 Metal & mineral (except petroleum)
423100 Motor vehicle & motor vehicle parts & supplies
423400 Professional & commercial equipment & supplies
423930 Recyclable materials
423910 Sporting & recreational goods & supplies
423920 Toy & hobby goods & supplies
423990 Other miscellaneous durable goods

Merchant Wholesalers, Nondurable Goods
424300 Apparel, piece goods, & notions
424800 Beer, wine, & distilled alcoholic beverage
424920 Books, periodicals, & newspapers
424600 Chemical & allied products
424210 Drugs & druggists' sundries
424500 Farm product raw materials
424910 Farm supplies
424930 Flower, nursery stock, & florists' supplies
424400 Grocery & related products
424950 Paint, varnish, & supplies
424100 Paper & paper products
424700 Petroleum & petroleum products
424940 Tobacco products & electronic cigarettes
424990 Other miscellaneous nondurable goods

Wholesale Trade Agents & Brokers
425120 Wholesale trade agents & brokers

999000 **Unclassified establishments (unable to classify)**

Schedule C— Profit or Loss From Business

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- IRS Pub. 334, *Tax Guide for Small Business*
- IRS Pub. 555, *Community Property*
- IRS Pub. 583, *Starting a Business and Keeping Records*
- IRC §61(a)(2), IRC §162, IRC §1402

Related Topics

- Business Deductions, Tab 8
- Meals, Entertainment, Travel, and Lodging, page 8-9
- Inventory/Cost of Goods Sold, page 8-13
- Start-Up/Organizational Costs, page 8-22
- Depreciation, Tab 9
- Starting a Business, Sch. M-1/M-3, Tab 27

Schedule C Filing Requirements

- Use Schedule C (Form 1040), *Profit or Loss From Business,* to report income and deductions from a business or profession operated as a sole proprietor. An activity is a business if the primary purpose is for income or profit, and the taxpayer is involved in the activity with continuity and regularity. See *Hobby Loss Rules,* page 5-21.
- Use Schedule C to report wages and expenses of a statutory employee. See *Statutory employee income,* page 5-9.
- Use a separate Schedule C for each spouse to report income and deductions of certain qualified joint ventures. See *Spousal business—qualified joint venture,* next column.
- Use Schedule C to report income shown on Form 1099-NEC, *Nonemployee Compensation.* See *Erroneous Treatment of Employees as Independent Contractors—Form 1099-NEC Received,* page 5-24.
- Use Schedule C to report certain income shown on Form 1099-MISC, *Miscellaneous Information.*
- Use Schedule C to report income shown on Form 1099-K, *Payment Card and Third-Party Network Transactions.* See *Form 1099-K in error or incorrect,* page 5-8.
- If a taxpayer owns and operates more than one sole proprietorship, file a separate Schedule C for each business activity. Combining separate activities on one Schedule C could result in negligence penalties. (Rev. Rul. 81-90)
- If a taxpayer receives income as both a self-employed individual and an employee in the same line of work, and expenses cannot be specifically identified as either for self-employment or as an employee, expenses must be allocated between deductible self-employment expenses and nondeductible employee expenses.

Schedule C or Partnership

If two or more individuals engage in a business together with the intent to share profits, the activity is a partnership, not a sole proprietorship. A partnership (including an LLC with two or more members) files Form 1065, *U.S. Return of Partnership Income,* unless it elects to be taxed as a corporation by filing Form 8832, *Entity Classification Election.* See *Partnerships and LLCs,* Tab 20.

Single-member LLC. A single-member LLC is generally disregarded and not treated as an entity separate from its owner for federal income tax purposes.

Disregarded entity. A single-member LLC owned by an individual files Schedule C, Schedule E (Form 1040), *Supplemental Income and Loss,* or Schedule F (Form 1040), *Profit or Loss From Farming,* as applicable.

Corporate election. A single-member LLC can elect to be taxed as a corporation. See *Entity Classification Election,* page 18-17.

Spousal business—qualified joint venture. A qualified joint venture whose only members are spouses may elect not to be treated as a partnership for federal tax purposes. A joint venture is qualified if:

- The only members of the joint venture are the spouses,
- Both spouses materially participate in the trade or business,
- A joint return is filed for the tax year, and
- Both spouses elect to have the provision apply.

Election to be treated as a qualified joint venture. The election is made by dividing all items of income, gain, loss, deduction, and credit between the spouses in accordance with their respective interests in the venture. Each spouse then completes a separate Schedule C, or Schedule F (Form 1040) for farm business ventures, and Schedule SE (Form 1040), *Self-Employment Tax,* based on this allocation.

Termination of partnership. If the spouses filed a Form 1065 for the year prior to the election, the partnership terminates at the end of the year immediately preceding the year the election takes effect. See *Terminating a Partnership,* page 20-19.

Community property laws. Spouses who wholly own an unincorporated business as community property under the community property laws of a state, foreign country, or U.S. possession can treat the business either as a sole proprietorship or a partnership. Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. See *Community Property,* page 14-4.

Spousal LLC. A spousal LLC may be treated differently if organized in a community property state versus a noncommunity property state.

- ***Community property.*** An LLC wholly owned by two spouses as community property may be treated as a disregarded entity or a partnership. (Rev. Proc. 2002-69)
- ***Non-community property.*** An unincorporated business organized as an LLC, wholly owned by two spouses in a non-community property state, must file as a partnership by default. The LLC is not qualified to be a joint venture because LLCs are state law entities.

Spouses with rentals. Spouses with rental real estate activity can make the election to be treated as a qualified joint venture and not be subject to SE tax on profits, assuming the rental activity is not otherwise subject to SE tax. (CCA 200816030)

Schedule C Recordkeeping and Substantiation Rules

Business records must be available at all times for inspection by the IRS. Business records are used to prove the source of receipts, as well as support deductible expenses and credits. There is no specific kind of recordkeeping required for sole proprietorships. Any system that clearly shows income and expenses is acceptable. See *Accounting Methods,* page 8-23.

Travel expenses. Special recordkeeping rules apply to business travel expenses. See *Substantiating Meals, Travel, and Lodging,* page 8-9.

Payroll. Special recordkeeping rules apply to employment tax records. See *Payroll Recordkeeping,* page 23-9.

Business bank account. A business should have its own bank account that is used for depositing business income and paying business expenses, separate from the owner's personal bank account.

- Business account activity may be tracked using a manual check register, a ledger, a spreadsheet, accounting software, etc.
- Deposit records should identify the source of the funds and whether deposits are business income, personal funds, or loans.
- Records of checks, electronic transfers, point-of-service transactions, and other withdrawals should identify the payee, business purpose, and other information that helps document the business expense.
- Avoid using the business account to pay personal expenses.
- Business profits can be withdrawn by writing a check to the business owner or by electronic transfer to the business owner's personal account. Outright cash withdrawals should be carefully documented.
- An IRS auditor may request a copy of electronic accounting files. See *Computerized records,* next column.

Court Case: Cohan, a theatrical manager and producer, entertained actors, employees, and drama critics. He also incurred travel expenses for business. He kept no records. He estimated that he had spent $11,000 during the first six months of 1921. The government disallowed all deductions on the grounds that it was impossible to tell how much he had in fact spent. The court ruled in favor of Cohan and his use of estimates to substantiate his deductions. This decision is referred to as the "Cohan Rule." (*Cohan,* 2nd Cir., March 3, 1930)

Response to Cohan. The IRC was amended to require adequate records or sufficient evidence corroborating a taxpayer's statement of travel, entertainment, and other expenses [IRC §274(d)]. In addition, entertainment expenses have subsequently been removed as an allowable deduction.

Court Case: In contrast to the *Cohan* court case, the IRS disallowed all deductions claimed on three separate Schedules C, and the Tax Court agreed. The taxpayer claimed that a house fire had destroyed documents that would have substantiated his deductions, but he failed to reconstruct his records in any meaningful manner. Therefore, the Court could not apply the Cohan rule in allowing estimates of the deductible amounts. (*Roumi,* T.C. Memo. 2012-2)

How long should records be kept? Records must be kept at least until the statute of limitations for a tax return has expired. See *Statutes of Limitations,* page 15-3.

Following are some general guidelines.

Recordkeeping Guidelines

If the taxpayer:	*Then the period is:*
Owes additional tax.	Three years.*
Omits reportable income in excess of 25% of gross income that should have been reported on the return.	Six years.*
Files a fraudulent return.	Unlimited.
Does not file a return.	Unlimited.
Files a claim for credit or refund after the original return has been filed.	Later of three years, or two years after tax was paid.
Files a claim for loss from worthless securities or a bad debt deduction.	Seven years.*

* After the later of the return due date or date filed.

Employment tax records. Employment tax records should be kept for at least four years after the date the tax becomes due or is paid, whichever is later.

Asset records. Asset records include acquisition cost, date, and any other information affecting basis. See *Basis and Holding Period Rules* chart, page 6-3. Asset records are used to calculate depreciation, amortization, and depletion deductions, and basis for gain or loss upon sale or other disposition. Asset records should be kept until the period of limitations expires for the year in which the asset is disposed of in a taxable disposition.

Computerized records. Business books and records maintained on a computer must provide enough detail to identify underlying source documents and substantiate entries on tax and information returns. (Rev. Proc. 98-25)

Planning Tips for Sole Proprietors

Starting a business. For more information on starting a business, see *Starting a Business, Sch. M-1/M-3,* Tab 27.

Form W-9, *Request for Taxpayer Identification Number and Certification.* Independent contractors should fill out and return Form W-9 before any services are provided. A written agreement should also be signed that states he or she is an independent contractor. The independent contractor should bill the sole proprietor for work performed. See *Independent Contractor vs. Employee,* page 5-22.

Retirement. Defer tax through retirement plan contributions, such as SEPs, SIMPLEs, defined benefit, defined contribution, and solo 401(k) plans. Unlike employees, sole proprietors generally have greater freedom of choice in choosing plans and greater access to withdrawing funds without having to first separate from service. See *Retirement, Social Security, and Medicare,* Tab 13.

Planning Tip: Depending on income and the contribution amount, a taxpayer who typically contributes to a SEP IRA may want to consider contributing to a traditional IRA instead. Contributions to SEP IRAs reduce qualified business income for purposes of the qualified business income deduction (QBID), while contributions to traditional IRAs do not.

Hire children as bona-fide employees. A child under age 18 working for a parent-owned unincorporated business is exempt from FICA (Social Security and Medicare taxes). Income tax is also reduced by shifting income to the child's lower tax rate. See *Family Businesses—Employing Family Members,* page 5-20.

Use health savings accounts (HSAs). HSAs can greatly reduce the cost of health care and work as an IRA-type of savings. Amounts distributed from the plan that are not spent on health

care are subject to penalty and tax. See *Health Savings Account (HSA),* page 14-6.

Charitable contributions. Convert Schedule A (Form 1040) charitable contributions into Schedule C (Form 1040) advertising expenses by donating money to a charity in exchange for advertising.

Business travel. Convert nondeductible vacation travel into business travel by planning vacations around business trips. See *Meals, Entertainment, Travel, and Lodging,* page 8-9.

Business credits. For more information on credits available to businesses, see *Business Credits,* Tab 31.

Start-up costs. Convert capitalized start-up costs into current operating deductions by planning for an earliest possible start date. See *Start-Up/Organizational Costs,* page 8-22.

Closing a business. For information on closing a business, see *Sales, Dispositions, and Liquidations,* Tab 28.

Small Business Compliance Act of 2021. The Small Business Administration (SBA) maintains a public website with links to small-entity compliance guides issued by federal agencies and those agencies' contact information. See https://www.sba.gov/about-sba/oversight-advocacy/office-national-ombudsman/compliance-contacts.

Beneficial ownership information (BOI) reporting. Beneficial ownership refers to identifying information about individuals who directly or indirectly own or control a company for FinCEN reporting purposes. See *Corporate Transparency Act (CTA),* page 27-6.

Schedule C Line-by-Line

Schedule C heading information:

Line A. Principal business or profession. Describe the business or professional activity and the type of product or service that provided the principal source of income for the business. If the taxpayer owns more than one business, complete a separate Schedule C (Form 1040) for each business.

Line B. Principal Business Activity Code. See the *Principal Business or Professional Activity Codes* chart, page 5-4.

Line D. Employer Identification Number (EIN). For information on how to obtain an EIN, see *Employer Identification Number (EIN),* page 5-1.

No EIN. If there is no EIN, leave line D blank. Do not enter the taxpayer's SSN on this line.

Sole proprietor. A sole proprietor is not required to have an EIN unless he or she has a qualified retirement plan, is a payer of gambling winnings, or is required to file employment or excise tax returns. However, a sole proprietor may obtain an EIN to use instead of his or her own Social Security Number when opening a business bank account or issuing Form 1099-NEC or Form 1099-MISC to subcontractors or vendors.

Single-member LLCs. By default, a single-member LLC owned by an individual is treated as a disregarded entity and follows the same EIN rules as other sole proprietors. A sole owner of an LLC that is not treated as a separate entity for federal income tax purposes, must enter on line D the EIN that was issued to the LLC, in the LLC's legal name, for a qualified retirement plan, to file employment, excise, alcohol, tobacco, or firearms returns, or as a payer of gambling winnings. If the LLC does not have such an EIN, leave line D blank.

Note: A single-member LLC is not a disregarded entity for employment tax purposes. [Reg. §301.7701-2(c)(2)(iv)(B)]

Line F. Accounting method. The cash method, accrual method, or any other method permitted by the Internal Revenue Code may be used. See *Accounting Periods and Methods,* page 8-23.

Line G. Material participation. If the sole proprietor does not materially participate in the business, losses may be limited under the passive activity loss rules. See *Material Participation,* Tab 7.

Line I and Line J. A sole proprietor is required to file Form 1099-NEC, *Nonemployee Compensation,* for any payments totaling $600 or more to independent contractors and other non-employees for services performed for the business. See *Independent Contractor vs. Employee,* page 5-22.

Form 1099-MISC, *Miscellaneous Information,* is used for rent and certain other payments totaling at least $600, and to report direct sales of at least $5,000 of consumer products to a buyer for resale.

Exceptions: Certain payments are not required to be reported on Form 1099-MISC or Form 1099-NEC, although they may be taxable to the recipient. These payments include the following:

- Payments to corporations (including an LLC treated as a corporation).
- Payments for merchandise, telegrams, telephone, freight, storage, and similar items.
- Payments of rent to real estate agents or property managers.
- Wages and allowances paid to employees (report on Form W-2).
- Payments to a tax-exempt organization including tax-exempt trusts, the United States, a state, the District of Columbia, a U.S. possession, or a foreign government.

See *Form 1099-NEC, Nonemployee Compensation,* page 23-7, and *Form 1099-MISC, Miscellaneous Information,* page 23-8.

For other information returns filing requirements, see *Guide to Information Returns* chart in the *2025 General Instructions for Certain Information Returns.*

Schedule C, Part I—Income

Gross income includes income from whatever source derived, unless specifically listed in the IRC as being exempt.

Line 1. Gross receipts or sales. Gross receipts from a trade or business can be in the form of cash, checks, and debit or credit card payments. Consider all Forms 1099 received for business income that must be reported.

If the total amount reported in box 1, Form 1099-NEC, exceeds the total reported on Schedule C, attach a statement explaining the difference.

Example: Terry is a cash basis tailor. She offers her services to various wedding dress and tuxedo rental stores, and she bills each store once a month. One store mailed her December payment on December 30, 2025, which she received on January 3, 2026. The store included the December payment on her Form 1099-NEC for 2025, which made her Form 1099-NEC income greater than the total includible on her 2025 Schedule C. Terry must attach a statement to her return explaining this difference.

Form 1099-K, *Payment Card and Third Party Network Transactions,* is an information return used to report payments received for goods or services during the year from payment cards (credit, debit, gift cards) or via payment apps and online marketplaces. The total payment amount received is reported as gross receipts or sales.

Form 1099-K in error or incorrect. A taxpayer may receive Form 1099-K in error or with incorrect information. In these cases, request a corrected form by contacting the issuer (filer) or the Payment Settlement Entity (PSE). Keep a copy of the corrected Form 1099-K and any correspondence with the filer or the PSE.

Corrected Form 1099-K not received. Enter payment amounts included in error on Form(s) 1099-K in the entry space at the top of Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.* For more information, see IRS Fact Sheet 2025-08.

Statutory employee income. If the taxpayer received a Form W-2 with box 13, *Statutory employee,* checked, the amount from box 1 of the Form W-2 is reported on line 1, Schedule C. Enter related statutory expenses on the appropriate lines of Schedule C and enter net profit or allowable loss on line 3, Schedule 1 (Form 1040).

- Do not carry net statutory income to Schedule SE (Form 1040). Social Security and Medicare tax should have been withheld and reported on the Form W-2.
- If a statutory employee also has self-employment income from another activity, the taxpayer must file a separate Schedule C for each activity. See *Statutory non-employee,* page 5-23.

Statutory employees are defined in IRC section 3121(d)(3) as:

- Agent-drivers or commission-drivers distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services.
- Full-time life insurance salespeople.
- Home workers making items according to specifications of the employer with materials or goods furnished to the worker by the employer. The finished products are then required to be returned to the employer.
- Full-time traveling or city salespeople selling for one principal employer (except for sideline sales activities on behalf of some other person).

Substantially all the services must be performed personally by the statutory employee for the employer. The statutory employee cannot have a substantial investment in facilities used in connection with performing the services (other than for transportation). The services cannot be in the nature of a single transaction. There must be a continuing relationship with the employer.

Digital asset income. Income received through digital assets as payment for goods and services must be converted to U.S. dollars as of the date the asset is received. The converted amount is reported as business income. For gain or loss on the sale or exchange of digital assets, see *Digital Asset Sale or Exchange,* page 6-14.

Barter income. Barter is the exchange of goods or services without the payment of money. When barter occurs in the course of a trade or business, the following rules apply.

- The fair market value of goods and services received must be included in business income in the year of receipt and is subject to self-employment tax.
- Associated expenses are deductible as business expenses.
- Bartering income is subject to 1099 reporting requirements. See *Form 1099-NEC,* page 23-7. Barter exchanges report trades on
- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions.* A sole proprietor includes barter exchange income on Schedule C if it occurs in connection with the sole proprietorship.

Author's Comment: Omission of barter income is a target in an IRS audit. Tax preparers should question their clients about bartering transactions and make sure all income has been reported.

Line 2. Returns and allowances. Report sales returns and allowances as a positive number on line 2, Schedule C. A sales return is a cash or credit refund given to a customer who returned defective, damaged, or unwanted products. A sales allowance is a reduction in the selling price of products, instead of a cash or credit refund.

Line 4. Cost of goods sold. Enter the cost of goods sold as calculated in Part III, Cost of Goods Sold, Schedule C. See *Schedule C (Form 1040), Part III—Cost of Goods Sold,* page 5-12.

Line 6. Other income. Enter on line 6, Schedule C:

- Finance reserve income.
- Scrap sales.
- Bad debts recovered.
- Interest on notes and accounts receivable.
- State gasoline or fuel tax refunds received in 2025.
- Credit for federal tax paid on fuels claimed on the 2024 return.
- Any credit amount for biofuel claimed on line 3, Form 6478, *Biofuel Producer Credit.*
- Any credit amount for biodiesel and renewable diesel fuels claimed on line 11, Form 8864, *Biodiesel and Renewable Diesel Fuels Credit.*
- Prizes and awards related to business.
- Taxable amount from Form 1099-PATR, *Taxable Distributions Received From Cooperatives,* allocated to the business.
- Recapture of excess depreciation, including Section 179 from Part IV, Form 4797, *Sales of Business Property,* when business use of listed property falls to 50% or less.
- Inclusion amount on leased listed property (other than a vehicle) when business use drops to 50% or less.
- Any credit amount for qualified sick and family leave wages.
- Any credit amount for COBRA premium assistance.
- Other kinds of miscellaneous business income including business-related crowdfunding.

Schedule C, Part II—Expenses

The Internal Revenue Code does not provide a complete list of expenses that are deductible for businesses. Instead, IRC section 162(a) states that a deductible business expense is any expense that is both ordinary and necessary. See *Business Deductions,* Tab 8.

Deductible Business Expense Factors	
Ordinary	Common and accepted in a particular industry.
Necessary	Helpful and appropriate for a particular trade or business, even if not indispensable.

Current deduction or capital expense. If real or tangible property is produced or acquired for resale, certain expenses attributable to the property must be included in inventory costs or capitalized. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

Expenses Not Allowed on Schedule C (Form 1040)	
Charitable contributions	Report qualified charitable contributions by a sole proprietor as itemized deductions on Schedule A (Form 1040).
Penalties and fines	Penalties, fines, and other costs for breaking the law are not generally deductible. However, penalties paid for late performance or nonperformance of a contract are generally deductible. See *Penalties and Fines,* page 8-7.
Political contributions	Direct or indirect contributions or gifts to political parties or candidates are not deductible.
Lobbying expenses	Lobbying expenses are generally nondeductible. [IRC §162(e)]

Line 8. Advertising. Advertising expenses directly related to a taxpayer's business activities are deductible.

Line 9. Car and truck expenses. See *Schedule C, Part IV—Information on Vehicle,* page 5-12. For information on deducting the business use of a vehicle, see *Business Autos,* page 10-2.

Standard mileage rate. The business standard mileage rate for 2025 is 70¢. For prior-year rates, see *Standard Mileage Rate* chart, page 10-1.

Line 10. Commissions and fees. Commissions and fees are paid for services conducted by nonemployees. Examples are paying an independent sales representative a commission or paying a finder's fee to someone outside the business. A commission paid to an employee is not reported here but is instead included in wages reported on Form W-2.

File Form 1099-NEC to report certain commissions and fees paid of $600 or more during the year.

Sales of property. A dealer in property may report the commissions and fees paid to facilitate the sale of property. For others, see *Tax Treatment of Settlement Costs on Purchase or Sale of Real Estate,* page 6-2.

Line 11. Contract labor. Contract labor is work performed for a business by non-employees, such as independent contractors. See *Independent Contractor vs. Employee,* page 5-22. For wages paid to employees, see *Line 26. Wages,* page 5-12.

Form 1099-NEC. If an independent contractor is paid $600 or more, the payer must issue a Form 1099-NEC. See *Form 1099-NEC, Nonemployee Compensation,* page 23-7.

Line 12. Depletion. Depletion is the using up of natural resources by mining, drilling, quarrying stone, or cutting timber. The depletion deduction allows an owner to account for the reduction of a product's reserve. To compute the depletion deduction, see *Depletion,* page 9-17.

Line 13. Depreciation and Section 179 expense deduction. Depreciation is the annual deduction allowed to recover the cost or other basis of business or investment property having a useful life of more than one year. See *Depreciation,* Tab 9.

Line 14. Employee benefit programs. Include contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan. Examples of employee benefit programs include accident and health plans, group-term life insurance, and dependent care assistance programs. Do not include any contributions made on behalf of the sole proprietor. See *Employee Fringe Benefits,* page 22-2.

Dependent care assistance program. Contributions made on behalf of employees to a dependent care assistance program are deductible employee benefits. If contributions were made on behalf of the sole proprietor to a dependent care assistance program, complete Parts I and III, Form 2441, *Child and Dependent Care Expenses,* to compute the deductible contribution.

Self-employed health insurance deduction. Health insurance paid on behalf of the sole proprietor as a self-employed taxpayer is deductible as an adjustment to income on line 17, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.* Deductible amounts include health insurance premiums paid for the self-employed taxpayer, spouse, dependents, and a child under age 27, if any of the following apply.

- The taxpayer was self-employed and had a net profit for the year (including self-employment earnings from a partnership).
- The taxpayer was a partner with net earnings from self-employment for the year reported on Schedule K-1 (Form 1065), box 14, code A.
- The taxpayer used one of the optional methods to calculate net earnings from self-employment on Schedule SE (Form 1040).
- The taxpayer received wages from an S corporation in which the taxpayer was a more than 2% shareholder. Health insurance benefits paid for the taxpayer are shown in box 1 and box 14, Form W-2.

The adjustment on line 17, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* is limited to the smaller of:

- Eligible health insurance premiums, or
- Net profit and any other earned income* from the business under which the insurance plan is established, reduced by:
  - The deduction on line 15, Schedule 1, for a portion of SE tax. See *Self-Employment Tax,* page 5-25, and
  - The deduction on line 16, Schedule 1, for any self-employed SEP, SIMPLE, or qualified plan contribution. See *Retirement, Social Security, and Medicare,* Tab 13.

* Earned income for a more than 2% S corporation shareholder is Medicare wages (box 5, Form W-2) from that corporation.

For purposes of the net profit limit, the taxpayer cannot combine Schedule C profits from multiple businesses for one health insurance plan. (CCA 200524001)

Form 7206. Use Form 7206, *Self-Employed Health Insurance Deduction,* to calculate the deduction if any of the following apply to the taxpayer.

- He or she has more than one source of income subject to self-employment tax.
- Form 2555, *Foreign Earned Income,* is filed.
- Amounts paid for qualified long-term care insurance are used to calculate the deduction.

Did You Know? All Medicare Parts are eligible for the self-employed health insurance deduction. Taxpayers can amend open years to claim omitted Medicare premium deductions. (CCA 201228037)

Subsidized health plan. Do not include any amount paid for any month or part of month in which the taxpayer was eligible to participate in a subsidized health plan maintained by the taxpayer's employer or spouse's employer.

Example: Jennifer was eligible to participate in a plan partially subsidized by her employer from January 1 through April 2. On April 3, she was covered under a plan established by her new self-employment business. She cannot use amounts paid for health insurance coverage for January through the end of April to compute the deduction.

Premium Tax Credit. No deduction is allowed for the portion of premiums for a qualified health plan equal to the amount of the Premium Tax Credit [IRC §280C(g)]. See *Premium Tax Credit,* page 11-13.

Health insurance in the name of the individual. To qualify for the self-employed insurance deduction the insurance plan must be established, or considered to be established, under the business. [IRC §162(l)(2)(A)]

- For self-employed individuals filing Schedule C (or Schedule F), a policy can be either in the name of the business or the individual. (Ltr. Rul. 200524001)
- For partners, a policy can be either in the name of the partnership or the partner. If the policy is in the name of the partner and the partner pays the premium, the partnership must reimburse the partner and report the premium amounts on Schedule K-1 (Form 1065), as guaranteed payments.
- For more than 2% shareholders, a policy can be either in the name of the S corporation or the shareholder. If the policy is in the shareholder's name and the shareholder pays the premiums, the S corporation must reimburse the shareholder and report the premium amounts on Form W-2 as wages. (Notice 2008-1)

See *Employee Fringe Benefits,* page 22-2.

Employee-spouse health insurance. A deduction on line 14, Schedule C, for 100% of the cost of providing health coverage for a sole proprietor and an employee-spouse and family may be claimed by following this procedure.

- The sole proprietor hires his or her spouse as a bona fide employee of the business.
- The sole proprietor provides family accident and health coverage for the employee-spouse, either through a self-insured medical expense reimbursement plan under IRC section 105(b), or by

purchasing an accident and health insurance policy under IRC section 106(a). The cost of health coverage and medical expense reimbursements are excluded from the employee-spouse's gross income (Rev. Rul. 71-588). See *Health Reimbursement Arrangement (HRA),* page 30-4.

- The sole proprietor is then covered by the plan as a member of the employee-spouse's family.
- Deductible expenses include reimbursed medical expenses for health insurance premiums and other costs not reimbursed by insurance.
- The accident and health policy should be purchased in the name of the employee-spouse to exclude the benefit from gross income. If the insurance is purchased in the name of the self-employed person, then a deduction for the cost of insurance claimed on Schedule C may be disallowed. The advantage of taking the deduction on Schedule C is that it also reduces the amount subject to SE tax.
- If the spouse is an independent contractor rather than an employee of the sole proprietor, then the cost of accident and health insurance benefits are not excluded from gross income by the spouse under IRC section 106(a).

Court Case: Although the taxpayer and his spouse had a bona fide employment agreement, a deduction on Schedule F (Form 1040) for health insurance premiums and medical expenses was not allowed under the provision for employee-spouse health insurance. The taxpayer failed to prove that the expenses for health coverage were incurred and paid by his spouse. The employer-spouse was the primary insured under the policy, and it was established that he incurred and paid the expenses in question, not his employee-spouse. The court determined that the amounts were not paid under an employee benefit program and were therefore not deductible. (*Albers,* T.C. Memo. 2007-144)

Court Case: In contrast to *Albers,* the court ruled a farming taxpayer, whose wife was a bona fide employee, could reimburse her for medical expenses through a medical reimbursement plan set up for his employees, even though one of the reimbursements made was for a joint health insurance plan in the taxpayer's name. The IRS contended the wife could only be reimbursed for medical costs and insurance in her name. The Tax Court concluded that since the employee-wife had paid nearly all the premiums from an account in her name, the deductions were allowable. (*Frahm,* T.C. Memo. 2007-351)

Line 15. Insurance (other than health). Business insurance premiums paid for a trade or business are deductible. However, deduct amounts paid for employee accident and health insurance on line 14, Schedule C (Form 1040). See *Insurance,* page 8-6.

Line 16. Interest. Deduct interest paid on debt used in connection with the business, including business portion of vehicle loans (in addition to standard mileage rate deduction). For applicable rules, see *Interest Tracing Rules (Allocation of Interest),* page 4-14.

Do not include on line 16, Schedule C (Form 1040):

- Interest claimed on Form 8829, *Expenses for Business Use of Your Home.* See *Business Use of Home,* page 5-13.
- Interest paid or assessed on income tax or underpayment penalties, even if tax is owed in connection with the business.
- Interest required to be added to basis under IRC section 263A uniform capitalization rules. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

Business interest limitation. A limitation applies to the deduction of business interest for taxpayers with average annual gross receipts in excess of $31 million (2025). For partnerships and S corporations, this limitation is applied at the partnership and S corporation level and any business interest deduction is used to determine the non-separately stated taxable income or loss of the partnership or S corporation. See *Business Interest Expense Limitation,* Tab 20.

Line 17. Legal and professional services. Fees charged by accountants and attorneys, that are ordinary and necessary expenses directly related to operating the business, and fees for tax advice and for preparation of tax forms related to the business, are deductible.

Line 18. Office expense. Office expenses include postage, and general office supplies such as paper, pens, pencils, staplers, printer toner, ink, etc.

Note: Office expenses for furniture and fixtures, rent, utilities, and renovations are deducted on other lines.

Line 19. Pension and profit-sharing plans. Amounts contributed to a pension, profit-sharing, or annuity plan for the benefit of the employees are deductible.

Any amounts contributed on behalf of the self-employed taxpayer should be deducted on line 16, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* not Schedule C. See *Retirement, Social Security, and Medicare,* Tab 13.

Line 20. Rent or lease. Use line 20a for vehicle, machinery, or equipment rentals or leases. Use line 20b for other property rentals, such as office space in a building. See *Rent or Lease,* page 8-7.

Line 21. Repairs and maintenance. Deduct the cost of incidental repairs and maintenance that do not add to the property's value or appreciably prolong its life. Do not deduct the value of the taxpayer's own labor. Do not deduct amounts spent to restore or replace property as those costs must be capitalized. See *Repairs and Improvements,* page 9-11.

Line 22. Supplies. Supplies are deductible to the extent they were actually consumed and used in the business during the year.

Exception: The cost of incidental materials and supplies kept on hand for which no inventories or records of use are kept are deductible in the year purchased. See *Materials and Supplies,* page 9-13.

The cost of books, professional instruments, and equipment is deductible if normally used within a year. If usefulness extends substantially beyond a year, the cost must generally be depreciated.

Do not include materials and supplies that must be accounted for as inventory. See *Schedule C, Part III—Cost of Goods Sold,* page 5-12.

Line 23. Taxes and licenses. Deduct the following taxes and licenses on line 23, Schedule C.

- State and local sales tax imposed on the business as the seller of goods or services. Sales tax imposed on the business and collected from customers must be reported in gross receipts or sales on line 1, Schedule C.
- Real estate and personal property taxes on business assets.
- Licenses and regulatory fees for the business paid each year to a state or local government. Some licenses, such as liquor licenses, may have to be amortized.
- Payroll taxes, such as the employer's share of FICA and FUTA. The employee's share of withheld FICA is deducted on line 26 as wages. Reduce the deduction by any amounts shown on line 4, Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips.*
- Federal highway use tax.
- Contributions to state unemployment insurance fund or disability benefit fund if considered taxes under state law.

Do not deduct any of the following on line 23.

- Federal income tax, including the taxpayer's SE tax. However, a portion of SE tax is deductible on line 15, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.*
- Estate and gift taxes.
- Taxes assessed to pay for improvements, such as paving and sewers. Add these taxes to the property's basis.

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- Taxes on the taxpayer's home or personal use property. For real estate taxes deductible on the business use of a home, see *Business Use of Home,* page 5-13.
- State and local sales taxes on property purchased for use in the business. Add these taxes to the cost basis of the property.
- State and local sales taxes imposed on the buyer that the business is required to collect and pay over to the state or local government. Do not include the tax collected in gross income. However, if the state or local government allows the business to retain any part of the sales tax collected, report that amount as other income on line 6, Schedule C.
- Other taxes and license fees not related to the business.

Line 24. Travel and meals. Use line 24a for lodging and transportation expenses connected with overnight travel for business while away from the taxpayer's tax home. Use line 24b for deductible meal expenses. See *Meals, Entertainment, Travel, and Lodging,* page 8-9.

Business meals. Business meals are 50% deductible.

Line 25. Utilities. Deduct only utility expenses for the business. Also see *Business Use of Home,* page 5-13.

Line 26. Wages. Include total gross salaries and wages paid to employees of the business (which includes withheld taxes), minus any employment tax credits being claimed. Do not include:

- Salaries and wages deducted elsewhere, such as wages included in cost of goods sold.
- Taxable fringe benefits paid to employees (such as personal use of a car) that are applicable to depreciation or to other expenses deducted elsewhere.
- Payments to independent contractors [deduct on line 11, Schedule C, instead].
- Any amounts paid to or taken as draw by the sole proprietor.

For information on Form W-2 and Form W-3, payroll tax return filing rules, and other labor law issues, see *Payroll and Labor Laws,* Tab 23.

See *Employee Fringe Benefits,* page 22-2.

Line 27a. Energy efficient commercial buildings deduction. Deduct part or all of the expenses of modifying an existing building to make it energy efficient. For more information, see *Energy Efficient Commercial Buildings Deduction,* page 8-6.

Line 30. Business use of home. Calculate the deduction for business use of the home using Form 8829, *Expenses for Business Use of Your Home,* or using the simplified method. See *Business Use of Home,* page 5-13.

Line 31. Net profit or loss. Enter net profit on line 3, Schedule 1 (Form 1040), *Additional Income and Adjustments Income.* If a loss, answer the at-risk question for line 32. If the taxpayer did not materially participate in the operation of the business, see *Passive Activity Losses,* page 7-7.

Earned income credit. If a taxpayer has a net profit on line 31, this amount may be used to qualify for the Earned Income Credit. See *Earned Income Credit,* page 11-8.

Qualified business income (QBI) deduction. A sole proprietor may qualify for the QBI deduction. See *Qualified Business Income Deduction (QBID)—IRC §199A,* page 8-15.

Line 32. At-risk question. If line 31 is a loss, and the taxpayer has amounts in the business for which the taxpayer is not at risk, the loss may be limited. See *At-Risk Rules,* page 7-12. If all investment is at risk, the loss is entered as a negative number on line 3, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.*

Schedule C, Part III—Cost of Goods Sold

In most cases, if the production, purchase, or sale of merchandise is an income-producing factor, the business must take inventories into account at the beginning and end of the tax year. This is true whether the cash or the accrual method of accounting is used. For more information on calculating the cost of goods sold deduction and inventory evaluation methods, see *Inventory/Cost of Goods Sold,* page 8-13.

Financial accounting treatment of inventories. See *Accounting Periods and Methods,* page 8-23.

Exception for a small business taxpayer. A small business taxpayer may choose to not keep an inventory, but he or she must still use a method of accounting for inventory that clearly reflects income [Reg. §1.471-1(b)]. See *Small Business Inventory Exception,* page 8-15.

Small business taxpayer. A taxpayer may qualify as a small business taxpayer if the business:

- Has average annual gross receipts of $31 million (2025) or less for the three prior tax years, and
- Is not a tax shelter.

Treating inventory as non-incidental material or supplies. If a business accounts for inventories as materials and supplies that are not incidental, it deducts the amounts paid to acquire or produce the inventoriable items treated as materials and supplies in the year in which they are provided to a customer. See *Materials and Supplies,* page 9-13.

Line 33. Inventory closing value method. Inventories can be valued at cost, the lower of cost or market, or any other method approved by the IRS.

Line 35. Inventory at beginning of year. Enter the amount from line 41, 2024 Schedule C. If there is a change in the method of accounting beginning with 2025, recalculate the 2024 closing inventory using the new method of accounting and enter the result. See Form 3115, *Application for Change in Accounting Method,* instructions for the IRC section 481(a) adjustment.

Line 36. Purchases less cost of items withdrawn for personal use. Include the cost of merchandise purchased for resale during 2025. If inventory is taken for personal use, subtract the cost of personal use items from total purchases for the year.

Line 37. Cost of labor. The cost of labor is added to inventory in manufacturing and construction type activities. Retailers and wholesalers do not add labor to inventory unless the uniform capitalization rules apply. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

Line 38. Materials and supplies. If producing a product to sell in a manufacturing or construction activity, include the cost of raw materials and supplies.

Line 39. Other costs. If the uniform capitalization rules apply, certain costs may be added to inventory. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

Line 41. Inventory at end of year. If the cash method of accounting is used, and inventory items are accounted for in the same manner as materials and supplies that are not incidental, enter the cost of inventory from line 40 that was not sold during the year. Otherwise, see *Identifying inventory items,* page 8-14.

Schedule C, Part IV—Information on Vehicle

If a deduction is taken for any car and truck expenses, complete one of the following.

- Part IV of Schedule C if:
  - The standard mileage rate is claimed, the vehicle is leased, or the vehicle is fully depreciated, and
  - Form 4562, *Depreciation and Amortization,* is not required for any other reason. If more than one vehicle is used for business,

attach a separate schedule with the information requested in Part IV, Schedule C, for each additional vehicle.
- Part V, Form 4562 if claiming depreciation on the vehicle or Form 4562 is required for any other reason.

For information on deducting the business use of a vehicle, see *Business Autos,* page 10-2.

Standard mileage rate. The business standard mileage rate for 2025 is 70¢. For prior-year rates, see *Standard Mileage Rate* chart, page 10-1.

Schedule C, Part V—Other Expenses

Include all ordinary and necessary business expenses not deducted elsewhere on Schedule C. List the type and amount of each expense separately. Other expenses include the following.
- Amortization from Form 4562. See *Amortization* chart, page 8-1.
- Deductible at-risk losses from previous years that were suspended under the at-risk rules. See *At-Risk Rules,* page 7-12.
- Debts and partial debts from sales or services that were included in income and are definitely known to be worthless. See *Bad Debts,* page 8-5.
- Up to $5,000 of certain business start-up or organizational costs if the business began in 2025. See *Start-Up/Organizational Costs,* page 8-22.
- Up to $15,000 of costs paid to remove barriers in 2025 to individuals with disabilities and the elderly.
- De minimis safe harbor for tangible property. See *De Minimis Safe Harbor Election,* page 9-12.
- Certain film and television and live theatrical production expenses.
- Up to $10,000 ($5,000 MFS) of certain forestation and reforestation costs. The remaining costs may be amortized.

Excess Business Loss Limitation

A loss from a trade or business of a noncorporate taxpayer may be limited [IRC § 461(l)]. Taxpayers cannot deduct an excess business loss in the current year. However, any disallowed excess business loss is treated as a net operating loss (NOL) carryover. See *Net Operating Loss (NOL),* page 8-20.

Excess business loss. An excess business loss is the amount by which the total deductions from a taxpayer's trades or businesses exceed the taxpayer's total gross income and gains from his or her trades or businesses, plus the threshold amount.

Gross income, gains, and deductions from performing services as an employee are excluded when determining excess losses.

A trade or business can include Schedules C and F activities and other business activities reported on Schedule E (pass-through income and losses from a partnership or S corporation). Business ordinary gains and losses reported on Form 4797, *Sales of Business Property,* can be included in the excess business loss calculation.

Threshold amount. For tax years beginning in 2025, the threshold amount is $313,000 ($626,000 MFJ).

Example: In 2025, Bob and Julie, (MFJ), have investment income of $700,000. In addition, they have $100,000 of gross business income and business losses of $900,000, with an aggregate business loss of $800,000. Their excess business loss is $174,000 [$900,000 – ($100,000 + $626,000)]. The $174,000 excess business loss is disallowed in 2025, added to their gross income, and carried forward to 2026, subject to NOL limits. Bob and Julie's adjusted gross income for 2025 is $74,000 [$700,000 + ($100,000 – $900,000 + $174,000)].

Ordering rules. First apply the at-risk rules (see *At-Risk Rules,* page 7-12), next apply the passive activity loss rules (see *Passive Activity Loss Limits,* page 7-7), then apply the excess business loss rules.

Farming losses. Taxpayers with losses from a farming business must apply the excess business loss limitation before carrying any net operating loss (NOL) back.

Farming and nonfarming losses. If a taxpayer incurs both farming and nonfarming business losses that are more than the threshold amount, the threshold amount must be allocated first to the farming losses to the extent the taxpayer has an NOL.

Form 461, *Limitation on Business Losses.* Use Form 461 to determine the amount of a taxpayer's excess business loss. The amount is included on line 8p, Schedule 1 (Form 1040).

Business Use of Home

Cross References

- Form 8829, *Expenses for Business Use of Your Home*
- IRS Pub. 587, *Business Use of Your Home*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*

Related Topics

- Real Estate Taxes, page 4-9
- Home Mortgage Interest, page 4-10
- Sales of Business Property (Form 4797), page 6-16
- Business Use or Rental of Home—Application of Exclusion Rules, page 6-25
- Depreciation, Tab 9

Business Use of Home Summary Chart

Tests for Self-Employed	*Exceptions*
1) Exclusive use test, page 5-14.	• Inventory or product sample storage. • Daycare facilities.
2) Regular use test, page 5-14.	• None.
3) Trade or business use test, page 5-14.	• Some rental activities. See *Mixed-Use Property—Vacation Homes (IRC §280A),* Tab 7.
4) Principal place of business test, page 5-14. (Includes administrative and management activities.)	• Meeting patients, clients, or customers in home office. • Separate free-standing structure.
Depreciation. Portion of home used for business is 39-year nonresidential real property.	
Employees. The business use of home deduction for employees is not allowed.	

Qualification Rules—Business Use of Home

Generally, a taxpayer cannot deduct items related to his or her home, such as mortgage interest, real estate taxes, utilities, maintenance, or insurance, as business expenses. However, a taxpayer may be able to deduct expenses related to the business part of the home if specific requirements are met. [IRC §280A(c)]

Requirements to qualify for a deduction. To take a business deduction, a taxpayer must use part of his or her home under one of the following situations.
- An area in the home is exclusively and regularly used as the taxpayer's principal place of business.
- An area in the home is exclusively and regularly used as a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of a trade or business.
- A separate structure which is not attached to the home is used in connection with a trade or business.
- An area in the home is used on a regular basis for storage of inventory or product samples.

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- The home is used for a rental activity. See *Mixed-Use Property—Vacation Homes (IRC §280A)*, Tab 7.
- The home is used as a daycare facility.

1) Exclusive Use Test

The exclusive use test is met if a specific area of the home is used only for business. The area can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition. This test is not met if the taxpayer uses the area both for business and for personal purposes, such as a den used for business during the day and TV viewing during the evening.

Exceptions to exclusive use test. The exclusive use test is not required for:

- An area used on a regular basis for storage of inventory or product samples.
- A home used as a daycare facility.

Storage of inventory or product samples. A taxpayer using part of a home for business to store inventory or product samples is not required to meet the exclusive use test. However, the taxpayer must meet all the following tests.

- The taxpayer is in the business of selling products at wholesale or retail.
- The inventory or product samples are kept in the home for use in the business.
- The taxpayer's home is the only fixed location of the business.
- The storage space is used on a regular basis.
- The storage space is a separately identifiable space suitable for storage.

Example: Peter is in the business of selling office supplies at wholesale to retail office supply stores. His home is the only fixed location for his business. He regularly uses storage shelves in his garage and basement for storage of inventory and product samples. The garage is also used to park the family cars, and the basement is also used as a recreation area for the family. The portions of the home used for storage space qualify for the business use of home deduction, even though these areas are not exclusively used for business.

Daycare facilities. The exclusive use test is not required if the home is used in a daycare business. To qualify, both of the following requirements must be met.

- The taxpayer must be in the trade or business of providing daycare for children, persons age 65 or older, or persons who are physically or mentally unable to care for themselves.
- The taxpayer must have applied for, been granted, or be exempt from having, a license or other approval as a daycare center under state law. If the application was rejected, or the license or other authorization was revoked, the taxpayer does not meet this test.

2) Regular Use Test

The regular use test means a taxpayer must use a specific area of the home for business on a regular basis. Incidental or occasional business use is not regular use. All facts and circumstances are considered in determining whether the business use is regular.

Court Case: A taxpayer was in the floor covering business and spent one hour in his home office each morning contacting customers, builders, and suppliers. In the evening, he spent a few more hours in his home office preparing various paperwork and returning calls. The court was satisfied that one hour in the morning and a few hours in the evening met the regular use test. (*Cole,* T.C. Memo. 1999-207)

Court Case: The taxpayers used their basement for meetings for their alleged business every two weeks. The court ruled the taxpayers did not devote substantial time and energy to the business activity and therefore the use of the basement did not qualify as regular use. Expenses for incidental or occasional use of a home office were not allowed. (*Moua,* T.C. Summary 2005-187)

3) Trade or Business Use Test

To satisfy the trade or business use test, a taxpayer must use part of the home in connection with a trade or business. If the use is for a profit-seeking activity that is not a trade or business, the business use of home deduction is not allowed.

Example: Kathy uses her den exclusively and regularly to read financial periodicals and reports and to carry out other activities related to her investments. She does not invest as a broker or dealer. Her activities are not part of a trade or business and, therefore, she cannot claim a deduction for the business use of her home.

Court Case: A taxpayer was a hospital employee. He also owned six rental units held for the production of income. The IRS denied the office-in-home deduction for the rental activity as it was not a trade or business. The court allowed the deduction and noted the personal efforts of the taxpayer to manage six units in seeking new tenants, supplying furnishings, cleaning, and otherwise preparing the units for new tenants. These activities were sufficiently systematic and continuous to place the taxpayer in the business of real estate rental. [*Curphey,* 73 T.C. No. 766 (1980)]

4) Principal Place of Business Test

A trade or business can have more than one location. To qualify for a business use of home deduction, the home must be the principal place of business for that trade or business. To make this determination, the following factors are considered.

- The relative importance of the activities performed at each place where business is conducted, and
- The amount of time spent at each place where business is conducted.

A home office qualifies under this test if:

- The home office is used exclusively and regularly for administrative or management activities of the trade or business, and
- There is no other fixed location where substantial administrative or management activities are conducted.

Administrative or management activities. Examples include billing customers, clients, or patients, keeping books and records, ordering supplies, setting up appointments, and forwarding orders or writing reports.

Administrative or management activities performed at other locations. The following activities will not disqualify a home office from being a principal place of business.

- Someone other than the taxpayer does administrative or management activities at locations other than the taxpayer's home office. For example, another company does the taxpayer's bookkeeping from its place of business.
- Administrative or management activities are conducted at places that are not fixed locations, such as a car or hotel room.
- The taxpayer occasionally conducts minimal administrative or management activities at a fixed location outside the home office.
- The taxpayer conducts substantial non-administrative or non-management business activities at a fixed location outside the home office. For example, the taxpayer meets with or provides services to customers, clients, or patients at a fixed location outside the home.

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- The taxpayer has suitable space to conduct administrative or management activities outside the home, but instead, chooses to use his or her home office for those activities.

Example: Mark is a self-employed plumber. Most of his working hours are spent at customers' homes and offices installing and repairing plumbing. He uses an office in his home regularly and exclusively for administrative activities, such as calling customers, ordering supplies, and customer billings. He writes up estimates for customers on their premises. He does not perform any substantial management activities at any other fixed location. He hires Susan as an independent contractor to perform bookkeeping and tax preparation services at her place of business. Mark's home office qualifies as his principal place of business for deducting expenses for the business use of his home.

More than one trade or business. The same home office can be used as the principal place of business for two or more separate business activities. The principal place of business test is determined separately for each activity.

Author's Comment: The fact that more than one business is using the home office does not disqualify the home office under the exclusive use test for another trade or business. In multiple business-use situations, the exclusive use test is applied by combining all trades or businesses using the same home office. The exclusive use test fails for all activities if one of the business activities using the home office fails under one of the other tests.

Exceptions to principal place of business test. The principal place of business test is not required for:

- Meeting patients, clients or customers.
- Separate structure.

Meeting patients, clients, or customers. The principal place of business test is not required if a taxpayer meets patients, clients, or customers in his or her home. The regular and exclusive use test must still be met. This exception applies only if the taxpayer meets both of the following tests.

- The taxpayer physically meets with patients, clients, or customers in the home, and
- Customer use of the home is substantial and integral to the conduct of the taxpayer's business.

Examples of taxpayers who may meet this exception include doctors, dentists, attorneys, and other professionals who maintain offices in their home. Using a home for occasional meetings and telephone calls will not qualify for this exception.

Example: Louise is a self-employed attorney. She works three days a week in her city office and two days a week in her home office used only for business. She regularly meets clients in her home office. Even though her principal place of business is her city office, her home office qualifies for a business deduction because she meets clients there in the normal course of her business.

Separate structure. The principal place of business test is not required if the area in the home used for business is a separate, free-standing structure, such as a studio, garage, or barn. The area must still meet the regular and exclusive use tests.

Example: Gloria operates a floral shop in town. She grows the plants for her shop in a greenhouse behind her home. She uses the greenhouse exclusively and regularly in her business. Because it is a separate structure, she can deduct the expenses for the business use of her greenhouse even though it is not her principal place of business.

Simplified Method

Electing the simplified method is an alternative to the calculation, allocation, and substantiation of actual expenses. In most cases, calculate the deduction by multiplying $5, the prescribed rate, by the area of the home used for a qualified business. The maximum area allowed is 300 square feet. For certain limitations, see *Allowable area,* below.

Deduction limited to business income. The deduction cannot be greater than business net income shown on line 29, Schedule C (Form 1040). No business use of home deduction is allowed if there is a business loss.

No carryover allowed. Any carryover from previously using regular method is carried over until the next year the regular method is used again.

Other provisions. Other provisions of the simplified method are:

- Allowable home-related itemized deductions, such as mortgage interest and real estate taxes, are claimed in full on Schedule A (Form 1040), subject to limitations.
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.
- If more than one business qualifies for the business use of home deduction, the election applies to all qualified business uses of home.
- If the taxpayer moves during the year, elect the simplified method for only one home. The regular method must be used for any other home.

Note: The simplified method reduces recordkeeping and substantiation but does not change the criteria for claiming a deduction.

Allowable area. The allowable area is the smaller of actual square footage of the business-use area of the home or 300 square feet. The allowable area may be smaller if the taxpayer conducted the business as a qualified joint venture with his or her spouse, the area used by the business was shared with another person's qualified business use, the taxpayer used the home for the business for only part of the year, or the area used by the business changed during the year.

Area used by a qualified joint venture. In a qualified joint venture, the taxpayer and spouse compute the deduction separately. Split the actual area used in conducting business between the taxpayer and spouse in the same manner as other tax attributes.

Shared use. A taxpayer who shares a home with someone else who also qualifies for a business use of home deduction may not include the same square footage to compute the deduction as the other person. The shared space must be allocated in a reasonable manner.

More than one qualified business use. A taxpayer that conducts more than one qualifying business is limited to a maximum of 300 square feet for all businesses. Allocate actual square footage used (up to 300 feet) among the qualified businesses in a reasonable manner. The taxpayer must use the same method for all qualified business uses of the same home for a particular year.

Rental use. If a taxpayer has a qualified business use of home and a rental use of the same home, the simplified method cannot be used for the rental use.

Part-year use or area changes. If qualified business use is for a portion of the year (for example, a seasonal business, a business that begins during the year, or the taxpayer moves during the year) or the taxpayer changes the square footage of business use, the deduction is limited to the average monthly allowable square footage. Compute the average by adding the amount of allowable square feet used in each month and dividing the sum by 12. Do not take more than 300 square feet into account for any month. If qualified business use was less than 15 days in a month, the taxpayer must use zero for that month.

Example: On July 20, Georgia began using 420 square feet of her home for qualified business use and continued using that space until the end of the year. Her average monthly allowable square footage is 125 square feet, which is computed using 300 square feet for each month August through December divided by 12 (1,500 ÷ 12 = 125). Her deduction is limited to $625 (125 × $5) using the simplified method.

Example: From January 1 through July 16, Jack used 300 square feet of his home for qualified business use. On July 17, Jack moved to a new home and immediately began using 200 square feet for the same qualified business use. Jack elects the simplified method for the first home and must use the regular method for the second home. His average monthly allowable square footage is 175 square feet, computed using 300 square feet for January through July divided by 12 (2,100 ÷ 12 = 175). Using the simplified method, his deduction for the first home is limited to $875 (175 × $5).

Daycare use simplified method. If a taxpayer does not use the area of the home exclusively for daycare, the prescribed rate ($5 per square foot) must be reduced before computing the business use of home deduction using the simplified method. The $5 rate is multiplied by a fraction, the numerator is the number of hours that the space was used during the year for daycare and the denominator is the total number of hours during the year the space was available for all uses.

Note: A taxpayer that uses at least 300 square feet for daycare regularly and exclusively during the year does not reduce the rate and is allowed the maximum deduction ($1,500) when electing the simplified method.

Regular Method

A taxpayer that does not elect the simplified method calculates the business use of home deduction using actual expenses by dividing home operating expenses between personal (indirect) and business use (direct), determining the business-use percentage of the home, and applying the deduction limitation.

Deductible business use of home expenses. Some expenses are deductible on Schedule A, whether or not a taxpayer uses his or her home for business. Others are deductible on Form 8829, *Expenses for Business Use of Your Home,* or Schedule A, *Itemized Deductions,* only if the home is used for business. See *Reporting Expenses for Business Use of the Home,* page 5-18.

Business Use of Home Deductibility

Deductible Regardless	*Deductible Only If for Business*
• Real estate taxes.* • Mortgage interest.* • Home equity interest.* • Casualty losses.*	• Homeowner's insurance. • Rent. • Repairs and maintenance. • Security system. • Utilities and services. • Depreciation (deductible after applying deduction limitation to above expenses).

*Subject to limitation or qualification.

Author's Comment: If the taxpayer received payments from the Homeowner Assistance Fund (HAF), a safe harbor method is available to compute his or her deductions for mortgage interest and real estate taxes. (Rev. Proc. 2021-47) See *Safe harbor deduction computation,* page 4-11.

Types of Business-Use-of-Home Expenses

Expense	*Description*	*Examples*	*Deductibility*
Direct	Expenses only for business part of home.	Painting or repairs only in the area used for business.	Full.*
Indirect	Expenses for keeping up and running the entire home.	Insurance, utilities, and general repairs.	Percentage of home used for business.*
Unrelated	Expenses only for parts of home not used for business.	Painting a room not used for business.	Not deductible.

*Subject to limitation or qualification.

Depreciation. A qualified home office is considered 39-year nonresidential real property. Depreciation is calculated by multiplying the basis in the home by the business use percentage, multiplied by the applicable percentage from the depreciation table for nonresidential real property. See *Nonresidential Real Property Mid-Month Convention Straight-Line – 39 Years,* page 9-22. For purposes of home office depreciation, the basis in the home is the smaller of:

- The FMV of the home minus the FMV of land on the date the home was first used for business, or
- The home's cost plus permanent improvements minus casualty losses minus the cost of land on the date the home was first used for business. See *Determining Residence Basis,* page 6-22.

Home improvements. The tax treatment of permanent improvements made to a home used for business depends on timing.

If Improvements Are Made:	*Then the Cost of Improvements is:*
Before using the home for business	Added to home's basis and depreciated as part of the entire home's adjusted basis.
After use of the home for business has begun	Depreciated as a separate asset, but only if improvements affect the business-use area.

Example: Rita put a new roof on her home in 2010 and replaced her furnace in 2025. She first used her home for business in 2014. The cost of the roof is added to the home basis, and the business portion is depreciated over 39 years, starting in 2014. The business portion of the furnace cost is depreciated as a separate asset over 39 years, starting in 2025.

Telephone. Basic local telephone service for the first line into the home is not deductible, even if used for business. Additional charges for business long distance or a second line used for business are deductible.

- Cell phone expenses may be deductible. See *Cell Phones,* page 8-6.
- Telephone costs are deducted on Schedule C (or Schedules E or F, as applicable), not as part of business use of the home.

Taxpayers claiming the standard deduction. If a taxpayer claims the standard deduction, do not include any mortgage interest or real estate taxes on lines 10 and 11, Form 8829, *Expenses for Business Use of Your Home.* Instead, claim the entire business use of the home portion of those expenses using lines 16 and 17 (excess mortgage interest and excess real estate taxes), Form 8829.

If the taxpayer is not increasing his or her standard deduction by a net qualified disaster loss, do not include any casualty losses on line 9, Form 8829. Instead, claim the entire business use of the home portion of the casualty losses on line 29 (excess casualty losses), Form 8829. If the taxpayer is filing Schedule A (Form 1040) to increase his or her standard deduction by a net qualified disaster loss, see Instructions for Form 8829, *Expenses for Business Use of Your Home,* or IRS Pub. 587, *Business Use of Your Home.* See *Net Qualified Disaster Loss,* page 4-26.

Mortgage interest. Taxpayers claiming the standard deduction should report mortgage interest as excess mortgage interest

on line 16, Form 8829. Taxpayers who itemize deductions treat all mortgage interest paid as a personal expense. Compute the amount that would be deductible as an itemized deduction on Schedule A and include it on line 10, column (b), Form 8829. See *Deductible Mortgage Interest Amount,* page 4-10.

Excess mortgage interest. Taxpayers claiming the standard deduction enter all home mortgage interest paid for loans used to buy, build, or substantially improve the home (acquisition debt) in which he or she conducted business on line 16, column (b), Form 8829.

If the taxpayer included an amount on line 10, column (b), Form 8829, and that amount was less than the full amount of interest paid because of the limits on deducting home mortgage interest as a personal expense, include the excess attributable to the acquisition debt for the home in which he or she conducted business on line 16, column (b), Form 8829. See *Mortgage interest,* page 5-16.

Real estate taxes. If the taxpayer is claiming the standard deduction, no amount should be reported on line 11, Form 8829. Instead, all real estate taxes should be reported as excess real estate taxes on line 17, Form 8829.

Total taxes not more than the limit. If the total itemized deduction for state and local income taxes (or, general sales tax), real estate taxes, and personal property taxes is not more than $40,000 ($20,000 MFS), enter all real estate taxes attributable to the home in which the taxpayer conducted business on line 11, column (b), Form 8829.

Total taxes greater than the limit. If the total itemized deduction for state and local income taxes (or, general sales tax), real estate taxes, and personal property taxes is greater than $40,000 ($20,000 MFS), use the following worksheet to calculate the amount to include on line 11, column (a), Form 8829.

Business Use of Home—Real Estate Taxes Worksheet

1) Enter the state and local income taxes (or sales taxes) that are personal expenses ..... 1) _____
2) Enter all the state and local real estate taxes paid on the home in which the taxpayer conducted business ..... 2) _____
3) Enter any other state and local real estate taxes the taxpayer paid that are a personal expense and not included in line 2 ..... 3) _____
4) Enter the state and local personal property taxes that are a personal expense..... 4) _____
5) Add lines 1 through 4..... 5) _____
6) Multiply line 2 by the business use of home percentage ..... 6) _____
7) Subtract line 6 from line 5..... 7) _____
8) Subtract line 7 from $40,000 ($20,000 if MFS). If zero or less, enter -0- ..... 8) _____
9) Enter the smaller of line 6 or line 8 here and on line 11, column (a), Form 8829..... 9) _____
10) Subtract line 9 from line 6 and enter it here and on line 17, column (a), Form 8829..... 10) _____

Determining business-use percentage. Home expenses are multiplied by the business-use percentage to determine the deductible portion of the expense.

Business-use percentage. Any reasonable method may be used to determine the business-use percentage.
The following are two common methods.

- Divide square footage of area used for business by total square footage of home.
- If all rooms are about the same size, divide the number of rooms used for business by total number of rooms in home.

Part-year use. Do not include home expenses for any period during the year where the home was not used for business.

Daycare. The business-use percentage of an area exclusively used for a daycare business is calculated under the business-use percentage method, previous column. For the portion of the home regularly used, but not exclusively used for the daycare business, multiply that portion by the business-use percentage of time.

Example: Jane uses her 1,600 square foot walkout basement for her daycare business. The total area of her home is 3,200 square feet so her business-use percentage is 50% (1,600 ÷ 3,200). Her daycare used the basement for a total of 3,000 hours during the year. The total number of hours for the year was 8,760 (24 hours × 365 days) so her daycare time percentage is 34.25% (3,000 ÷ 8,760). Any direct expenses, such as repainting the basement, are multiplied by 34.25% to determine the deductible business portion of the expense. Any indirect expenses, such as utilities, are multiplied by 17.13% (50% × 34.25%) to determine the deductible business portion of the expense.

Did You Know? In many cases, the basement and garage may be included in the total square footage of a daycare provider's home when calculating the business-use percentage. In addition to regularly used rooms, the business-use area can include:

- Entryways, halls, food preparation areas, and bathrooms.
- Basement with laundry or tool rooms, storage or furnace area, etc.
- Garage where business car is parked or where household tools, trash cans, or stored daycare items are kept.

Calculating time spent on daycare. The provider should keep a log of time spent conducting the daycare business, including:

- Dates and hours each person was in the provider's care, and
- Additional time spent organizing, preparing meals, and cleaning up. (Rev. Rul. 92-3)

Example: Beth cared for children 10 hours during the day. Since she spends an hour in the morning preparing meals and craft projects for the children, and another hour in the evening cleaning up, she may count 12 hours as time spent on daycare for that day.

Her guest room was used two hours during the day for naps, although it was available for diaper changing and other activities during the full 12-hour business period. Beth treats the guest room as used 12 hours for that day.

Deduction limitation. The business use of the home deduction is limited to net income from the business as follows.

1) Determine net business income.
   - The amount from line 29, Schedule C, plus
   - Any net gain derived from the business use of the home that is reportable on Schedule D (Form 1040) or Form 4797.
2) Deduct the business portion of real estate taxes, mortgage interest, and casualty losses included on lines 9, 10, and 11, Form 8829, from net business income. See *Taxpayers claiming the standard deduction,* page 5-16. If the result is:
   - Zero or less, stop. Carry any remaining expenses for business use of the home forward to the next year.
   - More than zero, continue.
3) Deduct all business expenses relating to the use of the home [other than real estate taxes, mortgage interest, casualty losses (included on lines 9, 10, and 11, Form 8829), and depreciation], but no more than the amount remaining from step (2). If the result is:
   - Zero, stop. Carry forward excess expenses, including business portion of depreciation on the home.
   - More than zero, continue.
4) Deduct the business portion of depreciation on the home, but no more than the amount remaining from step (3). Carry excess depreciation forward to the next year.

More than one business location. A taxpayer may conduct business in the home and in another location on a regular basis. See *Meeting patients, clients, or customers,* page 5-15. For purposes of the business use of home deduction limitation, income must be allocated between the locations. All relevant facts and circumstances are considered in making the income allocation, including time spent at each location, business investment at each location, etc.

Example: A tax professional has an office in the home where he meets with 40% of his clients and prepares their taxes. He also has an office in another location outside his home where he meets 60% of his clients and prepares their taxes. His tax preparation activity from both locations is reported on one Schedule C. Assuming his home office qualifies for a deduction under all other rules, he uses 40% of his net income for purposes of the home office deduction limitation rules.

Carryover of unallowed expenses. Deductions not allowed due to the net income limitation are carried over to the following year when using the regular method. They are added to current expenses from each category and subject to the deduction limit for that year for that category, whether or not the taxpayer lives in the same home during that year. If the simplified option is used, any carryover from a previous year is not allowed, and the taxpayer continues to carry over the disallowed amount to the next year the regular method is used again.

Simplified or Regular Method Election

Each year, a taxpayer may either compute the deduction using actual expenses (regular method) or elect to use the simplified method on a timely-filed, original tax return. Once a method is chosen for a tax year, it cannot be changed to the other method for that same year.

Business Use of Home Methods

	Simplified Method	*Regular Method*
Regular/exclusive use tests	No differences.	No differences.
Maximum square footage allowed for business.	300 square feet.	No maximum.
Expenses allowed	$5 per square foot.	Actual expenses determined and records maintained.
Depreciation deduction.	No.	Yes.
Depreciation recapture on sale of home.	No.	Yes.
Deduction cannot exceed gross income limitation.	No differences.	No differences.
Carryover of expenses in excess of gross income limitation.	No.	Yes.*
Home-related itemized deductions (i.e. mortgage interest and real estate taxes).	Claimed in full on Schedule A (Form 1040), subject to limitation.	Allocated between Schedule A (Form 1040) and business schedule.

* Loss carryover from use of regular method in prior year may not be claimed in a year the simplified method is used. The loss is carried over until the next year the regular method is used again.

Reporting Expenses for Business Use of the Home

Sole proprietors and statutory employees. Report the business use of the home deduction on line 30, Schedule C (Form 1040), regardless of the method used. See *Statutory employee income,* page 5-9.

Simplified method. The simplified method deduction is calculated on a worksheet.

Regular method—Form 8829, Expenses for Business Use of Your Home. The regular method deduction is calculated on Form 8829 which is attached to the tax return.

Farmers, partners, and employees. Do not use Form 8829. Instead, use the worksheet in IRS Pub. 587, *Business Use of Your Home,* to apply gross income limitations and determine deductible amounts. Business use of home expenses that are suspended due to income limitations can be carried forward, just as they are for sole proprietors.

Note: The worksheet in IRS Pub. 587 is not a required attachment. The same results can be obtained by using Form 8829 as a worksheet with minor line adjustments.

Farmers. Report deductible business use of home expenses as Other Expenses on line 32, Schedule F (Form 1040).

Partners. Report deductible business use of home expenses as unreimbursed partnership expenses on Part II, Schedule E (Form 1040). See *Unreimbursed Partnership Expenses,* Tab 20.

Employees (other than statutory employees). The business use of home deduction for employees is not allowed.

Rental of home office to employer. The deduction for business use of a home is limited if a taxpayer performs services as an employee in a part of his or her home rented to the employer and is reimbursed under an accountable plan. [IRC §280A(c)(6)]

- Report rental income on Schedule E (Form 1040).
- Deduct real estate taxes, mortgage interest, and casualty losses for the rented part on Schedule A (Form 1040), subject to any limitations.
- The business portions of other home expenses, such as insurance, utilities, repairs, and depreciation, are not deductible.

Example: Cathi is an employee of her S corporation which she runs from her home office. The S corporation deducts the rent it pays Cathi for use of the office. Cathi must report the rental income on Schedule E, but she cannot deduct any expenses on the business portion of her home other than mortgage interest, real estate taxes, and casualty losses.

Sole Proprietorships

Cross References

- Schedule C (Form 1040), *Profit or Loss From Business*
- IRS Pub. 15, *(Circular E), Employer's Tax Guide*
- IRS Pub. 334, *Tax Guide for Small Business*
- IRS Pub. 587, *Business Use of Your Home*
- IRC §162, *Trade or business expenses*

Related Topics

- Business Deductions, Tab 8
- Limited Liability Company (LLC), page 20-20

A sole proprietorship does not legally exist separate from the individual. Liabilities of the business are the taxpayer's liabilities. A sole proprietor risks his or her personal assets, as well as business assets in the venture.

Exception: A sole proprietorship with LLC status receives limited liability protection under state law. For federal tax purposes, a single-member LLC is generally disregarded and taxed as a sole proprietorship unless it elects to be taxed as a corporation.

For characteristics of for-profit trades or businesses, see *Hobby or Business,* page 5-21.

Daycare Providers—Deducting Meals

Meals provided to daycare recipients are deductible in full as an operating expense not subject to the 50% limitation rules. Do not deduct the cost of food consumed by the daycare provider and the provider's own children or family members.

Standard Meal and Snack Rates

	2025	2026
Continental U.S.		
Breakfast	$1.66	$1.70
Lunch and Dinner (each)	$3.15	$3.22
Snacks (each/up to 3)	$0.93	$0.96
Alaska		
Breakfast	$2.66	$2.72
Lunch and Dinner (each)	$5.10	$5.22
Snacks (each/up to 3)	$1.52	$1.55
Guam, Hawaii, Puerto Rico, Virgin Islands		
Breakfast	$2.14	$2.19
Lunch and Dinner (each)	$4.09	$4.18
Snacks (each/up to 3)	$1.22	$1.24

For prior tax years, see *Inflation Adjusted Amounts – Business*, page 1-3.

Food program reimbursements. Reimbursements received under the Child and Adult Care Food Program (CACFP) or other food program are taxable only to the extent they exceed the expenses for food for eligible children.

- If CACFP, or other food program reimbursements exceed the taxpayer's expenses, the difference is reported as "Other Income" in Part I, Schedule C. If no Form 1099-MISC has been issued, the food expense deduction may be reduced by the amount of any reimbursement received.
- Food program reimbursements for the daycare provider's own children are not income to the provider and should be clearly identified as such when reducing the amount reported as income.

Computing the deduction for meals and snacks. A family daycare provider may deduct actual food costs or may use the *Standard Meal and Snack Rates* table, above, to compute the deduction for food provided to eligible children. Only one method of computing food costs may be used in a tax year, but the method may be changed from year to year.

- For purposes of the standard rates, a family daycare provider is an individual in the business of providing daycare who:
  - Provides nonmedical childcare in the home of the provider,
  - Does not receive a transfer of legal custody, and
  - Generally provides childcare less than 24 hours each day.
- For purposes of the standard rates, eligible children are minor children receiving care in the home of the provider, not to include any of the following.
  - Children who are full- or part-time residents of the home in which the care is provided.
  - Children whose parents or guardians are residents of that home.
  - Children who receive daycare for personal reasons of the provider, such as caring for a relative as a favor.
- The standard meal and snack rates may be used for a maximum of one breakfast, one lunch, one dinner, and three snacks per eligible child per day. If using this method, the family daycare provider must keep records, including the name of each child, dates and hours of attendance, and type and quantity of each meal or snack served.
- The standard meal and snack rates include beverages but not the cost of non-food supplies such as food storage containers, paper products, or utensils. Deduct these costs separately.
- If the actual expense method is used instead of the standard meal and snack rates, separate records with receipts must be kept for the daycare food and for nondeductible family food costs.

Authors, Artists, and Musicians

Unique tax issues may apply to taxpayers involved in the creative or performing arts, such as authors, artists, photographers, or musicians.

Uniform Capitalization (UNICAP) Rules. Under the UNICAP rules of IRC section 263A, a taxpayer may have to capitalize certain indirect costs of producing a product or performing a service. One of the exceptions to the UNICAP rules is in the case of a self-employed freelance author, photographer, or artist. Expenses normally capitalized under UNICAP are deductible as current expenses. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

Qualified performing artists (QPAs). Employees who meet the QPA definition can deduct business expenses as an adjustment to income on line 12, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* by attaching Form 2106, *Employee Business Expenses.* For requirements to claim deductions, see *Qualified performing artists,* page 8-5.

Royalties. Royalties may be received for the performance of personal services or for the ownership of an intangible asset. Royalties are taxable as ordinary income and are generally reported on Schedule C (Form 1040), or Part I of Schedule E (Form 1040). For information about royalties from oil, gas, or mineral properties, see *Schedule E (Form 1040), Supplemental Income and Loss,* page 7-2.

- When the producer or creator of a musical composition, literary work, or work of art receives royalty income in connection with a copyright on that product, the royalty arises from the performance of services and is reported on Schedule C (Form 1040) as self-employment income and is subject to self-employment tax.
- Royalty income received by someone who purchases the copyright of a musical composition or literary work as an investment is reported on Schedule E (Form 1040) and is not subject to self-employment tax.
- Payments for the right to use a person's image or likeness are not income from services, even if described as royalties. See *Name, Image, and Likeness (NIL),* below.

Example: Paul was lead singer for the Zagnuts in 1979 and wrote their one hit wonder entitled "Wholly Bholly." He has been receiving royalties ever since, even though he has not performed as a professional musician for over 40 years. Paul must report his royalty income as self-employment income because he is receiving the income as a result of past personal services performed.

Sale of musical composition election. A taxpayer may elect to treat the sale or exchange of a musical composition or copyright in musical works as a capital asset if the taxpayer's personal efforts created the property, or the taxpayer acquired the property through circumstances (i.e. gift) entitling the taxpayer to the basis of the person who created the property. For details on how to make the election, see Regulation section 1.1221-3.

Name, Image, and Likeness (NIL)

Typically associated with student-athletes, any monetary or financial gain, including non-cash compensation such as merchandise or gift cards, received from a transaction in which the taxpayer benefited from the use of his or her name, image, or likeness, is NIL income. Generally, the recipient is considered an independent contractor for tax purposes and reports NIL income and related expenses on Schedule C (Form 1040). However, royalties and other NIL income that is not self-employment income is reported on Schedule E (Form 1040) instead.

Social Media Influencer/ Content Creator

Influencers are social media users who typically specialize in a specific industry, such as fashion, fitness, or food.They create and share content regularly with their followers to generate interest

in certain products or services. Influencers are typically classified as self-employed for tax purposes. Taxable income includes the value of any benefit received from merchants or others. It may also include the value of unsolicited products given to them with hope of a favorable review or recommendation.

Sharing (Gig) Economy

Taxpayers who use digital platforms to rent their home or provide on-demand work, services, or goods, are subject to taxation on income from those activities.

Income from a sharing economy activity is generally taxable even if the taxpayer does not receive a Form 1099-NEC, *Nonemployee Compensation,* Form 1099-K, *Payment Card and Third Party Network Transactions,* Form W-2, *Wage and Tax Statement,* or some other income statement. This is true even if the activity is a side job or as a part-time business and even if the taxpayer is paid in cash, property, goods, or digital assets. Depending on the circumstances, some or all of the taxpayer's business expenses may be deductible, subject to the normal tax limitations and rules.

Ride-share. Report all income and expenses associated with the business on Schedule C (Form 1040), *Profit or Loss From Business.* If there is a net profit of $400 or more, the taxpayer must also pay self-employment (SE) tax. See *Self-Employment Tax,* page 5-25.

Rentals. Generally, rental income is reported on Schedule E (Form 1040), *Supplemental Income and Loss,* and is not subject to SE tax. See *Rental Real Estate,* page 7-3. However, if substantial services are provided, income is reported on Schedule C (Form 1040) and is subject to SE tax. See *Providing substantial services,* page 7-5.

Note: Some Airbnb rentals that provide extra services could be considered substantial services and the income could then be subject to SE tax.

Personal property rentals. Schedule E (Form 1040) is not used to report income and expenses from the rental of personal property such as equipment, bicycles, or vehicles, unless the personal property is leased with real estate. See *Rental of personal property,* page 7-2.

Foster Care Business

Foster care payments received that do not qualify for the IRC section 131 exclusion, or are not reimbursements from a charitable organization, are considered earnings from self-employment. See *Foster Care Payments,* Tab 3.

Ordinary and necessary expenses incurred that are not reimbursed by any organization are deductible as business expenses. However, if a taxpayer receives both taxable income and excludable foster care payments, expenses allocable to the excludable payments are not deductible. Also, for taxpayers in the foster care business, unreimbursed expenses are not considered support for dependency purposes.

Children in Business

The following are some industry exceptions to the SE, FICA, and FUTA tax rules.

Paper route. A child under age 18 delivering newspapers to customers is exempt from SE tax, FICA, and FUTA. [IRC §1402(c)(2)(A) and IRC §3121(b)(14)]

Domestic services performed by a child. Domestic services include activities such as babysitting, cleaning, and lawn mowing.

- A child under age 21 performing domestic services for a parent is exempt from employment taxes on those services. [IRC §3121(b)(3)(B)]
- A child under age 18 performing domestic services in a private home of the employer is exempt from employment taxes if the domestic services are not the principal occupation of the child. [IRC §3121(b)(21)]
- Domestic services are not considered to be the principal occupation of a child who is a student.

Author's Comment: Although a child performing domestic services under the control and direction of the homeowner is exempt from employment taxes, the same child could also be considered an independent contractor. If the child is performing domestic services for a number of homeowners and providing his or her own supplies, then the activity could be a trade or business, subject to SE tax.

Example: Cal, age 16, earns $1,560 mowing lawns for three of his neighbors during his summer break from high school. He does not advertise or conduct the activity as a business. The homeowners provide equipment and gas and tell him when to work. Cal is considered a domestic employee of each of the neighbors who employ him. His income is not subject to FICA or FUTA, and his domestic employers are not required to withhold employment taxes from his wages. Since Cal's earnings are below the standard deduction for dependent children, he is not required to file a tax return.

Example: Kurt, age 17, works three days per week during the summer mowing lawns for various customers in the area. Kurt owns his own lawn mowing equipment, purchases his own gas and supplies, and distributes fliers advertising his services to the public. Homeowners expect certain standards to be met, but do not have substantial control over whom Kurt sends to mow the lawn or what time of day the lawns are to be mowed. Kurt nets $1,560 during the summer before going back to school as a full-time student. Kurt is self-employed, and although he owes no income tax on his earnings, he must file a tax return to pay $220 in self-employment tax.

Student employment. A student of any age working for a school, college, or university is exempt from FICA and FUTA if the student regularly attends classes and performs services as an employee of such school, college, or university. [IRC §3121(b)(10)]

Working for parent-owned unincorporated business. Children under age 18 working for parent-owned unincorporated businesses are exempt from FICA and FUTA. Children under age 21 working for parent-owned unincorporated businesses are exempt from FUTA. See *Family Business—Employing Family Members,* below.

Family Businesses—Employing Family Members

Family businesses organized as sole proprietorships offer several tax planning opportunities.

- A child employed by a parent is exempt from FICA until age 18 and FUTA until age 21. These exemptions do not apply when a child is employed by a parent-owned corporation.
- A child employed by a parent for domestic work is exempt from both FICA and FUTA until age 21.
- A parent employed by a child is exempt from FUTA.
- A spouse employed by a spouse is exempt from FUTA.
- A child employed by a parent shifts income from the parent's higher tax bracket to the child's lower tax bracket.
- A child employed by a parent could provide opportunities for the parent to utilize the education tax credits that may be lost due to AGI phaseouts. See *2025 Education Benefits Comparison Chart,* page 12-2.
- A spouse employed by a spouse can be covered under an employee health insurance plan that allows the sole proprietor to deduct health costs against SE taxable income. See *Employee-spouse health insurance,* page 5-10.
- When family members are employees of the sole proprietor, travel expenses may be deductible for family member employees when mixing business with vacation travel. The cost of travel for a non-employee family member is not deductible, even when the sole purpose of the trip is for business.

For a payroll tax chart, see *Special Rules for Various Types of Employment,* page 23-6.

Children employed by unincorporated parent-owned business. For the above rules to apply, the child must be a bona-fide employee of the parent-owned business. This means the child must actually render legitimate services as an employee of the business, the child must actually be paid for those services, and the payment must be reasonable in relation to the services rendered.

Example: Dan owns a website design business and employs his 16-year-old daughter, Cassie, to help. She provides legitimate services as an employee. In 2025, she earned $22,750 throughout the year helping her dad in his business. Assume Dan is in a combined 30% federal and state tax rate. The $22,750 in wages paid to Cassie reduces Dan's 2025 tax liability by $6,825, and his 2025 SE tax by $3,246, for a total tax savings of $10,071. Cassie's wages are not subject to FICA or FUTA. If she contributes $7,000 to a traditional IRA, she will have zero income tax in 2025.

Cassie's 2025 wages	$22,750
2025 IRA contribution	(7,000)
2025 standard deduction	(15,750)
Cassie's 2025 taxable income	$ 0

If Dan has a SIMPLE plan in place and Cassie were to contribute to it instead of an IRA (or in addition to contributing to an IRA), the amount of income that could be shifted to her would be more and therefore the potential tax savings could be even greater.

Note: This example does not take into account the qualified business income deduction when determining Dan's tax savings. See *Qualified Business Income Deduction (QBID)—IRC §199A,* page 8-15.

Court Case: The taxpayers employed their minor daughters in a dog breeding business. They performed duties like cleaning, taking out the garbage, and lawn mowing. The court agreed with the IRS and ruled against the taxpayers stating the children were not bona fide employees. The court cited the lack of Forms W-2, payments unrelated to dates and hours actually worked, failure to maintain adequate records of employment, and compensation for services in the nature of family chores, as reasons for the ruling. (*Alexander,* T.C. Summary 2007-127)

Hobby Loss Rules

Cross References

- IRS Pub. 5558, *Activities Not Engaged in For Profit (ATG)*
- IRC §183, *Activities not engaged in for profit*
- Reg. §1.183-1

Related Topics

- Miscellaneous Itemized Deductions, page 4-26

Hobby or Business

If a business or investment activity is not conducted as a for-profit business, IRC section 183 limits deductions to the amount of income from the activity. This rule applies to individuals, partnerships, estates, trusts, and S corporations (but not to other corporations). If an activity is considered a for-profit business, deductions can exceed income, allowing the resulting loss to offset other income.

Activities conducted as a hobby, or mainly for sport or recreation, come under this limit. An investment activity intended only to produce tax losses for the investors also comes under this limit.

Note: Individuals may not deduct expenses (other than cost of goods sold) associated with hobby income. See *Hobby expenses,* page 5-22.

Relevant Factors—Business Activity

In determining whether the taxpayer is carrying on a business activity for profit, all the facts are taken into account. No single factor alone is decisive. The following, though not all inclusive, can help in determining if the activity is a business.

1) **Manner in which taxpayer carries on the activity.** Carrying on the activity in a businesslike manner and maintaining complete and accurate books and records may indicate the activity is engaged in for profit.
2) **Expertise of taxpayer or his or her advisors.** Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are experts, may indicate the taxpayer has a profit motive.
3) **Time and effort expended by taxpayer in carrying on the activity.** The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.
4) **Expectation that assets used in activity may appreciate in value.** Profit includes appreciation in the value of assets, such as land, used in the activity.
5) **Success of taxpayer in carrying on other similar or dissimilar activities.** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he or she is engaged in the present activity for profit, even though the activity is presently unprofitable.
6) **Taxpayer's history of income or losses with respect to the activity.** A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is a hobby. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses may indicate that the activity is not being engaged in for profit. A series of years in which net income was realized could be evidence that the activity is engaged in for profit.
7) **Amount of occasional profits, if any, which are earned.** An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally determine that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small.
8) **Financial status of taxpayer.** Substantial income from sources other than the activity, particularly if the losses from the activity generate substantial tax benefits, may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.
9) **Elements of personal pleasure or recreation.** The fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as a hobby if the activity is in fact engaged in for profit as evidenced by other factors.

For more discussion and examples, see Regulation section 1.183-2(b).

Author's Comment: Regulation section 1.183-2(b) lists the element of personal pleasure or recreation as a factor in making the hobby vs. business determination, but that factor has been omitted from various help pages on the IRS website. It seems that the IRS acknowledges that taxpayers can take genuine pleasure in a for-profit business activity.

Activities that are possible hobbies. While any business may be established as for-profit or as a hobby, some businesses are more likely to be identified by the IRS as hobbies. The following activities are noted by the IRS as possible hobby activities.

continued on next page

- Airplane Charter
- Artists
- Auto Racing
- Bed and Breakfast
- Bowling
- Craft Sales
- Direct Sales
- Dog Breeding
- Entertainers
- Farming
- Fishing
- Gambling
- Horse Racing
- Horse Breeding
- Motocross Racing
- Photography
- Stamp Collecting
- Writing
- Yacht Charter

Presumption of profit. If an activity is profitable in three of the last five tax years, including the current year, the presumption is it is carried on for profit, and the hobby loss limitations do not apply. If the activity consists primarily of breeding, training, showing, or racing horses, the IRS will presume it is carried on for profit if a profit is produced in at least two of the last seven tax years, including the current year. [IRC §183(d)]

Court Case: A married couple ran a horse breeding and boarding activity in which they kept and cared for as many as 60 horses. The husband worked outside the home full-time while the wife worked full-time on the horse breeding and boarding activity. The husband also worked mornings, evenings, and weekends on the horse breeding and boarding activity. For the years in question, the taxpayers reported over $400,000 in losses. The court ruled the activity was not a hobby. Although recordkeeping was poor, it was adequate. Although the couple was self-taught, they accumulated many years of experience. They also had a legitimate, although unrealized, long-term goal of profiting from a self-perpetuating herd of purebred horses that would increase in value over time. (*Helmick,* T.C. Memo. 2009-220)

Reporting Hobby Income and Expenses

Occasional profits from hobby activities are not subject to self-employment tax and losses from hobby activities are limited and cannot be used to offset other income. Do not use Schedule C (Form 1040) or Schedule F (Form 1040) to report income and expenses from a hobby.

Hobby income. Gross hobby income for the purposes of the hobby loss rules equals gross receipts minus the cost of goods sold deduction. Hobby income may include capital gain, rent, and other income.

- Report capital gain from the sale of hobby assets on Form 8949, *Sales and Other Dispositions of Capital Assets.* Losses from such sales are nondeductible personal losses.
- Report all other hobby income, less cost of goods sold, on line 8j, Schedule 1 (Form 1040), *Additional Income and Adjustment to Income.* Any consistent method for determining cost of goods sold is permitted if it follows generally accepted accounting methods. [Reg. §1.183-1(e)]

Hobby expenses. Generally, if an activity is considered a not-for-profit hobby activity, expenses are limited to the amount of gross income from the activity. [IRC §183(b)]

The deductibility of all miscellaneous itemized deductions subject to the 2% AGI limitation is permanently repealed for tax years after 2017, which includes operating expenses associated with hobby activities. Therefore, while hobby income is still required to be included in gross income, hobby operating expenses are not deductible.

Note: Expenses related to an individual's sole proprietor business are deductible on Schedule C (Form 1040), *Profit or Loss From Business.*

Hobby Loss Example

The following example illustrates the mechanics of reporting hobby income and expenses.

Example: Laura buys a start-up kit to begin selling jewelry in a multi-level marketing organization. Product demonstrations usually take place in customer homes.

Laura's sales activity is a hobby. Her intent is not to make a profit, but to cover her costs and get discounts on jewelry for herself and her friends. She reports gross receipts minus the cost of goods sold on line 8j, Schedule 1 (Form 1040). Other related costs are not deductible.

Assume Laura incurs the following income and expenses.

Gross receipts (includes box 3, Form 1099-MISC and box 1, Form 1099-NEC)		$ 6,900
Cost of goods sold deduction:		
Opening inventory	$ 300	
Plus purchase of supplies and materials	7,500	
Minus personal use items and gifts	(3,900)	
Minus ending inventory	(200)	(3,700)
Gross income [reported on line 8j, Schedule 1, (Form 1040)]		$ 3,200

Other expenses:	
Incentives and prizes paid to downline	$ 200
Training meeting expense	100
Demonstration equipment	500
Start-up kit	1,000
	$ 1,800

Laura's other operating expenses are not deductible because her jewelry activity is considered a hobby.

Election to Postpone Determination of Hobby or Business Status

A taxpayer can elect to postpone an IRS determination as to whether the activity is a hobby or a business by filing Form 5213, *Election To Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit.* The form should be filed within three years after the due date for the tax return of the year in which the taxpayer first engaged in the activity.

Independent Contractor vs. Employee

Cross References

- Form 8919, *Uncollected Social Security and Medicare Tax on Wages*
- Form 8952, *Application for Voluntary Classification Settlement Program (VCSP)*
- Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*
- IRS Pub. 15, *(Circular E), Employer's Tax Guide*
- IRS Pub. 15-A, *Employer's Supplemental Tax Guide*
- IRS Pub. 1976, *Do You Qualify for Relief under Section 530?*
- IRC §3121(d), IRC §3508, IRC §3509
- Rev. Rul. 87-41

Related Topics

- Payroll and Labor Laws, Tab 23
- Form 1099-NEC, *Nonemployee Compensation,* page 23-7

Worker Classifications

A worker performing services for a business falls under one of the following classifications.

- An independent contractor.
- A common-law employee.
- A statutory employee.
- A statutory non-employee.

Withholding requirements. An employer must generally withhold federal income taxes, withhold and pay over Social Security and Medicare taxes (FICA), and pay federal unemployment tax (FUTA) on wages paid to an employee. A payer does not generally have to withhold or pay over any federal taxes on payments to independent contractors.

Penalties and interest. When the IRS determines that a worker is actually an employee rather than an independent contractor, the employer is subject to penalties for failure to withhold and remit income, FICA and FUTA taxes, interest on the underpaid amounts, and penalties for failure to file information returns.

Independent contractor. Taxpayers who are in an independent trade, business, or profession in which they offer service to the general public are generally independent contractors. An individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done or how it will be done. The earnings of an independent contractor are subject to self-employment tax.

Common-law employee. A worker is treated as an employee if the payer can control what will be done and how it will be done. This is so even if the employee is given freedom of action. The right to control the details of how the services will be performed is the determining factor. The business hiring the employee is responsible for withholding income tax and FICA as well as being liable for FUTA and various state employment taxes. An employee may be eligible for fringe benefits offered by the employer.

Corporate officer. Any officer of a corporation providing services for his or her corporation in exchange for compensation is an employee of the corporation. [IRC §3121(d)(1)]

Corporate director. A director of a corporation in his or her capacity as such is not an employee of the corporation. Director fees are reported on box 1, Form 1099-NEC, and are subject to self-employment tax. [Reg. §31.3121(d)-1(b)]

Statutory employee. A worker may qualify as an independent contractor under common-law rules, but be treated as an employee for certain employment tax purposes. [IRC §3121(d)(3)]

For a list of workers classified as statutory employees and for rules on how to report their income and expenses, see *Statutory employee income,* page 5-9.

Court Case: A taxpayer worked from home, providing auditing services for an insurance company. Although he had signed an employment contract and received a Form W-2, he considered himself to be an independent contractor and reported his income and expenses on Schedule C (Form 1040). The IRS rejected this treatment of Form W-2 wages as Schedule C income and the Tax Court agreed. The court determined that the taxpayer was a common-law employee and not an independent contractor or statutory employee. His income was reportable as wages and his business expenses were deductible only as miscellaneous deductions on Schedule A (Form 1040), subject to the 2% AGI limitation in place for that tax year. (*Feaster,* T.C. Memo. 2010-157)

Statutory non-employee. A statutory non-employee is a worker who could be considered a common-law employee, but is treated as self-employed under the Internal Revenue Code. (IRC §3508)

There are three categories of statutory non-employees.

- ***Direct seller.*** A direct seller is an individual who sells consumer products outside of a permanent retail store, sells consumer products for resale outside of a permanent retail store, or delivers or distributes newspapers or shopping news.
- ***Licensed real estate agent.*** This category includes individuals engaged in appraisal activities for real estate sales if income is based on sales or other output.
- ***Companion sitter.*** A companion sitter is an individual who provides personal attendance, companionship, or household care services to children or individuals who are handicapped or elderly, and who is not an employee of a companion sitting placement service. See *Household Employees,* page 14-2.

To be considered statutory non-employees, direct sellers and licensed real estate agents must meet two additional requirements.

- Substantially all payments for services performed are directly related to sales or other output, rather than hours worked, and
- Services are performed under a written contract stating that they will not be treated as employees for federal tax purposes.

Factors Used to Determine Independent Contractor vs. Common-Law Employee Status

Except for specific types of statutory and non-statutory employees, the general rules for classifying workers as independent contractors or common-law employees center on who has the right to control the details of how services are to be performed.

Revenue Ruling 87-41 lists 20 factors used to make this determination. IRS Pub. 15-A, *Employer's Supplemental Tax Guide,* groups these factors into three categories.

1) Behavioral control.
2) Financial control.
3) Type of relationship between the parties.

1) **Behavioral control.** Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work.

   Type and degree of instruction. Employers generally control when, where, and how work is to be done, what tools or equipment to use, what workers to hire or to assist with the work, where to purchase supplies and services, what work must be performed by a specified individual, and what order or sequence to follow.

   Training that the business gives to the worker. Employees may be trained to perform a service in a particular manner. Independent contractors generally use their own methods.

2) **Financial control.** Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job.

   Extent of the worker's unreimbursed business expenses. Independent contractors are more likely to incur expenses that are not reimbursed, such as fixed overhead costs incurred regardless of whether work is currently being performed.

   Extent of the worker's investment. Independent contractors often have significant investment in facilities or tools used to perform services for someone else, such as maintaining a separate office or other business location.

   Extent to which the worker makes his or her services available to the public. Independent contractors are generally free to offer their services to other businesses or consumers. They often advertise and maintain a visible business location.

   Method of payment for services performed. Employees generally are guaranteed a regular wage and work for an hourly fee or a salary. Independent contractors are generally paid a flat fee for a specific job.

   Extent to which the worker can make a profit. Independent contractors can make a profit or incur a loss.

3) **Type of relationship.** Type of relationship refers to facts that show how the worker and business perceive their relationship to each other.

   Written contracts. While written contracts can describe the relationship and intent between the parties, simply stating in a contract that the worker is an independent contractor is not sufficient to determine the worker's status. How the parties

work together determines whether the worker is an independent contractor.

Employee-type benefits provided to worker. Employers often provide fringe benefits to employees, such as health insurance, pensions, and vacation pay.

Permanency of the relationship. Employer-employee relationships generally continue indefinitely.

Extent services performed by the worker are a key aspect of the business hiring the worker. A worker who is key to the success of a business is more likely to be controlled by the business, which indicates employee status.

Safe Harbor—Worker Status

A business can treat a worker as an independent contractor, even if the worker would otherwise be considered an employee under the common-law rules. Three requirements must be met. (Section 530 of the Revenue Act of 1978)

1) **Reasonable basis.** A reasonable basis exists for not treating workers as employees if:
   - The business relied on judicial precedent or published ruling, or
   - A prior IRS employment audit of the business did not reclassify similarly treated workers as employees, or
   - A significant segment of businesses in the same industry treats similar workers as independent contractors, or
   - The business relied on any other reasonable basis, such as the advice of a lawyer or accountant familiar with the business.
2) **Reporting consistency.** All required federal tax returns, including Forms 1099-NEC, must have been filed consistent with the treatment of the worker as an independent contractor.
3) **Substantive consistency.** The employer must have treated the worker, and similar workers, as independent contractors.

Author's Comment: According to the IRS Office of Chief Counsel, the reasonable basis standard is most clearly met if the taxpayer can demonstrate actual reliance on the relevant authority prior to making the initial decision of whether workers will be treated as employees or independent contractors. (PMTA 2011-15)

Court Case: A taxpayer treated workers hired to perform masonry services as independent contractors, a typical practice in the construction trades. The tax court determined that the workers were really employees. Relief was denied because the taxpayer failed to timely file and issue Forms 1099-MISC* to the workers. The taxpayer was liable for payroll taxes, penalty, and interest for the years in question. (*Atlantic Coast Masonry, Inc.,* T.C. Memo. 2012-233)

* Form 1099-NEC was not yet in use.

Other Employer Relief—Worker Status

Misclassified employees. Employers who do not qualify for safe harbor relief, above, may be able to use reduced tax rates and correct the tax treatment of misclassified employees. Reduced rates apply only to the employee portion of FICA taxes and to federal income tax that should have been withheld. Requirements and procedures for obtaining IRC section 3509 relief are explained in Chapter 2 of IRS Pub. 15, (*Circular E) Employer's Tax Guide.* (IRC §3509)

Income taxes not withheld. Relief of employer liability for federal income tax not withheld from a payee may be granted using the following procedure. [IRC §3402(d)]

- Obtain Form 4669, *Statement of Payments Received,* from each payee, attesting that income tax has been paid on the compensation.
- Using Form 4670, *Request for Relief for Payment of Certain Withholding Taxes,* as a cover sheet, submit all Forms 4669 for the tax year.
- The employer will be assessed applicable penalties and interest.

Erroneous Treatment of Employees as Independent Contractors—Form 1099-NEC Received

A taxpayer does not necessarily have to have a business for payments to be reported on Form 1099-NEC, *Nonemployee Compensation.* A worker may have performed services as a nonemployee, even without realizing it, because the payer has determined that an employer-employee relationship did not exist.

A worker who receives Form 1099-NEC instead of Form W-2 has two options.

1) File Schedule C to report the income and any expenses, and Schedule SE (Form 1040) to pay the self-employment tax on the earnings, or
2) File Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding.* The IRS will then decide if the worker should have been treated as an employee, subject to income and FICA tax withholding.

Form 8919, *Uncollected Social Security and Medicare Tax on Wages.* The worker may choose to report the income as wages on his or her tax return before receiving the SS-8 determination. Submit Form 8919 with the tax return and check box G under the reason codes. Use Form 8919 to compute and report the employee's share of FICA taxes. By filing Form 8919, the taxpayer's Social Security earnings will be credited to his or her Social Security record.

Note: If the IRS determines that the worker who filed Form 8919 is really an independent contractor, then the personal return must be amended. If the IRS agrees that the worker is really an employee, the employer will be liable for employment taxes.

Voluntary Classification Settlement Program

The Voluntary Classification Settlement Program (VCSP) permits eligible taxpayers to reclassify workers as employees for future tax periods and obtain relief similar to that available under IRC section 3509. See *Other Employer Relief—Worker Status,* previous column.

VCSP eligibility requirements. To be eligible for the VCSP, a taxpayer must:

- Want to voluntarily reclassify certain workers as employees for federal income tax withholding, Federal Insurance Contributions Act (FICA), and Federal Unemployment Tax Act (FUTA) taxes (collectively, federal employment taxes) for future tax periods,
- Be presently treating the workers as nonemployees,
- Have filed all required Forms 1099 for each of the workers to be reclassified for the three preceding calendar years (a taxpayer will meet this requirement if it filed all required Forms 1099 for the workers being reclassified for the period of time that the workers worked for the taxpayer. For example, a taxpayer who has only been in business for two years meets this requirement if the taxpayer filed all required Forms 1099 for the workers being reclassified for those two years),
- Have consistently treated the workers as nonemployees,
- Have no current dispute with the IRS as to whether the workers are nonemployees or employees for federal employment tax purposes,
- Not be under employment tax audit by the IRS (if the taxpayer is a member of an affiliated group, this requirement is met only if no member of the affiliated group is under employment tax audit by the IRS),
- Not be under examination by the Department of Labor or any state agency concerning the proper classification of the class or classes of workers, and
- Not have been examined previously by the IRS or the Department of Labor concerning the proper classification of the class or classes of workers, or, the taxpayer is in compliance with the

results of any previous worker classification audit by the IRS or the Department of Labor.

Form 8952, *Application for Voluntary Classification Settlement Program (VCSP).* Form 8952 can be filed at any time. However, Form 8952 must be filed at least 120 days prior to the date the workers are to be treated as employees.

The IRS is not obligated to accept the taxpayer's application to participate in the VCSP.

Self-Employment Tax

Cross References

- Schedule SE (Form 1040), *Self-Employment Tax*
- IRC §1401, *Rate of tax*
- IRC §1402, *Definitions*

Related Topics

- Ministers, page 14-5
- Payroll and Labor Laws, Tab 23
- Self-Employment Tax—Sale of Business, page 28-4

Who Pays Self-Employment (SE) Tax

Taxpayers generally pay SE tax when net earnings from self-employment are $400 or more. A taxpayer is self-employed if he or she carries on a trade or business as a sole proprietor (including farmers) or as a general partner in a partnership. A trade or business generally is an activity carried on for a livelihood or in good faith to make a profit. Facts and circumstances determine whether or not an activity is a trade or business. A taxpayer does not actually have to make a profit to be a trade or business. For a list of activities with descriptions of whether income earned is subject to SE tax, see *Self-Employment Tax Situations Chart,* page 5-3.

Self-Employment Tax

Self-employment tax is comprised of Social Security and Medicare tax assessed on taxpayers who work for themselves. Self-employment tax is similar to FICA taxes withheld from the pay of most wage earners. For more information on Social Security credits and coverage, see *Social Security,* page 13-26.

Author's Comment: Not reporting all self-employment income, or incorrectly reporting self-employment income for the wrong spouse may cause lower Social Security benefits at retirement.

Self-employment (SE) tax rate. The SE tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Schedule SE (Form 1040), *Self-Employment Tax.* A taxpayer must pay self-employment tax and file Schedule SE if net profit from self-employment is $434 or more, unless an optional method is chosen. See *Self-Employment Tax Optional Methods Election,* next column.

Percentage of income subject to self-employment tax. Multiply net profit by 92.35% (.9235) to get net earnings subject to SE tax.

- If net earnings are $176,100 (2025) or less, multiply the amount by 15.3% (.153), which results in total self-employment tax.
- If net earnings are more than $176,100 (2025), multiply the amount by 2.9% (.029) and add $21,836.40 to the result for total self-employment tax.

Enter total self-employment tax amount on line 4, Schedule 2 (Form 1040), *Additional Taxes.*

Maximum earnings subject to self-employment tax. Only the first $176,100 (2025) of net earnings from self-employment is subject to the 12.4% Social Security part of self-employment tax. All net earnings from self-employment are subject to the 2.9% Medicare part of self-employment tax.

More than one business. If a taxpayer has earnings from more than one business, combine the net profit (or loss) from each to determine total earnings subject to self-employment tax.

Deduction for one-half self-employment tax. A taxpayer can deduct one-half of the total self-employment tax amount as an adjustment to income on line 15, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.*

Additional Medicare tax. A 0.9% additional Medicare Tax applies to all earned income including self-employment income, over $200,000 (Single, QSS, HOH), $250,000 (MFJ), or $125,000 (MFS). Use Form 8959, *Additional Medicare Tax,* to compute the additional tax amount. For more information, see *Additional Medicare Tax,* Tab 3.

Claim all deductions. Taxpayers are required to claim all allowable deductions, including depreciation, in computing net earnings from self-employment for SE tax purposes. Penalties apply for making a false statement or representation in connection with any matter arising under the act. (Rev. Rul. 56-407)

Self-Employment Tax Optional Methods Election

Taxpayers with a loss or small amount of income may elect one or both optional methods to compute SE tax. Using an optional method gives credit toward Social Security and may increase certain tax credits.

Nonfarm optional method. Qualifications include:

- Self-employed on a regular basis (net earnings from self-employment were $400 or more in at least two of the previous three tax years).
- Net nonfarm profits were less than $7,840 (2025), and less than 72.189% of gross nonfarm income.
- Used nonfarm optional method less than five years. There is a five-year lifetime limit. The years do not have to be consecutive.

Farm optional method. Qualifications include:

- Gross farm income was $10,860 (2025) or less, or
- Net farm profits were less than $7,840 (2025).

Use Part II, Schedule SE (Form 1040), to elect and compute an optional method.

There is no limit on how many years the farm options method can be used.

Note: Do not combine farm and nonfarm earnings to compute net earnings under either method when using both optional methods.

Schedule F— Profit or Loss From Farming

Cross References

- Schedule F (Form 1040), *Profit or Loss From Farming*
- Schedule J (Form 1040), *Income Averaging for Farmers and Fishermen*
- Form 4835, *Farm Rental Income and Expenses*
- Form T (Timber), *Forest Activities Schedule*
- IRS Pub. 225, *Farmer's Tax Guide*

Related Topics

- Farm Rentals, Tab 7
- Passive Activity Losses, page 7-7
- Business Deductions, Tab 8
- Depreciation, Tab 9

Where to Report Sales of Farm Products

Item Sold	*Schedule F (Form 1040) Profit or Loss From Farming*	*Form 4797, Sales of Business Property*
Farm products raised for sale.	X	
Farm products bought for resale.	X	
Farm assets not held primarily for sale, such as livestock, held for draft, breeding, sport, or dairy purposes (bought or raised). See *Reporting Farming Activities,* below.		X

Reporting Farming Activities

Where?	*SE Tax?*	*Description of Activity*
Schedule F (Form 1040)	Yes	• Income received from operating, managing, or cultivating a farm for profit, either as owner or tenant, or for caring for someone else's crops or livestock. • Farm rental income received by landowner or sublessor who materially participates in a sharecrop arrangement. • Most agricultural payments. See *Agricultural Program Payments,* page 5-27. • Sale of farm products raised on the farm for sale or purchased for resale.
Form 4835	No	• Farm rental income received in a sharecrop arrangement in which the taxpayer did not materially participate. • Report income in the year crops are converted into money or equivalent regardless of accounting method.
Schedule E (Form 1040)	No	Cash rent received from a tenant who uses the taxpayer's land, based on a flat charge.
Schedule C (Form 1040)	Yes	• Income from contract harvesting of a commodity raised by someone else. • Rental income received by a self-employed taxpayer in the business of renting farm equipment to farmers.
Line 8i, Schedule 1 (Form 1040)	Maybe [1]	Any net income received from sales or prizes related to a 4-H or FFA project.
Line 8l, Schedule 1 (Form 1040)	No	Personal property rental income received by a taxpayer who is not in the business of renting. Report related expenses on line 24b, Schedule 1 (Form 1040).
Form 4797	Maybe [2]	• Sale of farm products not held primarily for sale (such as draft, breeding, dairy, or sport livestock), whether purchased or raised. • Sale of farm equipment, buildings, or other depreciable property.

[1] If the project is primarily for educational purposes, not for profit, and completed under the rules of the sponsoring 4-H or FFA organization, it may not be subject to SE tax.

[2] The portion of depreciation that must be recaptured as ordinary income may not be subject to SE tax if due to Section 179 or special depreciation property falling below 50% business use.

Farming Activities

A taxpayer is in the business of farming if he or she cultivates, operates, or manages a farm for profit, either as owner or tenant. A farm includes stock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards.

Farm Accounting Methods

Most business taxpayers use either the cash method or the accrual method of accounting. Generally, if a business produces, purchases, or sells merchandise, it must keep an inventory and use the accrual method for sales and purchases. However, the accrual method for a business with inventory is not required under certain rules and the business can use the cash method of accounting, even if it has inventory. Most farming businesses may use the cash method of accounting.

Gross receipts test. The cash method of accounting may be used for taxpayers (other than tax shelters) with average annual gross receipts of $31 million (2025) or less for the three prior tax-year periods.

Inventory. Taxpayers that meet the gross receipts test are not required to account for inventories, but rather may use a method of accounting for inventories that either:

- Treats inventories as non-incidental materials and supplies, or
- Conforms to the taxpayer's financial accounting treatment of inventories.

See *Small Business Inventory Exception,* page 8-15.

Farming business. A farming business owned by a C corporation, and partnerships with a C corporation partner, are exempt from using the accrual method if the business meets the gross receipts test.

Change in accounting method. A change in accounting method (from accrual to cash), or treatment of inventory, is considered a change in the taxpayer's method of accounting and subject to an IRC section 481(a) adjustment. See *Change in Accounting Method,* page 8-25.

Farm Inventory

Farm inventory includes all items held for sale or for use as feed, seed, etc., whether purchased or raised, that are unsold at the end of the year. See *Inventory/Cost of Goods Sold,* page 8-13. Farmers who use the accrual method for inventory, see chart, below.

Farm Product Inventory Required

Farm Product	*Yes*	*No*
Eggs under incubation in a hatchery operation and accrual method of accounting is used.	X	
Harvested and purchased farm products held for sale or held for feed or seed, such as grain, hay, silage, cotton, tobacco, concentrates, etc.	X	
Supplies acquired for sale or that become a physical part of items held for sale.	X	
Incidental supplies and supplies that do not become part of items held for sale. [1]		X
Livestock held primarily for sale or purchased for resale.	X	
Fur-bearing animals such as mink, chinchillas, foxes, etc., held by a farmer who is in the business of breeding and raising them.	X	
Livestock held for draft, breeding, dairy, or sport. [2]	X	X
Raised livestock held for draft, breeding, dairy, or sport purposes and unit-livestock-price method is used. [3]	X	
Growing crops with a pre-productive period of two years or less.		X
Growing crops when UNICAP rules apply. [4]	X	

[1] Deduct as farm expense in the year used or consumed.

[2] Such livestock may be either depreciated or included in inventory. The method must be consistent from year to year and can only be changed with IRS approval. See *Livestock,* page 5-29.

[3] See *Unit-livestock-price method,* page 5-27.

[4] See *Uniform Capitalization Rules for Farmers,* page 5-30.

Inventory valuation methods. Farm inventory can be valued under methods available to other businesses (cost, lower of cost or market, etc.). Farmers also have two additional methods unique to farming.

- ***Farm-price method.*** Entire inventory (except livestock) is valued at its market price less the direct cost of disposition.

- ***Unit-livestock-price method.*** Livestock is grouped and classified according to type and age, and then a standard unit price for each animal within a class or group is used to determine the value of inventory.

Crop Method of Accounting Election

If crops are planted and harvested in different tax years, a farmer can elect the crop method of accounting to deduct the entire cost of production, including expenses for seed and young plants, in the year income is realized from the crop. IRS approval is required, even for the first tax return. File Form 3115, *Application for Change in Accounting Method,* to obtain IRS approval. (Reg. §1.162-12)

Agricultural Program Payments

Most agricultural program payments are taxable. Taxable amounts reported on Schedule F (Form 1040) are also subject to SE tax.

Commodity Credit Corporation (CCC) loans. Loan proceeds are generally not included in income. But if a farmer pledges a portion of crop production to secure a CCC loan, the proceeds can be treated as a sale of crops. The amount reported as income is added to the basis of the commodity. IRS approval is not required to adopt this method and the farmer generally must report all CCC loans in later years in the same way.

A taxpayer can use cash to repay a CCC loan, purchase CCC certificates for use in repayment of the loan, or deliver the pledged collateral as full payment for the loan at maturity. For information about treatment of market gain associated with the repayment of CCC loans, see IRS Pub. 225, *Farmer's Tax Guide.*

Excess farm losses. The excess farm loss limitation under IRC section 461(j) has been permanently suspended for tax years after 2017. Rather, the excess business loss limitation applies to all taxpayers other than C corporations [IRC §461(l)]. See *Excess Business Loss Limitation,* page 5-13.

Conservation Reserve Program (CRP). Under the CRP, the government pays owners or operators with highly erodible or other specified cropland to convert its usage to a less intensive use.

A taxpayer must include the annual rental payments and any one-time incentive payment that he or she receives under the program on Schedule F (Form 1040). Certain cost-share payments may qualify for the cost sharing exclusion.

Court Case: A non-farmer reported CRP income as rental income. The Tax Court agreed with the IRS' decision to treat the income as farm income subject to SE tax. The Circuit Court reversed the Tax Court decision, ruling the CRP payments to a non-farmer are considered rental income. (*Morehouse,* 8th Cir., October 10, 2014)

Social Security recipients. CRP payments made to taxpayers who are receiving Social Security retirement or disability benefits are exempt from self-employment tax. [IRC §1402(a)(1)]

Crop insurance and crop disaster payments. Insurance proceeds (including government disaster payments) received due to damaged crops are taxable in the year received. This includes payments for the inability to plant crops because of drought, flood, or any other natural disaster.

Election to postpone reporting. The taxpayer can elect to postpone reporting income until the following year if:

- Cash method of accounting is used,
- Insurance proceeds are received in the same year the crops were damaged, and
- Under normal business practice, the taxpayer would have included more than 50% of the income from the damaged crops in any tax year following the year the damage occurred.

To elect to postpone income, check the appropriate box in Part I, Schedule F (Form 1040), and attach a statement to the return with the following information.

- A statement that the taxpayer is postponing income under IRC section 451(f) and Regulations section 1.451-6.
- Description of the specific crops damaged.
- A statement that under normal conditions, more than 50% of the income from some or all of the damaged crops would have been included in income in a tax year following the year the crops were damaged.
- The cause of damage and date(s) it occurred.
- Total payments received from insurance with an itemization for each specific crop, and dates payments were received.
- Name of insurance carrier(s).

Feed assistance and payments. The government provides benefits to qualifying livestock producers when a natural disaster causes a livestock emergency. Benefits may be in the form of partial reimbursement of the cost of feed, certain transportation expenses, and donations of, or sale at, below market price of feed owned by the CCC. Include the following in taxable income.

- The market value of donated feed received.
- The difference between the market value of feed and the reduced price of feed purchased by the taxpayer.
- Any cost reimbursements received.

These benefits are taxable in the year received. They cannot be postponed under the crop insurance or weather-related sale of livestock rules. A corresponding deduction for the cost of feed is allowed.

Cost-sharing exclusion (improvements). An exclusion from income is allowed for payments received under a federal or state cost-sharing conservation, reclamation, and restoration program. The exclusion applies if all of the following tests are met.

- Payment was for a capital expense. Payments for expenses that are currently deductible do not count.
- The improvement does not substantially increase annual income from the property. An increase in income is substantial if it is more than the greater of 10% of average annual income prior to receiving the improvement, or $2.50 times the number of affected acres.
- The Secretary of Agriculture certified that the payment was primarily made for conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

For a list of qualifying programs and the calculation of the excludable amount, see IRS Pub. 225, *Farmer's Tax Guide.*

Patronage Dividends From Cooperatives

When a farmer buys supplies from a cooperative, the cooperative may later refund a portion of the purchase price in the form of a patronage dividend. The refund generally represents the excess net earnings of the cooperative. Patronage dividends are reported to the farmer on Form 1099-PATR, *Taxable Distributions Received From Cooperatives.*

Tax reporting. Report the total amount received on Part I, Schedule F (Form 1040), and allocate the dividends by source as follows.

- *Attributable to deductible farm expenses* ..... *Taxable*
- *Attributable to personal expenses* ..... *Nontaxable*
- *Attributable to the purchase of capital assets* ..... *Reduce asset basis*

Qualified written notice of allocation received. Include the stated dollar value in income in the year received. The amount included in income that exceeds money received becomes the basis in the notice. A written notice of allocation is qualified if at least 20% of the patronage dividend is paid in money or by qualified check and either of the following conditions is met.

- Notice is redeemable in cash for at least 90 days after it is issued.
- Taxpayer agreed to include the stated dollar value in income in the year received by either signing a written agreement, getting membership in the cooperative, or by endorsing and cashing a qualified check that was paid as part of the same patronage dividend.

Any loss on redemption is deductible on Part II, Schedule F (Form 1040).

Nonqualified notice of allocation. Do not include the stated dollar value in income when received. The basis in the notice is zero. Tax is paid on any amount received from its sale in the year of disposition.

Per-Unit Retain Certificate From Cooperatives

A per-unit retain allocation is an amount paid to patrons for products sold for them that is fixed without regard to the net earnings of the cooperative. Per-unit retain certificates generally receive the same tax treatment as patronage dividends.

Farm Debt Cancellation

When farm debt is cancelled or forgiven, the amount forgiven may be includable in taxable income on line 8, Schedule F (Form 1040).

Qualified farm debt exclusion. Farmers can exclude from income a cancelled debt that is qualified farm debt owed to a qualified person. The exclusion applies only if the farmer was solvent when the debt was cancelled, or, if insolvent, only to the extent the cancelled debt is more than the amount by which the farmer was insolvent. Qualified farm debt must meet both of the following requirements.

- Debt was incurred directly in operating a farming business, and
- At least 50% of total gross receipts for the previous three tax years preceding the year of debt cancellation were from farming business.

Qualified person. A qualified person is actively and regularly engaged in the business of lending money, including any federal, state, or local government, or any of their agencies or subdivisions, and the USDA. A qualified person does not include any of the following individuals:

- A person related to the farmer.
- A person from whom the farmer acquired the property (or a person related to this person).
- A person who receives a fee from the farmer's investment in the property (or a person related to this person).

Reduction of tax attributes. A farmer must use special rules to reduce the basis of property for excluded cancelled qualified farm debt. Under these rules, qualified property is reduced in the following order.

1) Depreciable qualified property.
2) Land that is qualified property and used or held for use in farming business.
3) Other qualified property.

Qualified property. Qualified property is any property used or held for use in a trade or business or for the production of income.

Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness.* File Form 982 to report the exclusion and the reduction for certain tax attributes listed above.

For information on debt cancellation, other exclusions, and bankruptcy, see *Foreclosures, Repossessions, and Cancellation of Debt,* page 6-27.

Net Operating Losses on Farms

If a farmer's deductible loss from operating a farm is more than the farmer's other income for the year, a net operating loss (NOL) may exist.

NOL limitation for farmers. Farming losses must be carried back two years (unless election to forgo carryback is made) and carried forward indefinitely. See *Net Operating Loss (NOL),* page 8-20.

Farming loss. A farming loss is the smaller of:

- The amount that would be the NOL for the tax year if only income and deductions attributable to farming business are considered.
- The NOL for the tax year.

Excess Farm Loss Limitation

See *Excess Business Loss Limitation,* page 5-13, and *Commodity Credit Corporation (CCC) loans,* page 5-27.

Income Averaging for Farmers and Fishermen

If farm income is high in the current year and low in any of three prior (base) years, a farmer may qualify to calculate a lower tax by income averaging on Schedule J (Form 1040), *Income Averaging for Individuals With Income from Farming or Fishing.*

Election. When electing to use Schedule J (Form 1040), the taxpayer:

- Need not have been in the farming business in any of the base years.
- May have a different filing status than in the base years.
- Need not have been required to file a tax return in any of the base years, although base year income amounts are needed for Schedule J (Form 1040).
- Does not use income averaging for AMT calculations.
- Does not recalculate AMT or Kiddie Tax for any of the base years.
- Must combine income, gains, losses, and deductions from farming and fishing businesses if the taxpayer is engaged in both activities.

Fishing business. IRS regulations define a fishing business as:

- Catching, taking, or harvesting activities that result in the killing of fish or the bringing of live fish on board a vessel, support operations at sea, but not processing of fish, or
- Lessors of fishing boats when payment is based on share of catch, or
- Crewmembers when compensation is based on a share of the catch. (Reg. §1.1301-1)

Eligible taxpayers. A taxpayer can use income averaging in any year in which he or she was engaged in a farming or fishing business as an individual, a partner in a partnership, or a shareholder in an S corporation. Services performed as an employee do not qualify unless received as a shareholder/employee of an S corporation.

Corporations, partnerships, estates, and trusts do not qualify.

Elected farm income (EFI). Income from the farming business is the sum of any farm income or gain minus any farm expenses or losses allowed as deductions. It does not include gain or loss from the sale or disposition of land, or from the sale of grazing, development, or similar rights.

EFI is the amount of income from the farming business that the taxpayer elects to have taxed at base rates. Any type of income attributable to the farming business may be designated, however, EFI cannot be more than taxable income. Any EFI from net capital gain attributable to farming cannot be more than the taxpayer's total net capital gain.

Prepaid Farm Expenses

Prepaid farm supplies. Prepaid farm supplies include feed, seed, fertilizer, and similar farm supplies that are not used or consumed as of the end of the tax year. If the cash method of accounting is used to report income and expenses, a deduction for prepaid

farm supplies may be limited to 50% of the total other deductible farm expenses for the year [all Schedule F (Form 1040) deductions except prepaid farm supplies].

Example: Ken bought $5,500 worth of fertilizer in 2025 that will not be used until 2026. His other deductible farm expenses in 2025 total $10,000. Ken's deduction for prepaid farm supplies in 2025 cannot be more than $5,000 (50% of $10,000). The $500 excess is deductible in 2026 when the fertilizer is used.

Exceptions: The limit on deducting prepaid farm supplies does not apply for farmers if either of the following is true.

- Prepaid farm supplies are more than 50% of other deductible farm expenses because of a change in business operations caused by unusual circumstances.
- Total prepaid farm supplies expense for the preceding three tax years is less than 50% of total other deductible farm expenses for those three tax years.

Prepaid livestock feed. Cash method farmers cannot deduct in the year paid the cost of feed that livestock will consume in a later year unless all the following three tests are met.

1) The payment is for the purchase of feed rather than a deposit,
2) The prepayment has a business purpose and is not merely for tax avoidance, and
3) Deducting the prepayment does not result in a material distortion of income.

If all three tests are met, the deduction for prepaid livestock feed is still subject to the 50% rule discussed previously.

Real Estate Taxes on Farm Land

Taxes on the portion of the farm used as the tax-payer's personal residence should be deducted as itemized deductions on Schedule A (Form 1040) rather than as business deductions on Schedule F (Form 1040).

Did You Know? According to IRS Pub. 225, the business and nonbusiness portion of property taxes can be determined based on the assessed valuation. For example, a 160 acre farm may have a personal residence sitting on a two-acre parcel of land. 98.75% of the total land area is used for farming. However, the assessed valuation of the property may only show 50% allocated to the land and farm buildings, while the other 50% is allocated to the house. This may seem less advantageous for deduction purposes, but when the property is eventually sold, only 50% of the total sale price would be allocated to the business, while the other 50% could qualify for the IRC section 121 sale of home exclusion of a personal residence.

Farm Truck and Car Expenses

Farmers can calculate the deduction for the business use of vehicles under either the standard mileage rate method or actual expense method. See *Business Autos,* page 10-2.

Business use percentage for farm vehicles. Farmers can claim 75% of the use of a car or light truck as business use without any records if the vehicle is used during most of the normal business day directly in connection with the farming business.

Fuel and road use excise tax. Owners, tenants, or operators of a farm may be eligible to claim a credit or refund of excise taxes on fuel used for farming purposes in carrying on a trade or business of farming on a farm in the United States.

Claim the credit on Form 4136, *Credit for Federal Tax Paid on Fuels,* filed annually with the individual or business tax return. Claim refunds on Form 8849, *Claim for Refund of Excise Taxes,* filed quarterly. No credit or refund is allowed for any personal, household, or non-fuel use, except in some circumstances for undyed diesel fuel or undyed kerosene.

Fuel Use—Credit or Refund

Fuel Used on Farm for Farming Purposes	*Credit*	*Refund*
Gasoline	Yes	No
Aviation gasoline	Yes	No
Kerosene used in aviation	Yes	Yes
Undyed diesel fuel and undyed kerosene	Yes[1]	Yes[1]
Other fuels, including alternative fuels	Yes[1]	Yes[1]
Off-Highway Business Use Fuel	***Credit***	***Refund***
Gasoline	Yes	Yes
Undyed diesel fuel and undyed kerosene	Yes[2]	Yes[2]
Other fuels, including alternative fuels	Yes	Yes

[1] Credit or refund by the farmer only, even if purchased by someone else and used on the farm for farming purposes.
[2] Applies to undyed kerosene not sold from a blocked pump, or for blending with undyed diesel for household heating, lighting, or cooking.

Did You Know? No credit or refund is allowed for any dyed diesel fuel or dyed kerosene, which are usually purchased tax free. If these fuels are used for taxable purposes, Form 720, *Quarterly Federal Excise Tax Return,* must be filed to pay excise tax and avoid penalties.

Depreciation for Farm Property

Farm property such as machinery, equipment, livestock, or structures with a useful life of more than a year must generally be depreciated. For general depreciation rules, the Section 179 deduction, and the special depreciation allowance, see *Depreciation,* Tab 9.

For property acquired and placed in service after December 31, 2017, the recovery period for any new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) is five years.

Farming Asset Recovery Periods

Assets:	*GDS Life*	*Method*	*Sec. 179*
Agricultural and horticultural single purpose structures	10 yrs	200% DB	Yes
Autos	5 yrs	200% DB	Yes
Cattle (dairy or breeding)	5 yrs	200% DB	Yes
Computer and peripheral equipment	5 yrs	200% DB	Yes
Drainage facilities	15 yrs	150% DB	Yes
Farm buildings (other than single purpose structures)	20 yrs	150% DB	No
Farm machinery and equipment (new)	5 yrs	200% DB	Yes
Farm machinery and equipment (used)	7 yrs	200% DB	Yes
Fences (agricultural)	7 yrs	200% DB	Yes
Fruit or nut trees and vines	10 yrs	SL	Yes
Goats and sheep (breeding)	5 yrs	200% DB	Yes
Grain bin	7 yrs	200% DB	Yes
Hogs (breeding)	3 yrs	200% DB	Yes
Horses, breeding and working, up to age 12 when placed in service	7 yrs	200% DB	Yes
Horses, breeding and working, over age 12 when placed in service	3 yrs	200% DB	Yes
Horses, racing, over age 2	3 yrs	200% DB	Yes
Horses, racing, age 2 or younger	7 yrs	200% DB	Yes
Nonresidential real property	39 yrs	SL	No
Qualified improvement property	15 yrs	SL	Yes
Qualified production property, placed in service after July 4, 2025	39 yrs	SL	No
Residential rental property	27.5 yrs	SL	No
Trucks (less than 13,000 lbs)	5 yrs	200% DB	Yes
Water wells	15 yrs	150% DB	No
For other depreciation recovery periods and methods, see Tab 9.			

Livestock. Livestock purchased for draft, breeding, or dairy purposes can be depreciated only if they are not kept in an inventory

account. Livestock a farmer raises usually has no depreciable basis because the costs of raising them are deducted and not added to their basis. However, for immature livestock, depreciation begins when the livestock reaches the age of maturity (when the livestock can be worked, milked, or bred), and the basis is their initial cost.

Fruit or nut trees and vines. For an orchard, grove, or vineyard acquired before the trees or vines have reached the income-producing stage, and having a pre-productive-period of more than two years, the pre-productive-period costs must be capitalized under the UNICAP rules (unless the farmer elects not to use the rules). Depreciation begins when the trees and vines reach the income-producing stage (bear fruit, nuts, or grapes in quantities sufficient to commercially warrant harvesting).

Special depreciation. Plants bearing fruits and nuts are eligible for special depreciation in the year planted or grafted. See *Special Depreciation Allowance,* page 9-10.

Business Use of Home—Farmers

A farmer may be able to deduct certain expenses for business use of the home, subject to limitations. The simplified method is also available. Deduct on line 32, Schedule F (Form 1040). See *Business Use of Home,* page 5-13.

Soil and Water Conservation Expenses

A taxpayer in the business of farming can choose to deduct certain expenses for:

- Soil or water conservation,
- Prevention of erosion of land used in farming, or
- Endangered species recovery.

Otherwise, these expenses are capital expenses that must be added to the basis of the land. The deduction is limited to 25% of gross income from farming. Unused amounts can be carried over.

Uniform Capitalization Rules for Farmers

UNICAP rules for farmers do not apply to the following property.

- Any animal.
- Any plant with a preproductive period of two years or less.
- Costs of replanting certain plants lost or damaged due to casualty.

The first two exceptions do not apply to farm corporations, partnerships, or tax shelters that are required to use the accrual method of accounting. See *Uniform Capitalization (UNICAP) Rules,* page 8-14.

In addition, a farming business with gross receipts under $31 million (average of three prior years) is not subject to the uniform capitalization rules unless the taxpayer is a tax shelter prohibited from using the cash method. [IRC §263A(i)].

Timber Sales by Farmers

The tax treatment of timber sold by farmers depends on whether the timber is held as an investment or is a product of the farm.

- Standing timber held as an investment is a capital gain asset. Report gains or losses from a sale on Form 8949, *Sales and Other Dispositions of Capital Assets,* and on Schedule D (Form 1040), as applicable.
- Timber held, purchased, or raised primarily for sale to customers is an ordinary income asset. Report sales proceeds on Schedule F (Form 1040), line 1 (purchased timber) or line 2 (raised timber).

Elections:

- IRC section 631(a) permits the election to treat cut timber as a sale or exchange, resulting in a basis adjustment when an actual sale or exchange occurs.
- IRC section 631(b) permits an election to treat outright sales of timber as section 1231 gain or loss. The payment date may be treated as the date of sale, even if cutting or disposition of the timber has not yet occurred.

Form T (Timber), *Forest Activities Schedule.* Attach Form T to the tax return if electing to treat cut timber as sale or exchange, making an outright sale of timber, or claiming cost depletion. Form T is not required if the taxpayer only has an occasional sale of timber. See instructions for Form T.

Timber basis. Timber basis is recovered through depletion, which occurs when standing timber (including Christmas trees) is cut. Cost depletion is the only method permitted for timber. It is claimed as a deduction on Schedule F (Form 1040) in the year of sale or other disposition of cut timber, or in the year the farmer elects to treat cutting as a sale or exchange. See *Depletion,* page 9-17.

Postponing Gain on Weather-Related Sales of Livestock

If more than the normal amount of livestock, including poultry, is sold because of a drought, flood, or other weather-related condition, gain from the additional animals can be postponed until the following year. All the following must be true.

- Principal trade or business is farming,
- Cash method of accounting is used,
- Under usual business practices, the taxpayer would not have sold the additional animals this year except for the weather-related condition, and
- The weather-related condition caused an area to be designated as eligible for federal assistance.

How to postpone gain. To postpone gain, attach a statement to the tax return for the year of sale which includes the following information.

- A statement that the taxpayer is postponing gain under IRC section 451(g).
- Evidence of the weather-related conditions that forced the early sale and date the area was eligible for federal assistance.
- Explanation of the relationship between the area affected by the weather-related condition and the resulting early sale of livestock.
- Number of animals sold in each of the three preceding years.
- Number of animals the taxpayer would have sold under normal weather conditions.
- Total number of animals sold and the number sold due to the weather-related conditions.
- Computation of income to be postponed for each class of livestock.

Involuntary conversion rules for livestock. Gain on livestock sold under the weather-related sales rules discussed above can be postponed under the involuntary conversion rules if replacement property is purchased within the replacement period. See *Involuntary Conversions,* page 6-25.

- If it is not practical to invest sales proceeds in other livestock, the proceeds can be used to purchase other property used in farming (but not real property) and still qualify for postponement of gain.
- The replacement period is extended from the usual two years to four years if weather-related conditions occur in an area eligible for federal assistance. (Notice 2006-82)
- The IRS may further extend the four-year replacement period if the weather-related conditions that caused the area to be eligible for federal assistance continue beyond three years. The replacement period is extended for applicable regions listed in Notice 2025-52.

~ End ~