

Module 3.2: Sole Proprietors, Home Office Expense & Estimated Taxes

You are considered a sole proprietor for tax purposes if:

- You are the exclusive owner of an unincorporated business. As we've discussed, some sole proprietors choose Limited Liability Status. Since this is a state designation, it does not affect your federal tax requirements.
- You are an independent contractor who is not an employee, but provide services for compensation. You usually have a profit motive and have chosen to do these services as a contractor instead of working as an employee.
- You receive a 1099-NEC for work that you did instead of the W-2 you were familiar with. This often happens when people just take a job to earn some money without asking any questions other than how much and when is payday. Suddenly the taxpayer is handed a 1099-NEC in January. They consider themselves an employee until they sit down to do their taxes and find out the government considers them self-employed and instead of a refund, they get handed a bill for how much tax they have to pay.

I really do consider it unethical to hire someone *without* telling them that they will be paid as a independent contractor and they will be responsible for paying their own taxes. Of course, I understand why business owners do it. They don't have to pay for 1/2 of the payroll taxes or unemployment taxes if they hire independent contractors, and a lot of these people are doing it illegally. As we discussed in the Hiring Help module, you can't treat people as an employee and pay them as independent contractors. If someone should file a complaint with the IRS, they can make the business pay all of those taxes they tried to get out of paying, plus penalties and interest. It's not worth losing your business over.

Even though some portion of your gross income may be reported to the government on the 1099 series forms, cash receipts are not included in the information sent to the IRS by third parties. Since all taxpayers are required to pay the correct amount of tax, it is the business owner's obligation to track and report any cash or credit transactions received.

Schedule C

Sole proprietors file IRS form Schedule C, *Profit or Loss From Business*. Since sole proprietors are considered not separated from their owner, the Schedule C is attached to your personal Form 1040 return. The profit or loss is carried from the bottom of the Schedule C to page one of the Form 1040. It is then added to or subtracted from the other income of the taxpayer (and spouse if filing jointly), such as W-2 income, interest, or retirement income.

For example, if you had a \$20,000 business loss reported on your Schedule C and earned \$80,000 at another job, then your Adjusted Gross Income would be \$60,000 (\$80,000-\$20,000). This would reduce your personal tax liability.

It is not my intention here to go over this tax form line by line. What I do want to accomplish is to point out the things you should be aware of in filing a Schedule C, some of which tax preparers fail to address. Let's begin by reviewing the most common documents received by sole proprietors:

Form 1099-NEC is used for Tax Years 2020 and later to report non-employee compensation. This is generally payment for services provided by someone who is not an employee of the payer.

Form 1099-MISC was used to report non-employee compensation through 2019. Other types of income, including rents and royalties, are still reported on this form.

Form 1099-K is for payments made through payment cards and third-party networks. For many retailers, this indicates payments that were made using credit or debit cards. The American Rescue Plan of 2021 (ARPA) lowered the Form 1099-K reporting threshold to \$600, similar to other Forms in the 1099 series. This rule is in effect for transactions settled after December 31, 2021 and replaces the \$20,000 and 200 transaction threshold currently in place. This means a whole lot more people are going to be receiving this form starting with their 2022 taxes.

There is also an additional checkbox on the 1099-NEC and 1099-MISC that is marked if the payer made direct sales of \$5,000 or more to the person receiving the form(s). This tells the IRS that you purchased products for resale and is most often received by direct sales or party plans like Pampered Chef, Avon or Mary Kay.

Business Codes

Sole proprietorships are required to list a business code on Schedule C. The IRS requires this information to get a better sense of your type of business, and whether the income and expenses are reasonable. The IRS has a large database of businesses in every industry and may use a deviation from the industry average to choose which returns to audit. So, if your business changes their primary activity, you will need to determine the correct business code for the return going forward.

The instructions for Schedule C include a list of codes that are based on the North American Industry Classification System (NAICS). The codes used for Schedule C are not identical to the NAICS codes, so you should always use the ones in the IRS instructions. I have include a copy of them in the download section.

Business Deductions

Most business deductions are not reported to the IRS by third parties. It is the responsibility of the business owner to track their expenses, and retain the documentation needed to prove deductions if needed. If the business had expenses, but the receipts were lost, it is reasonable to use other methods to prove the expense. (Check out the Bonus section on how to reconstruct your records if you need to.)

Businesses may deduct all ordinary and necessary expenses. The most common expenses have dedicated lines on Schedule C. There is also a line for Other Expenses, but if an expense has a dedicated line, that line should be used. The instructions for Schedule C have detailed descriptions of what should be included on each line.

There are a series of expenses that can be handled in more than one way. That is what rest of this module is about, so you can make an informed decision and choose which direction works the best for you.

Employee vs Contractor Deductions

If a sole proprietor pays independent contractors, the amount paid can be deducted. If you pay anyone \$600 or more during the calendar year, you must issue Form 1099-NEC to report the payments to the IRS by January 31st of the following year.

If a sole proprietor has employees, you may deduct wages, benefits paid by the employer, and the business share of payroll taxes. The payroll taxes paid by the employer include the employer's portion of social security and medicare taxes, unemployment taxes (federal and state), and any other items required to be paid by the employer. You can NOT deduct the employees' share of taxes, social security and medicare withheld.

NO deduction is allowed for the sole proprietor's own compensation, including amounts withdrawn for personal use.

Transportation & Travel Deductions

When traveling out of town overnight for business, you can deduct the expenses for flying, staying in motels and reasonable meal expenses (there are limits). However, when traveling by automobile, there are two different ways that you can deduct the expenses. They are standard mileage or actual expenses.

It is important that you understand, when you can use each one, the documentation required, and why it often gives you a larger deduction than the actual money you spent. Because this deduction can make such a huge difference in your taxable net profit, I have dedicated the entire Module 3.3 to this subject.

Meals, Entertainment & Gifts

With the passage of the Tax Cuts and Jobs Act in 2017, you can no longer deduct entertainment expenses you may spend on a customer, but food and gifts you can with restrictions.

There are two ways that food can be deducted, depending on its business purpose. You should therefore have two categories in your accounting system that you track this under. The most common is the business meal expense which allows you to deduct 50% of the cost of taking a client out to eat. (The theory here is that you can't deduct the half you spent on yourself.) In your bookkeeping system, you should enter the entire amount that you spent, and the 50% split will happen when the tax return is prepared.

The other way that food can be deducted is if you are providing it for the convenience of the employer. For instance, if you buy pizza for everyone if they work during lunch to beat that deadline you have, then it is deductible at 100%. This could also apply to buffets for open houses or business conferences. If you just lump both kinds of food expense together, you have to use the 50% deduction, so make sure you make two accounts for this.

When it comes to gifts, the IRS doesn't care what you spend. That said, you can only deduct \$25 of the cost per client per year. I have a client that was buying \$100 bottles of wine for Christmas gifts to his best clients - that is, until I told him he couldn't deduct the other \$75 on his taxes. He doesn't spend more than \$25 anymore unless it is a REALLY good client.

Depreciation

If the business buys property or capital equipment (which has a projected life of more than one year), such as a compressor, trailer or vehicle, they must be reported *separately* - from a tax point of view - as depreciable items. You are allowed to deduct the entire amount of the purchase (up to a certain amount) *or* deduct a little bit of the purchase price over several years. This is advantageous if you figure your profits are going to be more in future years and thus could use the deductions more in the future than in the current year. Depreciation is an important part of your tax decisions and you will find a complete discussion of how to use it to reduce your taxes in Module 3.8.

Home Office Deduction

Sole Proprietorship is the only business format that is allowed to take the home office deduction. There are two ways to take this deduction: the percent of actual expenses or the simplified method.

The IRS has established two tests that you must pass to qualify for the home office tax deduction. The first is called the "Regular and Exclusive Use" test, and the second is the "Principal Place of Business" test. You'll need to pass both tests to qualify for the deduction.

1. Regular and Exclusive Use Test

To pass this test, you must regularly use part of your home exclusively for business. For example, if you have an extra room in your home set up as your office and managing your business is the only thing that room is used for, then you have passed the Regular and Exclusive Use test. A specific area of your home that is not a separate room but is used exclusively for business also qualifies. You don't have to have walls around it.

If you have a seasonal business—selling holiday gift baskets, for example—that operates from September through December, you are eligible to take this deduction for the four months in which you operate your business.

As with most IRS rules, there are a couple of exceptions. You do not have to pass this first test if either of the following applies:

- The part of your home that is used to store inventory or product samples such as your garage that would be dual purpose.
- You use part of your home as a daycare facility, because there are special rules for these.

2. Principal Place of Business Test

To pass the requirements of this test, you must use your home office as your principal place of business, exclusively and *regularly*. You can have more than one place where you conduct business. However, to be eligible for the home office deduction, you need to conduct the majority of the administrative or management activities for your business at your home office.

The IRS considers the following items to be good examples of what they consider to be administrative or management activities:

- Invoicing customers
- Bookkeeping
- Scheduling appointments
- Inventory and/or supply ordering
- Preparing reports

Home Office Deduction Example

Here is an example of a self-employed plumber who meets the requirements of the home office deduction:

John is a self-employed plumber. Most of John's time is spent at customers' homes and offices installing and repairing plumbing. He has a small office in his home that he uses exclusively and

regularly for the administrative or management activities of his business, such as phoning customers, ordering supplies, and keeping his books.

John writes up estimates and records work completed at his customers' premises. He does not conduct any substantial administrative or management activities at any fixed location other than his home office. John does not do his own billing. He uses a local bookkeeping service to bill his customers.

John's home office qualifies as his principal place of business for deducting expenses for its use. He uses the home office for the administrative or managerial activities of his plumbing business, and he has no other fixed location where he conducts these administrative or managerial activities. His choice to have his billing done by another company does not disqualify his home office from being his principal place of business.

Types of Home Office Expenses You Can Deduct

Here are some examples of the home office expenses you can deduct:

- Repairs and maintenance to the area used for business
- Utilities
- Real estate taxes
- Insurance
- Home mortgage interest

You may be able to deduct some expenses from your taxes in full while others can only be partial deductions. The IRS breaks down deductibility by types of expenses: Direct, indirect, and unrelated.

For instance, if you only paint your office you could deduct 100% of the cost. That's referred to as a Direct Cost. However, if you painted your entire 2,000 square ft house and your office was only 100 square ft, then you could only deduct 5% of the cost of painting the whole house. ($100 \text{ sq ft} \div 2000 \text{ sq ft} = 5\%$) Your utilities, taxes, and insurance would also be deducted as the percentage of space your office occupies in the entire house. These are referred to as Indirect Costs.

Computing the Home Office Tax Deduction

As I mentioned earlier, you have two choices when it comes to figuring out your deduction: the simplified method or the regular method. As the name implies, the simplified method is the easier route to go, but it's only available if your expenses don't exceed your income. Otherwise, you'll have to use the regular method.

To calculate the home office deduction using the simplified method, you need the following information:

- The square footage of the area of your home that you use exclusively and regularly for business. This area cannot exceed 300 square feet. For tax purposes, this is called the allowable area.
- Your business's annual income. You should be able to get this information from your profit and loss (P&L) statement for the current tax year.
- Your total annual business expenses not related to the use of your home. You wouldn't consider rent, for example. You should be able to get your total expenses from your P&L statement for the current tax year.

Example Calculation Using the Simplified Method

Once you have computed the allowable area, your gross income, and total expenses, follow the steps below to calculate your home office deduction:

1. Multiply the allowable area (up to 300 square feet) by \$5 (daycares have special rules).
2. Take your gross business income and subtract your total business expenses. If your total expenses exceed your gross income, then you are not eligible to take the home office deduction.
3. If the difference between your gross income and total expenses is a positive number, then proceed to step 4. However, if you have a loss, then you do not qualify for a home office tax deduction.
4. Take the smaller of the results between steps 1 (the \$5 a square foot) and 2 (your gross profit). This is the amount you are allowed to deduct for your home office expenses.

If you do not meet the requirements to take the home office deduction using the simplified method because your expenses exceed your income, then you can use the actual expenses method to see if you qualify to take the home office tax deduction. While this method requires a bit more work to calculate, it could give you a larger deduction because it is based on actual expenses as opposed to just a formula based on the square footage of your office space.

For example, under the simplified method, a business owner who lives in New York City with a 200-square-foot home office and another business owner who lives in Boise, Idaho, with a 200 square foot home office would both end up with the same deduction, assuming that their gross income is more than \$1,000: $(200 \times \$5 = \$1,000)$

Because it is much more expensive to live in New York City, it may work in that taxpayer's favor to use the actual expenses method rather than the simplified method.

Example Calculation Using the Actual Expenses Method

1. Calculate the percentage of your home used exclusively and regularly for business. If you have a 2,000-square-foot home and your home office is 200 square feet, then the percentage of your home office space is 10%. $200 \div 2000 = 10\%$
2. You would then deduct 100% of the Direct Costs and 10% of the indirect Costs.

Similar to the simplified method, if your gross income exceeds your total expenses, under the actual expenses method, you can deduct all of your direct expenses and indirect business expenses related to the use of your home office.

However, if your total business expenses exceed the gross income from your business, then your deduction for certain expenses for the business use of your home will be limited under the actual expenses method.

Home Office Deduction Form

Since the home office tax deduction is only available to self-employed businesses and single-member LLCs that file a [Schedule C](#), you need to complete home office deduction [Form 8829](#). Then, follow the instructions on the deduction form to transfer your deduction to the appropriate line on your Schedule C.

Finally, you should keep any documentation you used to calculate your home office deduction. In case of an audit, keep these records on file for at least three years after the date that you filed your tax return. If possible, scan these documents to your computer for safekeeping.

Self-Employment Taxes

One of the biggest shocks most new entrepreneurs get when they start a business the first time is the amount of taxes that have to be paid out of your income. This is why I stress so much that you learn all of the things in this course, so that you may legally reduce your net profits to reduce your tax liabilities.

The first year a businessperson turns a profit, they become responsible for self-employment taxes (also called payroll taxes or Social Security & Medicare taxes), if your net profit was \$400 or more. These currently run up to 15.3 percent of the NET PROFIT that the sole proprietorship reported on Schedule C. They include two components:

- A 12.4 percent tax for old age, survivors, and disability insurance (OASDI - which most people know as Social Security), which has a dollar cap that is adjusted each year. For instance, for 2021, only the first \$142,800 is assessed this tax.
- A 2.9 percent tax for Medicare, which has no dollar cap.

Employers report income taxes, social security taxes, and medicare taxes withheld from employee's wages using Form 941, *Employer's Quarterly Federal Tax Return*. It is due by the last day of the month that follows the end of the quarter (i.e. April 30 for quarter ending March 31, July 31 for quarter ending June 30).

A sole proprietorship is *not* subject to Federal Unemployment Tax (FUTA), unless it has employees. The FUTA tax is 6.2 percent of the first \$7,000 of each employee's salary. There may also be a state employment tax (which can be taken as a credit on the federal FUTA).

Federal unemployment taxes are paid using Form 940. This tax is paid by employers only and is not deducted from employees wages. Generally, FUTA taxes are deposited on a quarterly basis. However, if the quarterly amount due is \$500 or less, you can carry it forward and add it to the next quarter. If it is \$500 or less for the entire year, you just send it with the annual return.

What so many new small business people do not consider is that they need to be putting away at least 25% to 30% of their net profits just to cover tax liabilities. This includes the 15.3% for self-employment taxes plus regular income tax of 10-21% of you net income. And having to come up with the money to pay a large tax bill at the end of the year has doomed many small businesses to failure.

The amount of estimated taxes to pay will also depend on whether you want to avoid penalties. To avoid a penalty for underpayment of estimated tax for 2021, the sole proprietor should pay the smaller of 100% of the tax shown on their previous years personal return or 90% of the current years tax due on their personal return.

For sole proprietors with a variable income, it's a best practice to make three to four estimated payments through out the year. The due dates are April 15th for profits in January to March, June 15th for profits in April and May, September 15th for profits from June to August, and January 15th of the next year for profits in the last four months of the year. This is another reason why you need a good accounting system that can tell you your net profit at any point in time.

To get the forms to send in your estimated taxes, you can download them from the [IRS.gov](https://www.irs.gov) website by searching for Form 1040-ES, *Estimated Tax for individuals, pages 9 & 11*. I have also included a link below the video that will take you directly to the form.

Adjustments to Income

In the last part of this module, I want to touch on some adjustments to income that are available to sole proprietors on their personal tax returns.

If the sole proprietor is not eligible for health insurance coverage through an employer (or your spouses employer), you may deduct the premiums you pay for health care coverage from our

income for yourself, your spouse, and your dependents. This deduction is limited to the profit the business makes less 1/2 of the Self-Employment tax. Premiums paid for Medicare Parts A, B, C, and D are eligible for this adjustment also. And so is Marketplace health insurance.

Sole proprietors may choose to set up retirement accounts for themselves and their employees and reduce their taxable income. Several options are available, including Individual Retirement Arrangements (IRA), Simplified Employee Pensions (SEP), Savings Incentive Match Plan for Employees (SIMPLE) and Qualified Plans like 401Ks. Although these programs are not directly a part of the three pillars, I have so many questions about this subject, that I have written an article in the Bonus section that goes over fringe benefits.

The last adjustment I want to reference is the Qualified Business Income Deduction (QBI). Sole proprietors are eligible for a deduction of up to 20% of their qualified business income. The purpose of this deduction is to allow sole proprietors, S corporation shareholders, and partners a reduction in income tax that is similar to the 21% flat corporate tax rate introduced in 2018. This adjustment is deducted after the standard or itemized deductions and can't be more than 20% of the taxpayer's taxable income. It doesn't have any affect on self-employment tax.

Final Thoughts

While running even a sole proprietorship is not exactly as easy as buying a paint brush and finding a house to paint, do not let the paperwork requirements overwhelm you. To make sure that you have a good understanding of the requirements, I would advice talking to a professional tax advisor and make sure you have a good understanding of your responsibilities. Make sure you consult a reputable firm like H&R Block and ask for a Master Tax Advisor that specializes in business returns. Initial consultations are normally at no cost at a good firm.

And having gone through this course, you will be able to properly interview the tax professional that you decide to put on your team.