

Accredited Tax Preparer(ATP)

Preparatory Course

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Chapter 3

OTHER INCOME

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Identify how various types of income are reported on the federal income tax return
- Understand when a refund, credit, or offset of income taxes received may have to be reported as additional income
- Describe the tax treatment of alimony received
- Identify how net business income or loss is reported
- Name situations for which Form 4797 must be filed
- Identify which types of income and losses are reported on Schedules E and F
- Understand how to report unemployment compensation

BUSINESS INCOME (OR LOSS) REPORTED ON SCHEDULE C

If you have a business or professional practice that you run as a sole proprietor, you must report your net business income or loss on your tax return. The same is true for an independent contractor, freelancer, or gig worker who is not an employee. Reporting income is required whether you run the activity full-time or on a sideline basis. There is no threshold amount of income needed to require reporting.

To enter your business income or loss, you must complete Schedule C and attach it to the tax return. This schedule allows you to report your income and expenses, as well as business use of a personal vehicle for which a business deduction is taken.

You must include on the form the six-digit code for your principal business or professional activity. There's a chart in the instructions to Schedule C listing the various codes from which one must be chosen.

Business Income

Gross receipts (what a business takes in) include fees, proceeds from sales, interest on business accounts, and any other business-related ordinary income. Some income may be reported to a sole proprietor on an information return, but whether or not such a form is received, all income must be reported on the tax return. Some income may be received in exchange for other property or services (bartering directly or through a barter exchange); it is taxed in the same way as payments in cash.

Any returns or allowances can be subtracted from gross receipts. When gross receipts are derived from the sale of goods, they are reduced by the cost of goods sold (COGS). COGS represents the cost of inventory, for which there are various ways to figure value. COGS is figured in a separate part of Schedule C and then used to reduce gross receipts to arrive at gross profit and gross income.

A small business, which is one that meets a gross receipts test, can avoid reporting inventory and instead report sales as non-incidental material and supplies (items you keep track of because they're not incidental, like paper clips). This accounting method option allows you to deduct inventory purchases in the year they are first used or consumed in your operations.

Business Expenses

Generally, any ordinary and necessary business expense is deductible. Examples include advertising, car and truck expenses, legal and accounting fees, repairs, taxes and licenses, and utilities. There are no dollar limits on these expenses. For some expenses, however, there may be dollar limits or timing rules to curtail current write-offs. For example:

- If a business meal is deductible, only 50% is allowable as a write-off.
- Claiming a home office deduction using the IRS-created simplified method instead of figuring this deduction based on actual expenses (which requires you to complete a separate form to be attached to the return); the simplified method is based on a dollar amount per square foot up to a set limit.
- Interest on business loans may not be fully deductible in the current year. There is a limitation on deducting net business interest when it exceeds 30% of adjusted taxable income of the business, but the excess is carried forward.

for example, your income turns out to be higher than what you claimed when you applied for the coverage, you may have to repay some or all of the advanced credit. The repayment is treated as an additional tax. You must reconcile the advance payments with the amount of the credit to which you are eligible. You can use information provided to you by the marketplace on Form 1095-A to help you make this computation. The reconciliation is done on a special tax form.

Self-Employment Tax

Individuals who are self-employed (not employees) with self-employment income of at least \$400 for the year (a different amount applies to certain church employees) must satisfy their obligation for Social Security and Medicare tax by paying self-employment tax. In effect, a self-employed individual pays both the employer and employee share of FICA even though he or she is neither an employer nor an employee. The tax is based on net earnings from self-employment. If you have more than one business, your net earnings from self-employment are combined. If you have a loss in one business, it reduces the income from the other business(es) in figuring self-employment tax. If each spouse is self-employed, each must separately figure his/her self-employment tax; separate schedules are used for this purpose. Special rules apply for spouses in community property states.

Net earnings from self-employment means:

- **Sole proprietor or independent contractor.** Figure the tax based on profits shown on Schedule C. (Statutory employees eligible to file Schedule C do not pay self-employment tax; they are subject to FICA).
- **General partner.** Pay self-employment tax on the distributive share of partnership income as well as guaranteed payments. More specifically, net earnings are reported to a partner on Schedule K-1.
- **Limited partner.** This type of partner does not pay self-employment tax on his/her distributive share of partnership income, but does pay it on any guaranteed payments received. Again, refer to the partner's Schedule K-1.
- **Member of a limited liability company (LLC).** At present, the law is not settled on the rules for self-employment tax on a member of limited liability company. Clearly, if the member performs services, he/she is like a general partner and owes this tax. Check the member's Schedule K-1. But if the member is a silent investor who functions like a limited partner, there may be little or no self-employment tax owed. (The IRS has promised to provide guidance on this but has failed to do so for more than 20 years.)

As in the case of FICA, the Social Security portion of self-employment tax is figured only on net earnings from self-employment up to a set amount, which is adjusted annually for inflation. There is no cap on the Medicare portion of self-employment tax. If a self-employed person also has a job, the Social Security tax payments from taxable compensation are taken into account; a single earnings cap applies for this purpose. Thus, if a self-employed person's salary from a job at least equals the Social Security wage base for the year, then no self-employment tax for the Social Security portion is required. However, because there is no cap for Medicare, all taxable compensation from a job, plus all net earnings from self-employment tax are subject to this tax.

Other points about self-employment tax include the following:

- Self-employment tax is figured on a schedule attached to the return.

that you received too much of a benefit because your income is higher than you anticipated), or you may receive a tax refund if you underestimated the extent of your eligibility.

The special form and a tax return must be filed, even if gross income is below the filing threshold for your filing status. If you fail to file a return, it can affect your ability to obtain future advance credit payments.

HEALTH COVERAGE TAX CREDIT

Like the premium tax credit, the health coverage tax credit helps eligible taxpayers pay their health insurance premiums. The credit is limited to 72.5% of premiums. It can be used on an advance basis to cover this portion of premiums for health coverage. You send the balance of the premiums (27.5%) to the U.S. Treasury address that's used for this purpose (the check or money order is made payable to US Treasury—HCTC), and it should be accompanied by a payment coupon that is sent to you once you're approved for advance payments.

Eligibility

The credit is restricted to:

- An eligible trade adjustment assistance (TAA) recipient (an individual eligible for assistance because of a qualifying job loss), alternative TAA recipient, or reemployment TAA recipient
- An eligible Pension Benefit Guaranty Corporation (PBGC) payee who is age 55 to 65 and whose defined benefit (pension) plan was taken over by the PBGC
- The family member of an eligible TAA, RTAA, or RTAA recipient, or PBGC payee who is deceased or who finalized a divorce with you.

Other Rules

- To obtain the credit on an advanced basis, you must submit a special form to the IRS requesting this arrangement. Once you're enrolled, you don't need to register the following year.
- Whether or not you receive the credit on an advanced basis, you must complete a special form and attach it to your return for this credit. The amount is then entered on the schedule for additional credits and payments.
- You cannot claim the credit if you are the dependent of another taxpayer.
- You cannot claim the health coverage tax credit if you use the premium tax credit or if you are enrolled in a government health program (Medicare, Medicaid, CHIP, TRICARE).

CREDIT FOR THE ELDERLY AND PERMANENTLY DISABLED

There is a modest nonrefundable credit for those age 65 or older or retired on permanent disability and receiving taxable disability income for the year. The credit amount, which ranges from \$3,750 to \$7,500 (and is not adjusted annually for inflation), depends on adjusted gross income for your filing status. The adjusted gross income limits on the credit are fixed; they are not adjusted annually for

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. Except for certain military personnel, moving expenses paid by an employer are taxable compensation.

b. Incorrect. The employer figures the taxable portion and reports it as compensation on the employee's Form W-2.

c. Incorrect. While medical insurance for a spouse is tax-free, coverage for a domestic partner is taxable to the employee.

d. Correct. This use is treated as a *de minimis* fringe benefit, which is not taxed.

2. a. Incorrect. It is true that such interest must be reported on Form 1099-INT or 1099-OID.

b. Correct. All interest must be reported, regardless of whether the payer issues an information return.

c. Incorrect. Interest on municipal bonds is taken into account in figuring the taxable portion of Social Security benefits, but such interest is not directly taxed.

d. Incorrect. If interest income is more than \$1,500, Schedule B must be completed before entering the taxable amount of interest on the return.

3. a. Correct. Even though qualified dividends are taxed at the same rates as capital gains, they cannot be offset by capital losses.

b. Incorrect. It is true that qualified dividends can be paid by either type of corporation, as well as a foreign corporation that is readily tradable on a U.S. exchange.

c. Incorrect. Qualified dividends are taxed at zero, 15%, or 20%, depending on one's taxable income and filing status.

d. Incorrect. A taxpayer must have held the stock for a certain period to receive qualified dividend treatment. For example, common stock must be held for at least 61 days during the 121-day period that began 60 days before the ex-dividend date.