

# Schedule C – Travel, Meals & Entertainment

... and how to pass an audit when they are included on your Schedule C  
by Karen Coombes, E.A.

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# Schedule C – Travel, Meals & Entertainment

... and how to pass an audit when they are included on your Schedule C

## **By Karen Coombes, E.A.**

We're actually going to cover a lot more than Travel, Meals & Entertainment, but those are the main audit traps on Schedule C. First I'm going to walk us through a Schedule C and as we go we'll talk about problem areas. Then we'll look at Form 8829, review some specific and some general audit warnings and all along I'll be sharing some of my audit cases – some that turned out well for the taxpayer, and some that were, well, not so well.

### **Schedule C Basics**

The first question to be answered when you are presented with income and expenses for a business is whether or not it is, indeed, a "bona-fide" business. IRC 183, an oft-cited section of the Internal Revenue code, states that if an activity is not engaged in for profit, then no deduction attributable to such activity shall be allowed, except as provided for in IRC section 183. IRS studies business activities and has identified 21 businesses that have questionable profit motives – most of them involving sports, hobbies, recreation, and travel.

To determine the existence of a profit motive IRS applies a 9 factor test. None of the factors bear any specific weight and no single fact or group of facts is a determining factor. Surrounding circumstances are considered and additional facts are taken into account. The nine factors are:

1. The manner in which the taxpayer carries on the business
2. The expertise of the taxpayer or his/her advisors
3. The time and effort expended by the taxpayer in carrying on the business
4. The expectation that assets used in the business may appreciate in value
5. The success of the taxpayer in carrying on other similar, or dissimilar, businesses
6. The taxpayer's history of income or losses with respect to the business
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. The elements of personal pleasure or recreation

Activities deemed hobbies are allowed deductions, but only to the extent of income. Hobby income is reported on line 21 of Form 1040 as "other income", and is not subject to self-employment tax. Hobby expenses are reported under ordering rules and cannot exceed the hobby income. Category 1 expenses (mortgage interest, taxes and deductible casualty losses) are allowed first, and

in full, even if they exceed the hobby income. These expenses are deducted as they would be ordinarily on the appropriate line of Sch A. Category 2 expenses (expenses that do not reduce the basis in assets such as advertising, office expense, rent) are deducted next on Sch A as a miscellaneous itemized deduction subject to the 2% AGI limitation. Category 3 expenses (depreciation, amortization) would be deducted last, also as miscellaneous itemized deductions subject to 2% AGI limitation. When category 3 deductions are allowed and there is more than one asset, the depreciation or amortization should be allocated amongst all the assets.

A taxpayer who has formed a single member LLC will file a Schedule C in addition to the franchise tax return, unless he/she has filed an election for corporate status.

## **Sch C Reporting – Page 1** (Appendix – page 1)

### **Heading**

Provide the information requested in items A – H.

The business code in “B” is an important choice. IRS has studied various industries and has an idea of ordinary income and profit margins for those industries in different regions of the country. This data will be compared to the data on the tax return. The code used sets general expectations for profit margins and which expenses and in what amounts should be incurred. Businesses reporting amounts out of the ordinary may be targeted for audit.

“D” is completed only if the taxpayer has an EIN, which is required if the business has W-2 employees, a qualified retirement plan or pays excise, estate, trust, alcohol, tobacco or firearms taxes. Many business owners get an EIN even if they’re not required to for use in 1099 reporting, to use instead of their social security number on the forms. This is a good preventive measure for identity theft.

A business address is not required in “E” if the business is operated from the home address, but any other business address is required. PO Box numbers are not allowed – enter a street address only.

Check the applicable boxes in items “F”, “G” and “H”. The distinction between cash accounting and accrual accounting (box F) is very

important and has a definite impact on a business' bottom line. Accrual accounting records income when earned and expenses when incurred whereas cash accounting records income when received and expenses when paid. A double entry bookkeeping system and meticulous record keeping is a necessity for a business using accrual accounting.

## **Part I – Income**

This section reports gross income for the business. The gross receipts and sales reported on line 1 will be matched to 1099's on file at IRS, however all income is to be reported, not just income for which a 1099 is issued. Unreported income is frequently discovered when IRS audits a tax return. Bank statements are requested and a deposit analysis is done. Any deposits in excess of reported income that cannot be identified as non-taxable income (gifts, inheritances, etc) is added to taxable income.

Lines 2 through 6 adjust the amount on line 1 to arrive at Gross Income, line 7. Returns and allowances, line 2, are only reported if the amount is also included in gross receipts. This would be returned items, rebates or other reductions to the sale price. Line 6, other income, includes prizes and awards, scrap sales, credit for fuel tax claimed on prior year return, recovered bad debts, interest received, and various other items of income.

Interest income received by a Schedule C is reported on Schedule B, not on the Schedule C.

## **Part II – Expenses**

There are no hard and fast rules on categorizing business expenses. What one person calls 'office expense' another may call 'supplies'. Neither is it required that you pigeon-hole all expenses into the pre-printed lines on Schedule C. Page 2 provides space for additional categories of expense not listed on page 1.

Expenses must qualify to be deducted. Not all expenditures a business makes are tax deductible. The main criteria is that the expense is "ordinary and necessary" (IRC section 162). Expenses necessary to operate a business and that are ordinarily incurred in that business are generally allowed. For questionable expenses, if a direct relation to the

business can be established, and the expenditure can be proven to benefit the business (increased profits, enlarged customer base, etc) there's a good chance the expense will be allowed. My best example of this is a real estate agent I was representing. He bought an RV and had a skin made for it advertising his business. He parked it at all his open houses and in front of his office. He bought vendor space at all the local community events and set up the RV with the A/C going, TV for the kids to watch and a computer with internet to assist people in searching the MLS listings for a home, wrote contracts and took home loan applications right there. This certainly was not necessary, and not ordinary either, however the taxpayer was able to show increased call volumes, increased website activity and increased profits with spreadsheets, charts and monthly comparisons showing the results of his marketing and advertising efforts. IRS allowed the deduction. What made it work?  
DOCUMENTATION.

## **Totals and at risk boxes**

Expenses are totaled on line 28 and line 29 nets them with income for the tentative profit. If there's office-in-home expenses to deduct line 30 would be completed before entering the net profit or loss on line 31.

The amount on Line 31 is entered on line 12 of Form 1040, and, if a gain, is also entered on Schedule SE (Appendix page 7) for the calculation of self-employment tax. If line 31 is a loss, one of the at risk boxes must be checked.

If the taxpayer is personally liable for covering the business loss box 32a should be checked. If however, the taxpayer is not at risk; if non-recourse loans were used to finance the business or if money was borrowed from someone with no interest in the profits of the business, then box 32b should be checked, and Form 6198, At-Risk Limitations, completed. (Appendix page 3) This form limits the taxpayer's loss to the amount he/she is at risk. Losses in excess of at-risk amounts are carried over to the next year as a deduction from the activity that generated the loss.

### **Part III – COGS**

If the production, purchase or sale of merchandise is an income producing factor inventories must be used, a physical inventory count must be done the last business day of each year, and you must use the accrual method of accounting for purchases and sales. Small businesses with sales less than \$10 million are exempt from these requirements. They are allowed to deduct otherwise inventoried items as materials and supplies as they are used or paid for (whichever is last), and they can use cash accounting.

Inventory amounts are reported on line 35 (beginning inventory) and line 41 (ending inventory). An inventory method must be checked on line 33 and the Yes or No box checked on line 34.

All businesses report their purchases, materials, supplies, labor and any other costs directly related to the product or service sold, on lines 36 through 39. The resulting Cost of Goods Sold, line 42, is transferred to line 4 on page 1 of Sch C.

### **Part IV – Vehicle Info**

The deduction allowed for the business use of a vehicle is one of *the* most abused tax deductions. For many small business operators this is one of their biggest deductions – especially those in construction, real estate and outside sales. Keeping a mileage log is key and doing so - the few seconds it takes to record the trip information - is a small price for a big deduction.

IRS allows a choice of methods (standard mileage or actual expenses) for reporting car and truck expenses. If standard mileage is used and the business is not required to file Form 4562 (Appendix pages 4 and 5) the auto information is reported in Part IV of Schedule C. If Form 4562 is filed the auto information will be reported on page 2 of Form 4562. Both places have Yes/No checkboxes asking about availability and other vehicles. These boxes must be checked. Note that in Part IV of Schedule C it asks if written evidence exists to support the deduction. Answering yes, which is the correct answer, means a contemporaneous log of business miles is kept and IRS would expect to see that should the return be selected for audit.

If actual expenses are used the vehicle information will be on page 2 of Form 4562 (depreciation and mileage information) and the operating expenses will be on line 9 of Sch C.

## **Part V – Other Expenses**

Here is where you can report expenses that aren't included in the pre-printed categories on page 1 of the Sch C. This is where amortization is reported. I often see charitable contributions reported here, however the proper place to report contributions made by a business is on Sch A, unless there is a business purpose that would allow the contribution to be converted to a business expense.

### **Office-in-Home** (Appendix page 6)

Form 8829, Expenses for Business Use of Your Home is used to report an office-in-home. While the rules for O-I-H have relaxed over the years, IRS still has their antennae up for abuse of this deduction. The "Use Test" requires the O-I-H be used exclusively and regularly as the principal place of business for meeting with clients and/or for conducting administrative duties. If the office space is a separate structure it must have a direct connection to the operation of the business to qualify as O-I-H.

- Part I – area used
  - Answering questions 1 and 2 (and 4 through 6 for a day care operation) gets you to the business use percentage of the home on line 7
- Part II – figuring the deduction
  - Be certain direct and indirect costs are reported correctly - indirect costs (expenses relating to the entire home) have the business use percentage applied
  - direct costs (expenses relating only to the business use space) are deducted at 100%
- Part III – depreciation
  - Depreciate the home based on the lower of cost or FMV the date it was put into service, less land value
- Part IV – carryover of unallowed expenses
  - Mortgage interest and property tax deductions will be allowed in full, regardless of the income or loss on the Sch

C. Operating expenses and depreciation are carried over if their deduction results in net income below \$0.

## **Audit Warnings**

Returns are selected for audit for various reasons. DIF scores are used to identify potentially incorrect returns. NRP (National Research Project) audits focus on returns with specific forms and schedules such as Office-in-Home or Sch E rentals. Some are randomly selected. Economic reality can also be selection criteria. A recent technique IRS adopted was to audit returns that report mortgage interest in excess of total income on the return. Audit results are closely monitored by IRS to see which selection techniques provide the best results.

With that in mind, let's look at some of the issues I have seen come up repeatedly on audits of Sch C, and how to ensure your client's return will pass.

## **Hobby Business**

In my experience IRS is scrutinizing this much more closely than in the past. I recently had 2 audits where the taxpayer had to answer questions, basically the 9 factor test, to determine if their activity qualifies as a bona-fide business. If an activity does not make a profit 3 out of 5 years (2 out of 7 years for horse breeding, training, racing or showing) IRS will likely apply the 9 factor test. Activities that continually result in a loss, and that reduce otherwise high income on a tax return, are suspected hobby businesses. An example of that would be a physician with high W-2 wages whose spouse operates a small business that loses money every year. In these cases it is important to ask about profit motive. I had this very scenario a few years ago. I represented a couple - the husband was an orthodontist and the wife sold Mary Kay. I asked who her customers were and how she set prices. Her reply was that her customers were family and friends and she "just sold the stuff at cost". With no apparent profit motive the auditor disallowed the Sch C losses.

Businesses without books and records are prime candidates for application of the hobby loss rules. For-profit businesses are typically very concerned about cash flow and therefore keep books and records to monitor the business' performance. We'll talk about proper record keeping later.

There is a plus side to the hobby loss rules. If a taxpayer's activity *is* deemed a hobby and the taxpayer, on a fluke, has a profit (say he wins a stock car race or a fishing tournament) then it would be reported as hobby income on line 21 of Form 1040, *NOT* subject to SE tax.

An obvious disadvantage is when a taxpayer has hobby income and expenses, but does not file Sch A. The income is taxed at their marginal rate, and the expenses provide no deduction to the taxable income.

## **COGS > sales**

Except under extraordinary circumstances the Cost of Good Sold should not be more than the gross receipts of a business. This is an audit flag!! Careful review of inventory amounts, purchases, etc. is necessary if you ever see this. Be prepared to support the numbers when filing a return with COGS more than sales. IRS will use their bank deposit analysis mentioned earlier to look for unreported income when COGS exceeds sales. Another tool IRS uses in conjunction with the bank analysis, is a cash-T. If the cash-T does not balance they ask for explanations and look for unreported income.

A cash-T actually looks like a big letter T, with income on one side and expenditures on the other. IRS uses available information to create the expense side – how much the taxpayer pays for rent or mortgage payments, monthly utility bills, business operating expenses, auto operating expense, groceries, insurance, day care, tuition, charitable contributions and any other items they can glean from the tax return. Then they add up all the reported income. If it appears the income does not cover the expenses paid IRS will want to know how the taxpayer paid for everything.

## **Line 9 – car & truck expenses**

If car & truck expenses are included on an audited return you can count on that being an exam issue. Rarely does the proper documentation exist, and although the IRS is quite lenient with the allowance of recreated mileage logs, the substantiating information is often lacking, resulting in quite large adjustments to the return. If a taxpayer has been previously audited on mileage and did not keep a log then, and still doesn't, a recreated log does not have to be accepted.

Regardless of the method used, odometer readings and mileage logs are always required. To substantiate *total* miles reported 3<sup>rd</sup> party odometer readings will be requested. This would be receipts from oil changes, new tires, repairs, etc. when a service provider records the odometer reading of the vehicle. IRS will ask for one from as close to the beginning of the year and as close to the end of the year as possible for each vehicle. With that information they will extrapolate total miles for the year and compare to what was reported on the return. To substantiate *business* miles a mileage log is required. Having an appointment calendar, travel log or other records such as client lists and delivery invoices that support the mileage log provides excellent substantiation.

The required record keeping for claiming the standard mileage is an annual odometer reading and a mileage log, and, if there is a loan on the vehicle, the amount of interest paid for the tax year. The business use percent of the interest is deductible as business interest – but only for Sch C businesses, the deduction is not allowed for Sch A/2106 business use.

When claiming actual expenses the odometer reading and log are still required, in addition to the receipts for all operating expenses (fuel, repairs, insurance, interest, inspection, etc) and documentation of the cost basis of the vehicle for depreciation.

The requirements for a mileage log are that it contain the date, the beginning and ending odometer reading for each business trip (or total miles traveled), the business destination and the business purpose of the trip. IRS regulations allow certain types of vehicles such as delivery vans and flat bed trucks an exclusion from logging daily miles, and route drivers need only measure the route once and record the dates travelled, however annual odometer readings are always required to calculate total mileage for the year.

Beware the urge to use round numbers – reporting 20,000 total vehicle miles with 10,000 business miles, or 50%, or 75% business use. Real numbers will be more like 20,132 total miles and 9,688 business miles for business use of 48.12%. Rounding is only allowed to the next mile and total and business miles are expected to be exact.

And, lastly, be sure the facts support the deductibility of the miles. Be sure commuting miles are not counted in business miles and confirm the office/work location to properly determine starting and stopping points.

## **Line 24a – travel**

Travel expenses are yet another exam issue IRS gets a lot of adjustments on due to improper record keeping. To properly deduct travel expenses you need to know a lot of details. Where to? For how long? Who went? What was the purpose of the trip? What was the arrival time, and the departure time?

Some of the travel issues I've seen the last few years:

- 'Tax home' and 'more than one place of business' issues for taxpayers who live and/or work in more than one location.
- Arrival and departure times for out of town travel (the auditor examined the airline tickets to confirm travel times for allowable per diem each day).
- Taxpayer working a temporary job away from home (expenses can be allowed, or disallowed, depending on the length of time away and cost of travel).
- Business purpose/necessity of the trip.
- Personal vacation combined with business travel (the entire family was on the business trip at a vacation destination)

Taxpayers who incur business travel must keep the original source documents to substantiate their claims. IRS will not accept a line item on a credit card statement for travel expenses. Hotel receipts are required to show the dates of the stay and the breakdown of costs. A travel log will help substantiate expenses, along with any corresponding entries in appointment books or calendars.

## **Line 24b – meals & entertainment**

Meals and entertainment will most likely be an exam issue if it has been deducted on an audited return. The best advice here is to have taxpayers write on the receipt the name of the client entertained, the business relationship and the business purpose of the meeting. I tell my clients to do it right then, right there, right on the receipt. Having an appointment book or calendar showing the meeting and information regarding the client relationship (top-producing vendor of the taxpayer's product, etc) provides excellent substantiation.

Last year I represented a taxpayer under audit who had nearly \$10,000 in meals and entertainment receipts, including dinners for 4 (2 adult meals and 2 child's meals) two or three times a month at a restaurant around the corner from his home where he lived with his wife and 2 kids. Nothing was noted on any of the receipts and he had no substantiation for client meetings. IRS disallowed all meals except the ones that matched up with out of town travel receipts. Why didn't it work for him? Besides the fact he ignored the rules for allowable deductions, he had NO DOCUMENTATION.

In lieu of actual expenses a Sch C sole proprietor is allowed to use per diem rates for meals and incidental expenses while out of town on business, but the time, place and business purpose of the travel must be documented. An out of town period is one that requires rest, such as attendance at a 2 day seminar. A day trip across town or even a 2 hour drive to a one hour meeting would not qualify. Per diem rates change every October and vary according to location. (see IRS Publication 1542 for listings)

As a reminder, the 2010 deduction for meals and entertainment is limited to 50%, 80% for transportation workers subject to DOT hours of service rules.

## **Round numbers**

As mentioned earlier in vehicle mileage reporting, IRS allows rounding, but only to the next mile, or dollar. I recently represented a taxpayer in an audit where all the numbers on the Sch C ended in '50' or '00'. Not one verified amount matched what was reported in the tax return. The adjustments totaled over \$100,000, in the IRS' favor. The taxpayer merely guessed at the amount of income and expense, despite having pretty decent records with the correct amounts. He didn't bother to reconcile the bank statements to the books or add anything up for the tax return, but IRS was more than happy to! Why didn't it work for him? He had the documentation, he just didn't *USE* the documentation.

## **Duplication of Sch C expenses on Form 2106**

Many tax preparation software programs do not have adequate checks to ensure vehicle information and other expenses are not duplicated on Sch C and Form 2106. When preparing returns with both of these forms present careful review is necessary to ensure nothing is duplicated. Check also that any vehicle used on both forms shows the same total mileage and that the

business use miles reported on Sch C + the business use miles reported on Form 2106 are not more than the total miles on the vehicle. This is a common error on self-prepared returns.

## **Proper record keeping**

Record-keeping is vital to the success of any business. Without records one cannot monitor their business. Records allow a business operator to see where the income comes from and where it goes. Monthly profit and loss statements calculate the overall gain or loss for the period, along with the data needed to fine-tune operations. Knowing when and where and what to sell and recognizing costs that do not create a benefit for the business can make the difference between success and failure. Balance sheets create a snapshot picture of the business' financial health at any point in time – the assets and liabilities of the business. Both of these financial statements are required when seeking credit or applying for a business loan.

To simplify record keeping it is recommended that business and personal expenses be kept separate. Having separate bank accounts and credit cards for business use and adhering to a strict policy of using them only for business makes record keeping much easier. In addition, if there are interest charges and the account is used 100% for business the interest is deductible. I've had several audits where the interest reported on Sch C was from credit cards that were used for both personal and business purchases. Unless the taxpayer prepares a schedule splitting the purchases and related interest (which none of my clients did) the interest is disallowed. One client had taken out a pretty large business loan and deposited it into her personal account (mistake). Part of the money was used to pay business expenses, but it was also used to pay their personal rent and monthly expenses until the business got going. IRS disallowed all interest expense.

Business records should record all income received, the date of receipt, from whom, and what for. I recommend making a copy of all checks deposited, and writing detailed memos on any cash deposits. Attach the copy to the deposit slip and there will always be a record of the source of all income.

Expenses should be meticulously recorded as well. Creating a filing system to save receipts, as well as a system to record them, makes the process easier. Besides books, the original, or source documents, are examined in an audit and missing receipts result in lost deductions. There are occasions when IRS will accept a line item on a credit card to prove an expense but

the source document is usually required. If details of the purchase are not readily discernable from the credit card statement the original receipt will be needed to see what was purchased. For example, a credit card charge from the electric company will only be for utilities, but a credit card charge from the corner 7-11 store could be for gas or for beer and cigarettes.

Official bookkeeping ledgers, software and spreadsheets are not required, but certainly make the job easier and the information more user friendly. Handwritten records are acceptable, providing they adequately reflect the business operations and provide the information necessary to prepare the tax return. Transactions should be recorded as they occur, whether that be daily, weekly or monthly. Business records must be available at all times for inspection by the IRS. Having complete and accurate business records readily available eases the stress of an audit and greatly speeds up the process.

A business should also have a business plan, for both short and long term goals, and the plan should be updated as required. A business plan is a road map to success. It lays out the goals for a business and how they are to be achieved. If a business owner's desire is to earn \$50,000 a year he would write a business plan detailing how to do it. Having a business plan is a plus when the 9 factor test is applied.

When more than one business is being operated separate books are required for each business, with separate summaries of income and expense. Supporting records for the book's income entries might consist of cash register tapes, Forms 1099 received, invoices, receipt books, credit card charges and bank deposits and for expenses there could be cancelled checks, paid invoice receipts, credit card charge slips, petty cash slips and bank debit card statements. Different businesses will have different records; all will be accepted by IRS as long as they correctly and adequately reflect the business operations.

## **General Warnings**

...When the IRS requests bank statements in an audit they do more than a deposit analysis. Thanks to the wide-spread use of debit cards bank statements are now a looking glass into a taxpayer's life. Auditors scan bank statement transactions for indications of lifestyle, spending patterns, large expenditures and out of town purchases. I'll never forget the decorator I represented that lived in Austin and had a project in Dallas. She

had a mileage log that showed her driving to Dallas every weekend for several months, however her bank activity showed her buying gas and groceries, having her nails done, dining out and buying clothes - all in Austin - some of those very same weekends. The auditor matched up bank and credit card activity to the mileage log and tossed out half the mileage. Why didn't that work for her?

...Whenever possible IRS will want to see the prior and subsequent year returns for any taxpayer they audit. If adjustments are made in one year and similar problems are seen in other years they will open those years as well. Many of my audits start as one year and expand to include the year before and/or after, and some have even started out auditing 2 years at once.

...Be careful to separate supplies from asset purchases. When supplies appear unusually large auditors will examine them to see if any should be moved to the depreciation schedule.

...Look out for the weekend, or 'gentlemen' farmer who buys just enough goats for an ag exemption and then wants to write off \$1,000's of dollars in expenses every year. Unless a profit motive is proven the goat farm would be reclassified as a hobby farm, subject to hobby loss rules.

...Special rules for 2010 allow self-employment earnings to be reduced by SE health insurance premiums before calculating self employment tax. This adjustment is made on line 3 of Schedule SE (Appendix page 7). No adjustment is to be made on Sch C or anywhere else in the return. SE health insurance premiums are reported on line 29 of Form 1040 as usual, and included on line 3 of Schedule SE.

## **Conclusion**

The audit rate has been below desired levels for a long time. IRS has hired hundreds of new auditors across the country. My guess is that we'll see an increase in audits in the months and years to come. Therefore, in the best interest of our clients, we need to be certain all income is reported, and that all deducted expenses meet the qualifications for the deduction and are properly substantiated. The only way to make it work is with documentation, documentation and more documentation.