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Finance

Know the ins and outs of the Schedule C deductions game

When I sit down to discuss tax planning, many investors believe the ultimate purpose is to find tax loopholes, to generate deductions and find new tax breaks.

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However, the purpose of tax planning is to continue to explore opportunities and passions that generate income and expenses, while taking advantage of tax schedules.

When employees retire, they leave behind W-2s. At retirement, many former workers pursue passions and generate income from them. These clients can opt to service as a consultant or distributor or individual under a personal business. This service brings in revenue as a 1099. Presto! NO, a blessing.

Preretirement was full of personal costs. In post-retirement, you can turn your passions into a career and produce revenues that are only offset by business expense costs. You are not losing a W-2, you are gaining the benefits of a 1099. Its Schedule C deductions are better than most W-2 deductions. Schedule C is the profit and loss statement for sole proprietor businesses. Its deductions can significantly lower your tax bite.

For example, our firm has had numerous clients who were W-2 employees with Chevron. After retirement, these same individuals returned to their old desks as business consultants, which means they are invoicing ChevronTexaco Corp. for their time and efforts. These individuals are generating revenue, but as individual consultants they pay significantly less in taxes.

Let's examine the ins and outs of the Schedule C deduction game and discover how you can turn your passion for wine or flying into a career.

Who can play?

Schedule C deductions can only be acquired through self-employment. Self-employed can be defined as "an individual who operates a business or profession as a sole proprietor, partner in a partnership, independent contractor or consultant. He or she must report income on a Schedule C of Form 1040" ([illegible].com). What in the past, a dinner with a client was an expense. Now it is a deduction.

How to play

Schedule C is used to report income or loss from a business you operated as a sole proprietor.

According to Fremont CPA Ed Robinson, "an activity is considered a business if your primary purpose for engaging in that activity is for income or profit and you are involved in the activity on a regular or consistent basis."

Schedule C income is subject to a 15.3 percent self-employment tax, in addition to income taxes after all expenses. Due to this, it is important to include every business-related expense on your Schedule C. Every dollar spent reduces not only your regular income tax, but also the self-employment tax. Robinson says, "Deductions against self-employment income will typically reduce your tax bill by 30 percent to 50 percent."

Some deductions

- 179 depreciation rule: Many self-employed individuals can write off the full cost of particular assets in the year they buy them, rather than deducting the cost over the next couple years. Section 179 of the Internal Revenue Code allows you to deduct up to $100,000 in 2003, 2004 and 2005 of newly purchased equipment.
- Travel expenses: Travel expenses are accrued when you are away from your "home base" for longer than a normal workday. Deductible expenses include meals, lodging, transportation, automobile expenses, taxi fares, telephone expenses, laundry and dry-cleaning. Your airfare in the United States is 100 percent deductible, if your trip is primarily for business.
- Home office: "Almost 19 million Americans operate home-based businesses and may be eligible for the deductions", according to work at home gurus Paul and Sarah Edwards, also authors of "Home-based Business for Dummies." A home office may qualify for deductions if it is used for administrative or management activities for your business, and there is no other "permanent" location to conduct such activities. The home office deduction is available whether you are renting or own your home. You need to have a net income from your business, though.
- IRA distributions: The SEP IRA is a great way for small business owners to cut their tax bills. The owner gets a tax deduction, while the SEP-IRA contribution is not taxed as income. The earnings within the SEP IRA are tax deferred until the participant pulls money out, usually at retirement.
- Automobile expenses: These can be the most beneficial deductions for your business. There are two ways you can calculate your vehicle tax write-offs: mileage deductions or actual expense deductions.

Let it flow

After subtracting your deductions, the net effect is your personal net income. The income or losses flow onto your 1040 form. In many cases, the net results are very little income after expenses (and enjoyment) have been deducted to produce an improved lifestyle. Additionally, in many years, paper losses can be significant, which can carry positive tax results for you.

You then turn to the itemized deductions on your Schedule A form. Examples of these deductions include interest paid on your home, donations and losses due to theft. The number generated after both the Schedule C and Schedule A deductions have been subtracted is your taxable income. This is the amount used to determine how much you owe the IRS.

The big picture is the primary reason for tax planning. Spending hours examining the merits of acquiring shares of Home Depot or Lowes is important. However, these decisions can be myopic and inconsequential in comparison to the huge tax advantages available to many of you. So, don't be surprised if your year-end review includes tax advising.

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