

Earned Income, Self-employment Income and Business Expenses

Preparers often ask us, "What is earned income and how is net self-employment earnings computed?" Also, fraudulent claims of self-employment income and business expenses to qualify for or maximize EITC are increasing. Following are the questions most frequently asked by preparers about earned income, self-employment Income and business expenses.

Preparer Question	IRS Answer
<p>What is Earned Income?</p>	<p>Earned income includes all the taxable income and wages from working either as an employee or from running or owning a business. It also includes certain other types of taxable income. Earned income includes:</p> <ul style="list-style-type: none"> ▪ Wages, salaries, tips and other taxable employee pay ▪ Net earnings from self-employment ▪ Union strike benefits ▪ Long-term disability benefits received prior to minimum retirement age <p>Combat Pay-Your client can choose to have the full amount of nontaxable combat pay included in earned income for EITC. Your client's spouse can also choose separately to have his or her full amount of combat pay included in earned income. That means if single, your client cannot include only half of the amount to maximize the credit. If married, your client <i>can</i> claim the full amount of the nontaxable combat pay as earned income and your client's spouse choose zero. But, your client cannot claim the full amount and half of the spouse's. The choice is your clients; calculate which works best. Find the amount of nontaxable combat pay on Form W-2, in box 12, with code Q.</p>
<p>I know self-employed individuals have to report all income. My question is about deducting expenses. Are taxpayers required by law to claim all expenses pertaining to their business?</p>	<p>Yes. A self-employed individual is required to report all income and deduct all expenses. Revenue Ruling 56-407, 1956-2 C.B. 564, deals with the issue of taxpayers not taking all allowable deductions in computing net earnings from self-employment for self-employment tax purposes. Rev. Rul. 56-407 held that under §1402(a), every</p>

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	<p>taxpayer (with the exception of certain farm operators) must claim all allowable deductions in computing net earnings from self-employment for self-employment tax purposes.</p> <p>Net earnings from self-employment are included in earned income for EITC purposes. It is defined by cross-reference to the definition of net-earnings from self-employment under I.R.C. §1402(a). This ruling applies equally to the EITC. CCA 200022051 also provides insight regarding deduction of Schedule C expenses.</p>
<p>My client doesn't want to claim business expenses because it decreases the amount of EITC. As a tax preparer, what do I do?</p>	<p>A self-employed individual is required to report all business income and deduct all allowable business expenses (see above for source). They do not have the option of reporting what is most beneficial.</p> <p>Explain the requirement and talk about the consequences of not filing an accurate return. You may also want to present your client with the new Publication 4717, Help Your Tax Preparer get You the EITC You Earned. This publication explains preparer's due diligence requirements and the consequences of not filing an accurate return.</p> <p>If your client insists on not claiming all expenses, due diligence dictates you do not prepare the return.</p> <p>You may also want to report the potential fraud. See the Frequently Asked Questions section on Fraud for more information.</p>
<p>My client baby sits in her home earning taxable money that affects EITC. Is the baby sitter required to claim business use of home deductions?</p>	<p>The law requires a self-employed individual to report all income from self-employment and all the allowable expenses see reference above for more information.</p> <p>Determine if your client is in the trade or business on a regular basis. Is your client babysitting once in awhile to bring in a little extra cash, or does your client have children that they take care of on a regular basis? Is your client holding themselves out to the public as a provider</p>

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	<p>of services? If you feel the client is really participating in the business, then the Schedule C should report all the income and allowable deductions regardless of the impact on EITC. Those who baby sit on an occasional basis may have expenses related to the activity for food, diapers, etc.</p> <p>Determining whether an individual is carrying on a trade or business is outside the scope of EITC. <u>Refer to the IRS fact sheet on miscellaneous income available on irs.gov, Publication 525, Taxable and Nontaxable Income or Publication 529, Miscellaneous Deductions for more information.</u></p> <p>As a paid preparer, you should make adequate inquiries to satisfy yourself the information you are including on the return is correct, complete and consistent.</p>
<p>Some individuals commit fraud by claiming self-employment income. Why doesn't the IRS demand a taxpayer have a Form 1099 MISC for all income used to claim EITC?</p>	<p>IRS expects all self-employed individuals to keep and retain timely records of all business income and expenses. At this time, the law requires issuance of a Form 1099-Misc in situations of payments of \$600, more for services performed for a trade, or business by people not treated as its employees. Also, there are many non-business situations where payors pay \$600 or more but are not required to issue the form. It would place a tremendous paper work burden on individuals and small businesses to report all payments made for work performed in their home or place of business.</p>
<p>A pastor (clergy member) receives a housing allowance of \$10,000. Does this qualify as earned income for calculating EITC?</p>	<p>The rental value of a home provided to a clergy member or a housing allowance included in the pay is not generally subject to income tax but is included in net earnings from self-employment and used to compute the self-employment tax. You include the amount of net earnings from self-employment as earned income to compute EITC.</p> <p>See the exceptions for members of the clergy who have an approved Form 4361 or Form 4029 in Publication 517, Social Security and Other</p>

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<p>What should I do if an individual reports only enough Schedule C income and expenses to claim the maximum amount of EITC?</p>	<p>Information for Members of the Clergy and Religious Works.</p> <p>Fictitious Schedule C's especially those with no 1099 Misc support or no supporting income or expense records that qualify for or maximize EITC is a growing problem.</p> <p>To comply with EITC due diligence, you should ask enough questions until you are satisfied the individual:</p> <ul style="list-style-type: none"> • Is carrying on a business, • Has records or can reasonably reconstruct records to support the income and expense and • Reports all income and related expenses. <p>Be sure to document the questions you ask and the answers given. If not satisfied by the responses, you may want to report the potential fraud. See the Frequently Asked Questions section on Fraud for more information on reporting fraud.</p>
<p>I have a client who is self-employed but has no receipts for income or expenses. Should I refuse to prepare the return?</p>	<p>Not necessarily. You can take the opportunity to teach your clients about recordkeeping requirements. If your client has any records and data on the amount earned and any expenses, you can explain how to reconstruct and/or help make a reasonable estimate of the income earned and expenses. If you choose to help your client reconstruct the records, be sure to document how you computed the income and expenses. Refusing to prepare the return is a decision only you can make.</p>