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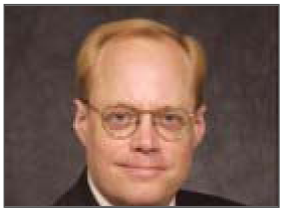

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Proprietors: To Avoid Audit, Avoid Schedule C

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To many of us, beach reading means trashy novels. If you're high-minded perhaps it means classics or beefy historical biographies. But I'll bet no one delights in reading the IRS's Statistics of Income Bulletin.

Even so, this IRS compendium of facts and figures about tax filings—abbreviated SOI—could impact your behavior if you venture into its dry pages. Before you leave the beach for the last time, here's the latest Summer 2011 SOI Bulletin from the IRS. One notable fact from the SOI relates to our old friend the sole proprietorship. It's the simplest way of conducting business.

There's no business entity and only one owner (though husband and wife filing jointly count as one). Despite its simplicity, I can't figure out why so many people still file that way. After all, it makes the tax return so terribly tempting to audit!

According to the SOI, for 2009, nearly 22.7 million individual income tax returns (nonfarm sole proprietorships) reported total profits of $244.8 billion on a Schedule C. That's the place on a Form 1040 for business conducted by a proprietor. These are only income statistics, but if you also look at IRS audit rates, it suggests doing it some other way.

Tax advisers have long known that Schedule C is one of the most likely types of returns (or parts of returns) to be audited. This proprietorship schedule is for a business you operate yourself that is not in a legal entity (such as a corporation, LLC or partnership). Common proprietorships are little enterprises run from your garage, on the internet, or on weekends, even though the bulk of your income may come from wages from your regular job. Still, a Schedule C could be a huge business making millions.

Schedule C is also the primary place you claim expenses from your proprietorship business. It's the primary way the IRS can audit a "hobby" activity you claim is a business but the IRS claims is not. This issue comes up a lot and the numbers can be big.

> ***Example***: If you have$1,500 of income from your "race car business" and $138,000 in expenses, it should go on your Schedule C. Your chances of audit with a Schedule C go up, and with this kind of Schedule C especially. Be particularly wary if you have several years of losses in a row.

See also:

Ten Ways To Audit Proof Your Tax Return

The ABCs of Hobby Losses and Profit Motive

When Taxpayers Go Fishing For Deductions

Hobby or Business: IRS Scrutinizes Brothel-Hopping

10 Tips For Deducting Your 'Hobby'

Business or Hobby? Answer Has Implications for Deductions

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