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If You Have a Side Hustle, Be Advised: The IRS is Cracking Down

For several years now, the IRS has required payments made to merchants through various marketplaces, payment processors (credit & debit cards), and third-party settlement organizations (TPSOs) to be reported on Form 1099-K. The purpose being to uncover merchants that do not report all of their income by comparing the 1099-K amounts to the amount reported on the individual's or business's tax return and following up with the under-reporters by correspondence or by audit.

In the past the filing threshold for 1099-Ks was when the gross amount of total reportable payment transactions during a calendar year exceeded $20,000, and the aggregate number of transactions for that payee in that year exceeded 200. Thus, entrepreneurs with a small side hustle selling merchandise on the Internet directly or through the likes of Amazon, E-Bay and others may not have received a 1099-K in the past.

That will all change beginning in January 2023 when reporting begins for 2022 transactions, since the American Rescue Plan Act of 2021 included a provision to reduce the reporting threshold to $600, effective in 2022. Also impacted by this reduced threshold will be homeowners who rent out their vacation homes through the likes of Airbnb and VRBO who generally avoided 1099-Ks in the past because of the 200-transaction threshold. Also, individuals providing services through Internet websites such as for delivery, babysitting, companionship, home cleaning, elder care and other services seldom met the $20,000 threshold and have not received 1099-Ks in the past.

The 1099-K only reports gross income, and the cost of the products sold and other business expenses can be deducted to determine a merchant's net taxable profit. Those renting vacation homes through TPSOs can deduct depreciation, utilities, repairs, and other expenses, while those providing services can deduct certain travel and other expenses. The net profits are subject to income tax, and generally are also subject to self-employment tax, including rentals where significant personal services are performed.

Thus, keeping records of expenses becomes important. Please contact this office for further information related to your specific side hustle and what expenses will be deductible.

Does a Tax Deduction and a Tax Credit Result in the Same Tax Benefit?

Tax lingo, even without getting into the weeds of the Internal Revenue Code, tax regulations, IRS rulings, etc., can be confusing. Two frequently used terms that taxpayers sometimes think provide the same tax benefit, but don't, are "tax deductions" and "tax credits." Although a tax deduction and a tax credit both help lower the taxpayer's tax, there's a difference between them, and there are distinct types of deductions and categories of credits. This article explains these terms. In general, a deduction reduces taxable income, whereas a credit reduces the tax itself.

Tax Deductions – Tax deductions reduce the taxable portion of an individual's income, which then reduces the tax on that income. But tax deductions come in a variety of flavors, as explained next:

Itemized Deductions – When taxpayers think of deductions, they typically think of the itemized deductions that are claimed on Schedule A. This is the only way to deduct personal expenses including but not limited to medical costs, state and local tax payments, investment and home-mortgage interest, charitable contributions (in most years), and other less frequently encountered expenses. In some cases, itemized deductions are limited. For instance, medical expenses are only deductible to the extent they exceed 7.5% of the taxpayer's adjusted gross income (AGI). Similarly, state and local tax payments (including those for income, sales, and property taxes) are currently capped at $10,000. However, pending legislation may increase or eliminate that limitation, time will tell. For any change, please contact this office. On top of that, itemization only reduces taxable income to the extent that the total of the itemized deductions exceeds the standard deduction. When the sum does not exceed the standard deduction, the itemized deductible expenses provide no federal tax benefits at all.

Above-the-Line Deductions – Certain deductions actually reduce income. These are commonly called above-the-line deductions because, when applied, they reduce the income figure that is used to calculate (AGI) Thus, their benefits apply regardless of whether the taxpayer uses itemized deductions. Above-the-line deductions include educators' expenses; contributions to health savings accounts, traditional IRAs, and certain qualified retirement plans; deductible alimony payments; and student-loan interest. Most of these deductions have annual maximums (not discussed in this article).

Below-the-Line Deductions – These are deductions allowed without having to itemize that reduce a taxpayer's taxable income but not their AGI. For example, for 2021 taxpayers who don't itemize their deductions are allowed a limited deduction for cash charitable contributions. That donation to charity is a below-the-line deduction. Normally, charitable contributions are only allowed when itemizing on Schedule A.

Another below-the-line deduction is the Section 199A qualified business income deduction that is generally 20% of net business income from pass-through activities.

You may wonder: why bother to distinguish between above- and below-the-line deductions? The AGI is used for applying limitations and phaseouts for a variety of deductions and credits. While Congress wanted taxpayers to benefit from below-the-line deductions, the legislators didn't want taxpayers to benefit too much – they didn't want the AGI to be reduced by these deductions because that could have resulted in more generous other deductions and credits.

Business Deductions – Generally, taxpayers who operate noncorporate businesses can deduct from their business income expenses that they incur when operating their businesses. These deductions (which cover advertising fees, employee wages, office-supply costs, etc.) are used to reduce profits, which in turn reduces AGI and taxable income and, ultimately, income tax. In addition, most self-employed taxpayers pay self employment tax on their net business income, so any reduction in their business profits also reduces their self employment taxes and possibly their Social Security taxes.

Asset-Sale Deductions – An individual who sells an asset is allowed to deduct that asset's cost from the sale price to determine the taxable profit. Good recordkeeping is helpful here because the original expense may have been incurred years prior, even though it is only deductible when the asset is sold. For example, any improvements that an individual makes to a home over years of ownership are not deductible until the home is sold. At that point, the individual can reduce the taxable gain from the sale by counting the improvements as part of the home's cost.

Tax Credits – Tax credits come in several varieties, and the amount of benefit can vary:

Refundable Credits – A refundable credit first offsets current tax liability and if there's any credit remaining after applying it to the tax, the difference is refunded to the taxpayer. Hence, the term refundable credit. Refundable credits include the Earned Income Tax Credit, the Child Tax Credit and the Premium Tax Credit (net of any advances received), as well as the American Opportunity Tax Credit (an education credit that is 40% refundable up to $1,000). As a matter of general interest, these credits are subject to significant filing fraud because of their refundability. The IRS also considers prepayments such as income-tax withholding and estimated tax payments to be refundable credits.

Nonrefundable Credits – A nonrefundable credit only offsets tax liability; any unused amount is lost (unless it can be carried over to another year; see below). Over time, Congress has become more generous with credits; most credits that are not refundable now carry over for a given period. Nonrefundable credits include the Saver's Credit, the Lifetime Learning Credit, and the Child and Dependent Care Credit.

Carryover Credits – For some nonrefundable credits, any unused current-year credit can be carried over to the next tax year (or for a longer period) until the carryover amount is used up. These credits include the Adoption Credit (which can carry over for up to five years) and the Home-Solar Credit.

Business-Tax Credits – Numerous business-tax credits are available; however, they are grouped into the General Business-Tax Credit, which is nonrefundable but if the credit exceeds the tax, the credit is eligible to be carried back for one year and forward for up to twenty years. (The carryback provision allows a business owner to amend the prior year's return so as to claim the credit.)

If you have questions related to how you might benefit from tax credits or deductions, please call this office.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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