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Direct Sellers

For use in preparing 2003 Returns

Attention: This publication will not be revised for use in preparing 2004 returns. For the next revision, we are considering using a new format that will not require annual updates. Since the tax law this publication covers generally does not significantly change from year to year, you can use this 2003 text as a general guide to prepare 2004 returns. To find changes that may affect 2004 returns, see *What's New* in your income tax return instructions; Publication 553, *Highlights of 2004 Tax Changes*; or *What's Hot In Tax Forms, Pubs, and Other Tax Products* at www.irs.gov/formspubs. To comment on this revision process, see *Comments and Suggestions* on page 2.



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Important Changes for 2003

Standard mileage rate. The standard mileage rate for the cost of operating your car in 2003 is 36 cents a mile for all business miles.

Increased section 179 deduction limit. The maximum section 179 deduction you can elect for property you placed in service in 2003 is \$100,000. For more information, see Chapter 2 in Publication 946.

Addition of 50% special depreciation allowance. For qualified property you acquire after May 5, 2003, and place in service in 2003, you can take a special depreciation allowance that is equal to 50% of the property's depreciable basis. However, you can elect to claim an allowance at the 30% rate for property that qualifies for the 50% rate, or elect to claim no special allowance. For more information, see chapter 3 in Publication 946.

Depreciation limits on business cars. The total section 179 deduction and depreciation (including the 30% or 50% special depreciation allowance) you can take on a car you use in your business and first place in service in 2003 is generally limited. For those limits and additional information, including the maximum depreciation you can deduct in later years, see *Passenger automobiles* under *Listed Property*, later.

Important Reminders

Accounting methods. Certain small business taxpayers that are **qualifying taxpayers** or **qualifying small business taxpayers** may be eligible to adopt or change to the cash method of accounting and may not be required to account for inventories. For more information, including the definitions of a qualifying taxpayer and a qualifying small business taxpayer, see Publication 538, *Accounting Periods and Methods*.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

Introduction

This publication explains general tax information of interest to direct sellers. It covers how to treat income, expenses, and other items related to having a direct-sales business. It also illustrates two filled-in tax forms that most direct sellers must file along with Form 1040. They are Schedule C (Form 1040), *Profit or Loss From Business*, and Schedule SE (Form 1040), *Self-Employment Tax*.

Who is a direct seller? Some of the characteristics that identify direct sellers are listed below. A more complete discussion is contained under the heading *Who Is a Direct Seller*, later.

- **How you sell.** You sell consumer products to others on a person-to-person basis, usually working out of your home. Or, you deliver or distribute newspapers or shopping news.
- **Where you sell.** You may sell door-to-door, through the sales party plan, or by appointment in someone else's home.
- **When you sell.** You may sell on a regular basis or only occasionally. You may sell full-time or part-time, such as a sideline to a regular job.

Who is not a direct seller? You are not a direct seller if you are employed in a store, sell through a retail sales outlet, or sell your employer's product away from the employer's place of business.

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can email us at ***taxforms@irs.gov**. Please put "Publications Comment" on the subject line.

You can write to us at the following address:

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- 1** Your Rights as a Taxpayer
- 15** Circular E, Employer's Tax Guide
- 15-A** Employer's Supplemental Tax Guide
- 15-B** Employer's Tax Guide to Fringe Benefits
- 334** Tax Guide for Small Business
- 463** Travel, Entertainment, Gift, and Car Expenses
- 505** Tax Withholding and Estimated Tax
- 525** Taxable and Nontaxable Income
- 533** Self-Employment Tax
- 535** Business Expenses
- 538** Accounting Periods and Methods
- 583** Starting a Business and Keeping Records
- 587** Business Use of Your Home
- 946** How To Depreciate Property

Form (and Instructions)

- SS-4** Application for Employer Identification Number
- Sch A (Form 1040)** Itemized Deductions
- Sch C (Form 1040)** Profit or Loss From Business
- Sch C-EZ (Form 1040)** Net Profit From Business
- Sch SE (Form 1040)** Self-Employment Tax
- 1040** U.S. Individual Income Tax Return
- 1040-ES** Estimated Tax for Individuals
- 1099-MISC** Miscellaneous Income
- 2210** Underpayment of Estimated Tax by Individuals, Estates, and Trusts
- 4562** Depreciation and Amortization
- 8829** Expenses for Business Use of Your Home

See *How To Get Tax Help* near the end of this publication for information about getting publications and forms.

Who Is a Direct Seller?

You are a direct seller if you meet **all** the following conditions.

1. You are engaged in one of the following trades or businesses.
 - a. Selling or soliciting the sale of consumer products, either—
 - i. In a home or other place that is not a permanent retail establishment, or
 - ii. To any buyer on a buy-sell basis or a deposit-commission basis for resale in a home or other place that is not a permanent retail establishment.
 - b. Delivering or distributing newspapers or shopping news (including any services directly related to that trade or business).
2. Substantially all your pay (whether paid in cash or not) for services described in (1) is directly related to sales or other output (including the performance of services) rather than to the number of hours worked.
3. Your services are performed under a written contract between you and the person for whom you perform the services, and the contract provides that you will not be treated as an employee for federal tax purposes.

As a direct seller, you usually sign up with a particular company to sell its product line. The company may refer to you by one of the following titles.

- Consultant
- Coordinator
- Dealer
- Demonstrator
- Designer
- Director
- Distributor or direct distributor
- Instructor
- Manager or supervisor
- Representative or sales representative

Self-employed. Direct sellers are self-employed. This generally means you have to pay self-employment tax (discussed later under *Business Taxes*).

Employee. You are a direct seller only if you are in business for yourself. Selling consumer products as a company employee does not make you a direct seller.

The fact that you work under another direct seller does not make you that person's employee.

Recruiting. You are engaged in the trade or business of selling or soliciting the sale of consumer products if you attempt to increase the sales of direct sellers who work under you (your **downline** group) and your earnings depend in

part on how much they sell. Recruiting, motivating, and training are examples of attempts to increase sales.

Host or hostess. You are not a direct seller if you simply host a party at which sales are made. Nevertheless, some information in this publication may still apply to you.

The **gift** you receive for giving the party is a payment for helping the direct seller make sales. You must report it as income at its fair market value. See *Other Income*, later.

Your out-of-pocket party expenses are subject to the 50% limit for meal and entertainment expenses, discussed under *Meals and Entertainment*, later. These expenses are deductible as miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income limit on Schedule A (Form 1040), but only up to the amount of income you receive for giving the party. See *Not-for-Profit Limit*, later.

Basic Tax Information

The following discussion gives basic tax information that may help if you have never been in business for yourself. For more information about starting a business, see Publication 583.

Employer Identification Number (EIN)

EINs are used to identify the tax accounts of employers, certain sole proprietors, corporations, partnerships, estates, trusts, and other entities.

If you do not already have an EIN, you need to get one if any of the following apply to your business.

1. You have employees.
2. You have a qualified retirement plan.
3. You operate your business as a corporation or partnership.
4. You file returns for:
 - a. Employment taxes,
 - b. Excise taxes, or
 - c. Taxes on alcohol, tobacco, or firearms.

You can apply for an EIN in the following ways:

- By going online—Click on the EIN link at www.irs.gov/businesses/small. The EIN is issued immediately once the application information is validated.
- By telephone at 1-800-829-4933 from 7:30 a.m. to 5:30 p.m. in the applicant's local time zone.
- By mailing or faxing **Form SS-4**, Application for Employer Identification Number.

Business Taxes

The following kinds of federal business taxes may apply to direct sellers.

- Income tax
- Self-employment tax

- Employment taxes

Your state, county, or city may impose other kinds of tax and licensing obligations.

Income tax. All businesses except partnerships must file an annual income tax return. (Partnerships file an information return.) For example, if you operate your direct-selling business as a sole proprietor, you must file Schedule C or Schedule C-EZ as part of your individual income tax return (Form 1040). You are a sole proprietor if you are self-employed (work for yourself) and are the only owner of your unincorporated business.

Self-employment tax. Self-employment tax is a social security and Medicare tax primarily for those who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of most wage earners. If you are a direct seller, you generally must pay this tax on your income from direct selling. You must pay it whether you are a sole proprietor or a partner in a partnership. Use Schedule SE (Form 1040) to figure your self-employment tax. For more information about self-employment tax, see Publication 533.

The Social Security Administration (SSA) time limit for posting self-employment income. Generally, the SSA will give you credit for self-employment income reported on a tax return filed within 3 years, 3 months, and 15 days after the tax year you earned the income. If you file your tax return or report a change in your self-employment income after this time limit, the SSA may change its records, but only to remove or reduce the amount. The SSA will not change its records to increase the amount of your self-employment income.

Employment taxes. If you have employees in your business, you generally withhold and pay the following kinds of employment taxes.

- The federal income tax you withhold from employees' wages.
- Social security and Medicare taxes—both the amount you withhold from employees' wages and the amount you pay as the employer.
- Federal unemployment (FUTA) tax (none of which is withheld from the employees' wages).

For more information, see Publication 15.

Other taxes. You can deduct personal property and other taxes as a business expense if you incur them in the ordinary course of your business. For information about deducting these taxes, see *Taxes* under *Business Expenses*, later.

Estimated Tax

The federal income tax is a pay-as-you-go tax. You must pay it as you earn or receive income during the year. There are two ways to pay as you go.

- **Withholding.** If you are an employee, your employer likely withholds income tax from your pay. By revising your W-4, you can increase your withholding to cover the

tax you owe on income from your job and from direct selling.

- **Estimated tax.** If you do not pay tax through withholding, or do not have enough withheld, you may have to pay estimated tax.

Estimated tax is used to pay both income and self-employment taxes.

General rule for making estimated tax payments. You must make estimated tax payments for 2004 if you expect to owe at least \$1,000 in tax, after subtracting your withholding and credits, and you expect your withholding and credits to be less than the smaller of the following.

- 90% of the tax to be shown on your 2004 tax return.
- 100% of the tax shown on your 2003 tax return. Your 2003 tax return must cover all 12 months for this rule to apply.

Paying estimated tax. You can use Form 1040-ES to figure your estimated tax and make quarterly estimated tax payments. Or, you can make estimated tax payments by electronic funds withdrawal or by credit card. See the Form 1040-ES instructions or *How To Pay Estimated Tax* in Publication 505.

Underpayment penalty. If you did not pay enough estimated tax or have enough income tax withheld, you may be subject to a penalty for underpayment of tax. You can use Form 2210 to figure the penalty. In most cases, you can have the Internal Revenue Service figure the penalty for you. See Form 2210 to determine if you must complete the form.

Exceptions. Generally, you do not have to pay an underpayment penalty if you meet either of the following exceptions.

- Your total tax is less than \$1,000.
- You had no tax liability last year.

For more information on estimated tax, see Publication 505.

Information Returns

You must file an information return to report that you made direct sales of at least \$5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment. The information return, Form 1099-MISC, must show the name, address, and identification number of the buyer (recipient). Check box 9 of Form 1099-MISC to show these sales. Do not enter a dollar amount.

You must also provide a statement to the buyer by January 31 of the year following the calendar year for which the information return is filed, showing your name, address, phone number for contacting you, and identifying number. The statement you give to the buyer for these direct sales may be in the form of a letter showing this information along with commissions, prizes, awards, etc. See the instructions for Form 1099-MISC for more information.

Penalties

The law imposes penalties for noncompliance with tax laws. Some of these penalties are discussed next. If you underpay your tax due to fraud, you could be subject to a civil fraud penalty. In certain cases, you could be subject to criminal prosecution.

Failure-to-file penalty. If you do not file your return by the due date (including extensions), you may have to pay a failure-to-file penalty. The penalty is usually 5% of the tax not paid by the due date for each month or part of a month that the return is late. This penalty cannot exceed 25% of your tax, and it is reduced by the failure-to-pay penalty (discussed next) for any month both penalties apply. However, if you file your return more than 60 days after the due date or extended due date, the minimum penalty is the lesser of \$100 or 100% of the unpaid tax. You will not have to pay the penalty if you show that you failed to file on time because of reasonable cause and not because of willful neglect.

Failure-to-pay penalty. You may have to pay a penalty of 1/2 of 1% of your unpaid taxes for each month or part of a month after the due date that the tax is not paid. This penalty cannot be more than 25% of your unpaid tax. You will not have to pay the penalty if you can show good reason for not paying the tax on time. This penalty does not apply during the automatic 4-month extension of time to file if you paid at least 90% of your actual tax liability on or before the due date of your return and you pay the balance when you file the return.

The monthly rate of the failure-to-pay penalty is half the usual rate (.25% instead of .50%) if an installment agreement is in effect for that month. You must have filed your return by the due date (including extensions) to qualify for this reduced penalty.

Penalty for frivolous return. You may have to pay a penalty of \$500 if you file a return that does not include enough information to figure the correct tax or that contains information clearly showing the tax you reported is substantially incorrect.

You will have to pay the penalty if you filed this kind of return for either of the following reasons.

- A frivolous position on your part.
- A desire to delay or interfere with the administration of federal income tax laws.

This penalty is in addition to any other penalty provided for by law.

Accuracy-related penalty. An accuracy-related penalty of 20% applies to any underpayment due to the following reasons.

- Negligence or disregard of rules or regulations.
- Substantial understatement of income tax.

This penalty also applies to conditions not discussed here.

Even though an underpayment was due to both negligence and substantial underpayment, the total accuracy-related penalty cannot exceed 20% of the underpayment. The penalty is not imposed if you can show reasonable cause and that you acted in good faith.

Negligence. Negligence includes a failure to make a reasonable attempt to comply with provisions of the Internal Revenue Code.

Disregard. Disregard means the careless, reckless, or intentional disregard of rules or regulations.

Substantial understatement of income tax. For an individual, income tax is substantially understated if the understatement exceeds the greater of the following amounts.

- 10% of the correct tax.
- \$5,000.

Information reporting penalties. A penalty applies if you do not file information returns by the due date, do not include all required information, or do not report correct information. The amount of the penalty is based on when you file the correct information return, as follows.

- Correct information returns filed within 30 days after the due date, \$15 each.
- Correct information returns filed after the 30-day period but by August 1, \$30 each.
- Information returns filed after August 1 or not filed, \$50 each.

Maximum limits apply to all these penalties.

Failure to furnish correct payee statements. If you do not provide a complete, correct, and timely copy of an information return (payee statement), you may be subject to a penalty of \$50 for each statement. If the failure is due to intentional disregard of the requirements, the minimum penalty is \$100 per statement with no maximum penalty.

Failure to supply identification number. If you do not include your identification number (SSN or EIN) or the identification number of another person where required on a return, statement, or other document, you may be subject to a penalty of \$50 for **each** failure. You may also be subject to the penalty if you do not give your identification number to another person when it is required on a return, statement, or other document.

You will not have to pay the penalty if you can show the failure was due to reasonable cause and not willful neglect.

Accounting Periods and Methods

All income tax returns are prepared using an accounting period (tax year) and an accounting method.

Accounting Periods

When preparing a statement of income and expenses, you must use books and records for a specific interval of time called an accounting period. The annual accounting period for your tax return is called a **tax year**. You can generally use one of the following tax years.

- **A calendar year**, which begins on January 1 and ends on December 31.
- **A fiscal year** (including a period of 52 or 53 weeks). A regular fiscal year is 12 con-

secutive months ending on the last day of any month except December.

You generally adopt a tax year by filing your first income tax return using that tax year. If you filed your first return as a wage earner using the calendar year and you later start your own business, you must continue to use the calendar year as your business tax year. You generally cannot change your tax year without IRS approval.

For more information, see Publication 538.

Accounting Methods

An accounting method is a set of rules used to determine when and how income and expenses are reported. You must use the same accounting method from year to year. The two most common accounting methods are the cash method and an accrual method. A third method, called a hybrid method, is generally a combination of cash and accrual.

The text and examples in this publication generally assume you use the calendar year as your tax year and either the cash or hybrid method as your accounting method. Generally, if inventories are needed to account for your income, you must use an accrual method, discussed later, for your sales and purchases. However, if you are a qualifying taxpayer or a qualifying small business taxpayer, you can use the cash method of accounting, even if you purchase or sell merchandise. You also can account for inventoriable items as materials and supplies that are not incidental. For more information, including definitions of a qualifying taxpayer, a qualifying small business taxpayer, and an explanation of materials and supplies that are not incidental, see Publication 538.

Cash method. Under the cash method, you report income in the year it is received, credited to your account, or made available to you on demand. You need not have physical possession of it. You deduct expenses in the year you pay them, even if they were incurred in an earlier year.

Check received. If you receive a check before the end of the tax year, you must include it in income for the year you receive it even though you do not cash or deposit it until the next year.

Accrual method. Under an accrual method, you generally report income for the tax year when all events have occurred that fix your right to receive the income and you can determine the amount with reasonable accuracy. Generally, you deduct or capitalize business expenses when all events have occurred that fix the fact of liability, the liability can be determined with reasonable accuracy, and economic performance has occurred. See Publication 538 for an explanation of economic performance.

Prepaid expenses. Expenses paid in advance generally can only be deducted in the year to which they apply under either the cash or an accrual method. (However, see *Exception for recurring items* under *Accrual Method* in Publication 538.) For example, suppose you have a subscription to a direct-selling journal that runs out at the end of 2003. It will cost you \$30 to renew the subscription for one year or \$54 for 2

years. You decide to renew for 2 years and mail your check at the end of November 2003. You cannot deduct the \$54 on your 2003 return. However, you can deduct half of the \$54 in 2004 and the other half in 2005.

Business Income

You must report all income you receive as a direct seller. This includes any of the following.

- Income from sales—payments you receive from customers for products they buy from you.
- Commissions, bonuses, or percentages you receive for sales and the sales of others who work under you.
- Prizes, awards, and gifts you receive from your selling business.

You must report this income regardless of whether it is reported to you on an information return.

Income From Sales

You have income from sales if your customers buy directly from you and you buy the products you sell from a company (or another direct seller).

If some of your customers buy their products directly from the company, you, as the sales agent, do not have any sales income from these transactions. You will generally receive a commission or **bonus** for making the sale, but you will have no direct income from the sale itself. If all of your sales are handled this way, the rules in this section do not apply to you. Report your commissions as other business income. For more information, see *Other Income*, later.

Depending on the company with which you are affiliated and the nature of its marketing and compensation plan, you may have income from sales, commissions, bonuses, or all three.

Example 1. Your customers pay you the retail price for goods they order. You forward the orders and payments to the company. The company sends the merchandise to fill the orders. The company also sends you a commission.

You are acting as a sales agent for the company. You did not purchase the products to sell to your customers. Your payment from the company is commission income, not income from sales. Include the commission in your gross receipts. The amount your customers pay for the goods they order is not included in income.

Example 2. Your customers pay you a deposit when you take their orders. You send the orders to the company, but keep the deposits for yourself. The company fills the orders by shipping the merchandise to your customers. Your customers pay the company the remainder of the retail price (usually cash on delivery).

You are acting as a sales agent for the company. The deposit is your commission income. You have no income from sales.

Example 3. Your customers pay you for the goods you sell them, either when you take their orders or when you make deliveries. After your customers place orders, you order the goods

from the company (or from a direct seller you work under). You either send the money directly to the company with your orders, or you are billed later. In either case, you are able to charge your customers more than you pay for the goods.

You are buying products **wholesale** and selling them **retail**. The full amount received from your customers is income from sales.

Example 4. You keep a supply of goods that your customers regularly buy from you. This allows you to fill their orders without delay. You order and pay for the goods before your customers request them.

You have purchased goods to resell to customers. The full amount received from your customers is income from sales.

Example 5. You have recruited several other direct sellers who order their products through you. Commissions or bonuses paid to you by the company are shared with the direct sellers in your **group** based on sales, purchases, or some other formula established by the company whose products you sell. You keep the portion of the commissions you are not required to distribute to the direct sellers in your group.

The bonuses you receive from the company are included in income as commissions, not as income from sales.

Gross Profit

Gross receipts minus cost of goods sold equals gross profit.

If you have income from sales and you are filing Schedule C, Form 1040, figure your gross profit and the income to report by following these steps.

1. Figure the total your customers paid you during the year for goods you sold them. Include this in the gross receipts you report on line 1 of Schedule C.
2. Subtract the amount (if any) your customers paid that you had to return in the form of refunds, rebates, or other allowances. Show this on line 2 of Schedule C.
3. Finally, subtract the cost of the goods sold (line 4 of Schedule C). To figure the cost of goods sold, you must know the value of the inventory at the beginning and end of the year, and your purchases during the year. See *Cost of Goods Sold*, next, and *Inventory*, later.

Cost of Goods Sold

To figure your cost of goods sold, follow these steps.

1. Start with the value of your inventory at the beginning of the tax year. This is usually the same as the value of your inventory at the end of the previous year. Valuing inventory is discussed later under *Inventory*.
2. Add to your beginning inventory the cost of merchandise you bought during the year to sell to customers. This does not include

the cost of merchandise you bought for your own use.

3. Subtract from this total the inventory on hand at the end of the year. The difference is your cost of goods sold during the year.

Example 1. Janet sells cookware on the sales-party plan. On December 31, 2002, she did not have any cookware on hand to sell to customers. She does not have a beginning inventory for 2003.

During the year, Janet spent \$5,270 on goods in her product line. Of this amount, \$130 was for cookware sets she gave for personal gifts and \$40 was for a set for her own use. She purchased \$5,100 [\$5,270 - (\$130 + \$40)] worth of goods to sell to customers.

On December 31, 2003, Janet had several sets of cookware in boxes for delivery to customers. The cost of these sets was \$220. Her ending inventory for the year is \$220, and her cost of goods sold for 2003 is \$4,880 (\$0 beginning inventory + \$5,100 purchases - \$220 ending inventory).

Example 2. Lisa is a direct seller of cosmetics. She has an established clientele and knows what items are steady sellers. When the company has a special sale on these items, she buys extra quantities for future sales. She had merchandise costing \$200 on hand at the end of 2002 (which would be her beginning inventory for 2003) and merchandise costing \$175 at the end of 2003. During the year she purchased \$3,250 of merchandise. Purchase returns and allowances were \$50. She withdrew \$200 of cosmetics for personal use. Lisa figures her cost of goods sold for 2003 as follows:

Beginning inventory	\$200
Add: Merchandise purchased during the year	\$3,250
Subtract: Purchase returns and allowances	50
Subtract: Goods withdrawn for personal use	200
Goods available for sale	3,000
Subtract: Ending inventory	175
Cost of goods sold	<u>\$3,025</u>

Lisa figures her gross profit by subtracting the cost of goods sold from her gross receipts (\$5,375) for the year as follows:

Gross receipts	\$5,375
Minus: Cost of goods sold	3,025
Gross profit	<u>\$2,350</u>

Purchases. When figuring cost of goods sold, include the **full cost** of all merchandise you buy to sell to customers. This cost includes all postage and freight charges incurred.

Figure your purchases at the actual price you pay. Deduct a **cash discount** or a **trade discount** in figuring the cost of your purchases. A cash discount or a trade discount is the difference between the invoice price and the actual price you have to pay.

Purchase returns and allowances. Subtract purchase returns and allowances from your total purchases for the year when figuring cost of goods sold. This includes any rebates or refunds you received off the purchase price. It also in-

cludes any credit you received for returned merchandise.

Personal withdrawals. Subtract from your purchases for the year the cost of goods in your product line that you bought for personal use and the cost of goods you withdrew from inventory. Merchandise is considered withdrawn from inventory when it is no longer available for sale to customers. For example, if you sell a particular kind of soap and give some as a gift or use some yourself, you must withdraw the soap from inventory because it is no longer available for sale. Follow this procedure for all products withdrawn for personal use, even if you are using the product only to familiarize yourself with its characteristics or to demonstrate loyalty to the company whose products you sell.

Inventory

Many direct sellers have little or no inventory. Others keep a considerable inventory on hand. If you must account for an inventory in your business, you must use an accrual method of accounting for your purchases and sales. However, see *Qualifying taxpayer* and *Qualifying small business taxpayer* in the discussion on exceptions under *Inventories* in Publication 538.

If you have income from sales, you need to know how to figure your inventory at the end of each tax year. Your inventory practices must be consistent from year to year.

Figuring inventory involves:

1. Taking inventory,
2. Identifying the cost, and
3. Valuing the inventory.

You need to know your inventory at the beginning and end of each tax year to figure your cost of goods sold. Beginning inventory will usually be the same as the prior year's ending inventory. Any differences must be explained in a schedule attached to your return.

Taking inventory. The first step is to identify and count all merchandise in your inventory. Include all goods to which you have title at the end of the year. This generally will be any goods you have on hand and have not yet sold to customers.

Include merchandise you have purchased, if title has passed to you even if you have not yet physically received the goods. You may have title to goods that were shipped to you but are still in transit and not yet received. If the risk of loss during shipment is yours, you will probably have title to the goods during shipment. If you buy merchandise that is sent C.O.D., title passes when payment and delivery occur.

Goods not yet paid for. You may have title to goods purchased but not yet paid for. If you are billed for merchandise, you must usually pay the bill within a certain time. In this case, you have title to the goods and must include them in inventory, provided they are not sold by the end of the year.

Consignments. Merchandise you receive on consignment is not purchased by you and is never included in your inventory. You have merchandise on consignment if you do not have to pay for what you have in stock until the time you

sell it and collect the retail price from the customer.

Identifying the cost. The second step in figuring your inventory is to identify the cost of inventory items. Use the **specific identification method** when you can identify and match the actual cost to the items in inventory. Most direct sellers will be able to use this method.

If you cannot identify specific items with their invoices, you must make an assumption about which items were sold during the year and which remain. Make this assumption using either the **first-in first-out (FIFO) method** or the **last-in first-out (LIFO) method**.

The FIFO method assumes that the first items you purchased or produced are the first items you sold, consumed, or otherwise disposed of.

The LIFO method assumes that the last items that you purchased are sold, consumed, or otherwise disposed of first.

Valuing the inventory. The third step in figuring your inventory is to value the items you have in inventory. The value of your inventory is a major factor in figuring your taxable income. The method you use is very important.

The two most common methods to value non-LIFO inventory are the **cost method** and the **lower of cost or market method**. LIFO inventory may only be valued at **cost**.

Cost method. If you use the cost method to value your inventory items, the value of each item is usually its invoice price. Add transportation, shipping, and other necessary costs to acquire the items. Subtract appropriate discounts you received.

Lower of cost or market method. See Publication 538 for a discussion of the lower of cost or market method.

New business. For a new business not using LIFO, you may choose either method to value your inventory. You must use the same method to value your entire inventory, and you cannot change the method without first obtaining IRS approval.

Other Income

You must report on your tax return all income you receive from your business unless it is excluded by law. In most cases, your business income will be in the form of cash, checks, and credit card charges. But business income can be in other forms, such as property or services. These and other types of income are explained next.

Commissions, bonuses, and percentages. Many direct sellers receive a commission on their sales or purchases. Your commission might be called a bonus or percentage, and it might be based on both your own sales and the sales of other direct sellers working under you, or on purchases from the company with which you are affiliated.

Report the full amount of any commissions you receive as business income, even if you pay part of it to other direct sellers working under you. You can usually deduct the part you pay to others as a business expense. For more information, see *Commissions* under *Other Expenses*, later.

Prizes, awards, and gifts. If you receive prizes, awards, or gifts in your role as a direct seller, report their full value as business income. The following are examples of items that must be included in income.

- Cash.
- Free merchandise.
- Expense-paid trips.
- Use of a car.
- Jewelry signifying your level of achievement as a direct seller.
- Membership in organizations or clubs.
- Tickets to sporting events, shows, or concerts.

Value of goods or services received. Report income received in the form of goods or services at their **fair market value**. Fair market value is the price agreed on between a willing buyer and a willing seller when both have reasonable knowledge of the facts and neither is forced to buy or sell.

Value of use of property. If you receive the free use of property through your direct-sales performance, you must include the fair market value of the use of the property in your business income. There are special rules for the free use of an automobile and certain other property. For more information, see *Valuation of Fringe Benefits* in Publication 525.

Capital Expenses

You must capitalize some costs rather than deduct them. These costs are a part of your investment in your business and are called **capital expenses**. When you capitalize a cost, you add it to the basis of the property to which it relates.

Although you generally cannot take a current deduction for a capital expense, you may be able to take deductions for these costs over a period of years as explained later under *Cost Recovery*.

Kinds of Capital Expenses

You must capitalize the following costs.

- **Going into business.** The costs of getting started in business, before you are authorized to start selling your company's products, are capital expenses. These **start-up costs** include the cost of exploring different direct-selling opportunities, the cost of any training you must have before becoming a direct seller for your product line, any fees you must pay to the company to become a direct seller, and similar costs. See chapter 9 of Publication 535 for information on how to treat these costs.
- **Business assets.** The cost of any asset (property) that will last substantially beyond the tax year it is placed in service is a capital expense. Examples of business assets include office furniture, business vehicles, and storage shelves. See *Cost Recovery*, later.

- **Improvements.** The costs of making improvements to a business asset are capital expenses if the improvements add to the value of the asset, appreciably lengthen the time you can use it, or adapt it to a different use. However, normal repair expenses are deducted as current business expenses and are not capitalized. For example, if you have a car you use only for business, you can deduct as business expenses, maintenance and repair costs such as tune-ups, new headlights, or brake repairs. The cost of overhauling the engine, however, would be a capital expense.

Demonstrators

If you keep your company's products on hand to show to potential customers, their cost may be part of the cost of goods sold, a capital expense, a business expense, or a personal expense, depending on the circumstances. The cost of a product you use yourself is a personal expense, even if you occasionally show it to prospective customers.

Example. Sheila is a direct seller who uses many of the products in her own home. When potential customers come to her house, she can show them drapes she bought from the company, as well as her lawn chairs, toaster, grill, tea set, and spice cabinet. By showing these items in her own home, she hopes to interest people in buying from her company or in becoming direct sellers themselves.

Sheila cannot take a deduction for the cost of any of these products. Because she uses them in her own home for personal reasons, their cost is not a cost of doing business.

Used one year or less. If you have a product you use as a demonstrator for one year or less and the demonstrator itself is not available for purchase by your customers, its cost is a business expense.

If the demonstrator itself can be bought by your customers, include it in your inventory.

Example 1. Constance is a direct seller of kitchenware. Customers must order items from a catalog, but she keeps at least one of each type on hand to show buyers. When her product line changes and an item is discontinued, she either starts using the demonstrator in her own kitchen or tries to sell it. When she had a garage sale, she sold a number of unused demonstrators.

Constance includes her demonstrators, including those for discontinued products, in her inventory of goods for sale. When she sells a demonstrator, including those she sold at the garage sale, she includes the income in her gross business receipts.

When Constance starts using a demonstrator in her own kitchen, it is a withdrawal of inventory for personal use. She subtracts the cost of the item from her purchases for the year. See *Personal withdrawals* under *Cost of Goods Sold*, earlier.

Example 2. Lydia sells needlework kits at sales parties. She has catalogs and a number of kits to show customers. She uses these kits to demonstrate various needlework techniques.

The demonstrator kits last less than one year and are not sold to customers. Some are ruined and thrown away. Their cost is a business expense.

More than one year of use. If you use a demonstrator for more than one year, its cost is a capital expense. However, if you expect to eventually sell the demonstrator, include it in your inventory of goods for sale.

Example 1. Mike sells educational books door-to-door. He carries copies of the books to show potential customers. If someone wants a book, he takes a deposit and delivers the book at a later time.

His product line changes little from year to year, so Mike can use a book as a demonstrator for a long time. Although he periodically replaces his demonstrators with new ones and sells the old ones at a discount, he has kept some books as demonstrators for up to 3 years.

Because Mike eventually sells his demonstrators, they remain part of his inventory of goods for sale.

Example 2. Janet sells the same line of educational books as Mike in *Example 1*. She tries to use her demonstrators as long as possible. She puts the books in plastic jackets to protect them, and ordinarily only stops using them as demonstrators when the company comes out with a new edition. Janet never sells the old demonstrators. She can recover the cost of the books she uses as demonstrators as discussed under *Cost Recovery*, next.

Cost Recovery

You can usually **recover** (subtract from income) your cost for capital expenses over a number of years. Each year a part of your basis is recovered through depreciation or amortization. Use depreciation to recover capital expenses for most tangible business assets. Use amortization to recover the cost of intangible assets, such as start-up costs. Amortization is discussed in chapter 9 of Publication 535.

Under certain circumstances, you may be able to recover a limited amount of the cost of qualifying property as a current expense by electing the **section 179 deduction** rather than recover the cost as a capital expense. The section 179 deduction is discussed later.

Form 4562. Generally, use Form 4562 to report depreciation, amortization, and the section 179 deduction. A filled-in Form 4562 is illustrated in an example in Publication 946.

Section 179 Deduction

You can elect to deduct all or part of the cost of certain qualifying property in the year you place it in service. Property is placed in service when it is first made ready and available for a specific use.

Qualifying property. Qualifying property includes tangible personal property for which depreciation is allowable. See chapter 2 in Publication 946 for more information.

Dollar limit. The maximum section 179 cost you can choose to deduct for 2003 is generally \$100,000.

Certain benefits, including an increased section 179 deduction, are available for certain property you place in service in the New York Liberty Zone or in an empowerment zone.

Business income limit. The total cost you can deduct each year after you apply the dollar limit is further limited to the taxable income from the active conduct of any trade or business during the year.

Any cost not deductible in one year because of this limit can be carried to the next tax year.

More information. For more information, see chapter 2 in Publication 946.

Depreciation

If you do not choose a section 179 deduction or you choose a section 179 deduction and do not recover all your cost, you can take a depreciation deduction (which may include a special depreciation allowance for qualified property) for part or all of the cost you did not claim as a section 179 deduction.

Property whose cost can be recovered through depreciation is depreciable property. Depreciable property includes most types of tangible property (except land), such as buildings, machinery, vehicles, furniture, and equipment. Depreciable property also includes certain intangible property.

You can depreciate property if it meets the following requirements.

- It must be property you own.
- It must be used in your business or income-producing activity.
- It must have a determinable useful life. This means it is something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.
- It must be expected to last more than one year.
- It must not be excepted property, such as property placed in service and disposed of in the same year.

You must use the modified accelerated cost recovery system (MACRS) to depreciate most property placed in service after 1986.

For information about the depreciation of property placed in service after 1986, see Publication 946. Chapter 4 contains a detailed discussion on figuring depreciation under MACRS.

For information about the depreciation of property placed in service before 1987, see Publication 534, *Depreciating Property Placed in Service Before 1987*.

Special depreciation allowance. You can take a special depreciation allowance to recover part of the cost of qualified property placed in service during the tax year. An allowance applies for the first year you place the property in service. For qualified property acquired before May 6, 2003, it is an additional 30% deduction. For qualified property acquired after May 5, 2003, it is an additional 50% deduction, or you can elect to take an additional deduction determined at the 30% rate. You can take the additional 30% or 50% deduction after any section

179 deduction and before you figure regular depreciation under MACRS for the year you place the property in service. For more information, see chapter 3 in Publication 946.

Listed Property

Listed property includes property which lends itself to personal use such as property used for transportation, entertainment equipment, certain computers, and cellular phones. In addition, there are recordkeeping requirements and rules you must follow when depreciating listed property. If listed property is not used more than 50% for a qualified business use during any tax year, you cannot claim the section 179 deduction or a special depreciation allowance and special rules apply to the depreciation deduction. See chapter 5 in Publication 946.

Passenger automobiles. For most passenger automobiles, the section 179 deduction and depreciation deduction (including the special depreciation allowance) you can claim is limited. See Publication 946 for limits that apply for trucks, vans and electric passenger automobiles placed in service in 2003.

For a passenger automobile that is qualified property for a special depreciation allowance (see definitions below) placed in service during 2003, the total of your section 179 deduction and depreciation deduction (including the special depreciation allowance) cannot be more than \$10,710 for a car acquired after May 5, 2003 (\$7,660 for a car acquired before May 6, 2003). If you elected **not** to claim the special depreciation allowance for the automobile or if the automobile is not qualified property, the limit is generally \$3,060. For 2004 and 2005, the maximum deduction amounts for a passenger automobile placed in service in 2003 are \$4,900 and \$2,950 respectively. The maximum deduction for each year after 2005 is \$1,775.

Qualified property for the 30% special depreciation allowance includes a car that meets all the following requirements.

- You bought the car new after September 10, 2001.
- You placed the car in service for business in 2003.
- You used the car more than 50% in a qualified business use.

Qualified property for the 50% special depreciation allowance includes a car that meets all the following requirements.

- You bought the car new after May 5, 2003.
- You placed the car in service for business after May 5, 2003.
- You used the car more than 50% in a qualified business use.



TIP You can elect to claim the 30% special depreciation allowance instead of the 50% special depreciation allowance for property that qualifies for the 50% allowance. This election applies to all property in the same property class placed in service during the year.



If your business/investment use of the automobile is less than 100%, you must reduce the maximum deduction amount proportionately.

Example. Peter purchases a used car this year for \$4,500 and he uses it 60% for business. The car is not qualified property for the 30% or 50% special depreciation allowance. He chooses to take a section 179 deduction for the car. The cost of Peter's car that qualifies for the section 179 deduction is \$2,700 ($\$4,500 \times 60\%$). However, Peter's section 179 deduction is limited to \$1,836 ($\$3,060 \times 60\%$).

Business Expenses

The operating costs of running your business are called business expenses. These are costs you do not have to capitalize or include in the cost of goods sold.

Keep business expenses separate from personal expenses. If you have an expense that is partly for business and partly personal, deduct only the business part on your business return.

To be deductible, a business expense must be both ordinary and necessary. An **ordinary** expense is one that is common and accepted in your trade or business. A **necessary** expense is one that is appropriate and helpful for your trade or business. An expense does not have to be indispensable to be considered necessary.

This section discusses business expenses you might have as a direct seller. For more information on business expenses, see Publication 535.

Salaries and Wages

You can generally deduct the pay you give your employees for the services they perform for your business. The pay may be in cash, property, or services. It may include wages, salaries, vacation allowances, bonuses, commissions, and fringe benefits.

If you are a sole proprietor, you cannot deduct your own salary or any personal withdrawals you make from your business. You are not an employee of the business.

For detailed discussions of salaries, wages, and other payments to employees, see Publications 15 and 15-A, and chapter 2 in Publication 535.

Taxes

You can deduct as a business expense various federal, state, local, and foreign taxes directly attributable to your direct-selling business. Some of these taxes were discussed earlier under *Business Taxes* and others are discussed next.

Income taxes. Most income taxes, including federal income taxes, cannot be deducted as a business expense. You can generally deduct personal state and local income taxes as an itemized deduction on Schedule A (Form 1040).

Personal property tax. You can deduct as a business expense any tax imposed by a state or local government on personal property used in your direct-selling business.

You can also deduct registration fees for the right to use property within a state or local area.

Example. May and Julius Winter drove their car 7,000 business miles out of a total of 10,000 miles during the tax year. They had to pay \$25 for their annual state license tags and \$20 for their city registration sticker. They also paid \$235 in city personal property tax on the car, for a total of \$280. They are claiming their actual car expenses for the year. Because they used the car 70% for business, they can deduct 70% of the \$280, or \$196, as a business expense.

Sales tax. Treat any sales tax you pay on a service or on the purchase or use of property as part of the cost of the service or property. If the service or the cost or use of the property is a deductible business expense, you can deduct the tax as part of that service or cost. If the property is merchandise bought for resale, the sales tax is part of the cost of the merchandise. If the property is depreciable, add the sales tax to the basis for depreciation. See Publication 551, *Basis of Assets*, for information about the basis of property.



CAUTION Do not deduct state and local sales taxes imposed on the buyer that you must collect and pay over to the state or local government. Do not include these taxes in gross receipts or sales.

Fuel taxes. Taxes on gasoline, diesel fuel, and other motor fuels that you use in your business usually are included as part of the cost of the fuel. Do not deduct these taxes as a separate item.

Interest

Interest is the amount charged for the use of borrowed money. You can generally deduct as a business expense all interest you pay or accrue during the tax year on debts related to your trade or business.

You can deduct interest on a debt only if you meet all the following requirements.

- You are legally liable for that debt.
- Both you and the lender intend that the debt be repaid.
- You and the lender have a true debtor-creditor relationship.

No deduction is allowed for interest paid or accrued on personal loans. If a loan is part business and part personal, allocate the interest between the two. For more information, see chapter 5 in Publication 535.

Example. During the tax year, you paid \$600 interest on a car loan. You used the car 60% for business and 40% for personal purposes. You can deduct \$360 ($60\% \times \600) as a business expense on your Schedule C (Form 1040) or Schedule C-EZ (Form 1040). The remaining interest (\$240) is a nondeductible personal expense.

Insurance

You can generally deduct premiums you pay for the following kinds of insurance related to your trade or business. This list is not all inclusive.

- Fire, theft, flood, or similar insurance.
- Car and other vehicle insurance on vehicles used in your business if you do not use the standard mileage rate to figure your car expenses.
- Credit insurance to cover losses from business bad debts.
- Liability insurance.
- Use and occupancy and business interruption insurance. This insurance pays for lost profits if your business is shut down due to a fire or other cause. Report the proceeds as ordinary income.

You generally cannot deduct the cost of life insurance paid on your own life. However, see chapter 7 in Publication 535 for information on when life insurance premiums are deductible.

Business and personal. If you pay premiums for insurance coverage that is both business and personal, deduct only the part that is for business coverage. For example, if you use your car 25% in your direct-selling business and 75% for personal transportation, you can deduct 25% of your car insurance premiums if you claim actual expenses for the use of the car.

When to deduct. You generally cannot deduct expenses in advance, even if you pay them in advance. This rule applies to both the cash and accrual methods. If you make an advance payment on an insurance policy that provides coverage substantially beyond the end of the current tax year, deduct only the part for the current tax year. You must wait until the following tax year to deduct the part for that year, and so on.

Example. You are a direct seller. In June 2003, you pay \$1,200 in premiums for theft insurance effective July 2003 through June 2005 (\$50 per month). You can deduct \$300 in 2003 ($\50×6 months), \$600 in 2004 ($\50×12 months), and \$300 in 2005.

Dividends. An insurance dividend is a return of part of the premiums you paid. If you receive dividends from business insurance premiums you deducted in an earlier year, report all or part of the dividend as business income. For more information on recovery of prior deductions, see Publication 525.

Telephone

You cannot deduct the cost of basic local telephone service (including any taxes) for the first telephone line you have in your home, even if you have an office in your home. However, charges for business long distance phone calls on that line, as well as the cost of a second line into your home used exclusively for business, are deductible business expenses.

Example 1. Leo had a separate telephone line installed in his home for his direct-selling business. He had this phone number printed on his business cards and always uses it only for business calls.

Leo can deduct the full amount of his business phone bill because the phone is used exclusively for business.

Example 2. Mary and George run an active direct-selling business out of their home. For February, their phone bill was \$65 (\$20 for basic telephone service and \$45 for long-distance calls).

The total charge for long-distance business calls on their bill is \$31. Mary and George can deduct \$31 as a business expense.

Away from home. If you travel away from home and make a business phone call, you can deduct the cost of the call, whether or not the rest of your travel expenses are deductible.

Business and personal calls. You can deduct telephone expenses only for business calls. Personal calls do not become business calls because some business is discussed.

Example. Lydia is interested in sponsoring others as direct sellers for her product line. She often talks by phone with her sister who lives 50 miles away. They talk about personal matters. When Lydia mentions her direct-selling work, she usually says something to encourage her sister to become a direct seller.

Lydia's phone calls to her sister are personal and nondeductible. Their primary purpose is not to recruit her sister as a direct seller, but to continue their personal relationship.

Other Expenses

Discussed next are other expenses you may have as a direct seller.

Licenses and regulatory fees. License and regulatory fees for your business paid each year to state or local governments are generally deductible business expenses. Some licenses and fees may have to be amortized. See chapter 9 of Publication 535 for information on amortization.

Catalogs. The cost of catalogs you use in your selling business for more than one year must be capitalized. The cost can then be recovered as explained under *Cost Recovery*, earlier. If the catalogs are used in your selling business for one year or less, you can deduct their full cost in the tax year you pay for them.

Commissions. If you must pay a bonus, percentage, or other type of commission to direct sellers working under you, you can deduct it. Report the full amount of any commissions you receive as business income, and deduct the commissions you pay as ordinary and necessary business expenses.

Example. Freda has her own direct-selling business and sponsors two other direct sellers. These direct sellers report their sales to her each month. She in turn adds their sales to hers and reports the total to the direct seller who sponsored her. In March, the people working under her each had \$400 in sales and she had \$500 in sales of her own. She reports to the company (or her sponsor) \$1,300 ($\$400 + \$400 + \500) in monthly sales for her group even though her income is only \$500.

Freda received a commission or **performance bonus** for March equal to 10% of the \$1,300, or \$130, in sales. She reports the entire \$130 as business income on her tax return.

Freda must pay the direct sellers working under her a commission of 7% on their monthly sales of \$400. She paid each of them \$28 (7% of

\$400) for their March sales. She deducts the total, \$56, as a business expense on her tax return.

Computer. If you use a computer in your direct sales business, you can depreciate it. However, if you use it 50% or less in your business, you must use the Alternative Depreciation System (ADS) under MACRS to figure your depreciation deduction. For more information, see chapter 5 in Publication 946.

Home meetings. If you have business meetings in your home, you can deduct expenses for the meetings as entertainment expenses and as expenses related to the business use of your home only when they meet certain tests.

- The expenses of entertaining business associates in your home are deductible as entertainment expenses if they meet the rules discussed under *Meals and Entertainment*, later, and you can prove your expenses as discussed later under *Recordkeeping*.
- The expenses of maintaining your home as a place of business are deductible if you meet the tests discussed under *Business Use of Your Home*, later.

Example. Barbara and Bill hold biweekly meetings in their home for the direct sellers who work under them. They discuss selling techniques, solve business problems, and listen to presentations by company representatives.

Because the meetings are for business, Barbara and Bill can deduct 50% of the cost of the food and beverages they provide. The 50% limit is explained later under *Meals and Entertainment*. They keep a copy of their grocery receipts for these refreshments, and record the date, time, and business nature of each meeting. Because the meetings are held in their living room rather than in a special area set aside only for business, they cannot deduct any of their home expenses for the meetings.

Journal subscriptions. If you subscribe to a journal for direct sellers, you can deduct the annual subscription fee as a business expense.

Club dues and membership fees. Generally, you cannot deduct amounts you pay or incur for membership in any club organized for business, pleasure, recreation, or any other social purpose. This includes country clubs, golf and athletic clubs, hotel clubs, sporting clubs, airline clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussions. The purpose and activities of a club, not its name, will determine whether or not you can deduct the dues.

Exception. None of the following organizations will be treated as a club organized for business, pleasure, recreation, or other social purpose, unless one of its main purposes is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

- Boards of trade.
- Business leagues.
- Chambers of commerce.
- Civic or public service organizations.

- Professional associations.
- Trade associations.

Legal and professional fees. Legal and professional fees, such as fees charged by accountants, that are ordinary and necessary expenses directly related to operating your business are deductible as business expenses. However, you usually cannot deduct legal fees paid to acquire business assets. Those are added to the basis of the property.

If the fees include payments for work of a personal nature (such as making a will), you can take a business deduction only for the part of the fee related to your business. The personal portion of legal fees for producing or collecting taxable income, doing or keeping your job, or for tax advice may be deductible on Schedule A (Form 1040) if you itemize deductions. See Publication 529, *Miscellaneous Deductions*.

Tax preparation fees. You can deduct as a trade or business expense the cost of preparing that part of your tax return relating to your business as a sole proprietor. The remaining cost may be deductible on Schedule A (Form 1040) if you itemize deductions.

You can also take a business deduction for the amount you pay or incur in resolving asserted tax deficiencies against your business as a sole proprietor.

Samples and promotional items. You can deduct the cost of samples you give to your customers and the cost of promotional items such as posters. You cannot deduct the cost of any samples you use personally.

Service charges. You can deduct service charges you pay on orders for goods. The service charge can be a flat charge or it can be based on other criteria.

Supplies. Unless you have deducted the cost in any earlier year, you generally can deduct the cost of materials and supplies actually consumed and used during the tax year.

If you keep incidental materials and supplies on hand, you can deduct the cost of the incidental materials and supplies you bought during the tax year if all three of the following requirements are met.

- You do not keep a record of when they are used.
- You do not take an inventory of the amount on hand at the beginning and end of the tax year.
- Your taxable income is clearly reflected by this method.

Business Use of Your Home

Many direct sellers work out of their homes and have business expenses for using their homes. You can deduct expenses for using your home if you meet certain tests.

Qualifying for a Deduction

To deduct expenses related to the business use of part of your home, you must meet the following tests. Even if you meet the tests, your deduction may be limited. See *Deduction limit*, later.

1. Your use of the business part of your home must be:
 - a. Exclusive (however, see *Exception under Exclusive use*, later),
 - b. Regular,
 - c. For your trade or business, AND
2. The business part of your home must be **one** of the following:
 - a. Your principal place of business (defined later),
 - b. A place where you meet or deal with clients or customers in the normal course of your trade or business, or
 - c. A separate structure (not attached to your home) used in connection with your trade or business.

Exclusive use. Exclusive use means you use a specific part of your home solely for carrying on your direct-selling business. You do **not** meet the exclusive use test if you use the area in question for your direct-selling business and that same part for personal purposes.

Example. You use a den in your home to write orders and do the paperwork for your business. The den also is used by your children to do their homework. You cannot claim any business deduction for the use of the room.

Exception. If you use part of your home for the storage of inventory or product samples, you can claim expenses for the business use of your home without meeting the exclusive use test. However, you must meet all the following tests.

- You keep the inventory or product samples in your home for use in your direct-selling business.
- Your home is the **only** fixed location of your business.
- You use the storage space on a regular basis.
- The space you use is separately identifiable and suitable for storage.

Example. Your home is the only fixed location of your business. You regularly use half your basement for storing inventory as well as for personal purposes. You can deduct the expenses for the storage space even though this part of your basement is not used exclusively for business.

Regular use. Regular use means you use a specific part of your home for business on a continuing basis. Occasional or incidental business use of part of your home does not meet the

regular use test even if you do not use that part for any other purpose.

Principal place of business. Your home office will qualify as a principal place of business if you meet **both** the following requirements.

- You use it exclusively and regularly for the administrative or management activities of your trade or business.
- You have no other fixed location where you conduct substantial administrative or management activities of your trade or business.

Alternatively, if you do business at more than one location and your home office does not qualify as your principal place of business based on these rules, you determine your principal place of business based on the following factors.

1. The relative importance of the activities performed at each location.
2. The time spent at each location if the relative importance factor does not determine your principal place of business.

Place to meet clients or customers. If you meet with clients or customers in your home in the normal course of your direct selling business, even though you also carry on business at another location, you can deduct your expenses for the part of your home used exclusively and regularly for business if **both** the following apply.

- You physically meet with clients or customers on your premises.
- Their use of your home is substantial and integral to the conduct of your business.

You do not qualify to deduct expenses for the business use of your home if you have only occasional meetings or telephone calls.

Separate structure. You can deduct the expenses for a separate free-standing structure, such as a studio, garage, or barn, if you use it exclusively and regularly for your business. This structure does not have to be your principal place of business or a place where you meet clients or customers.

Deduction limit. If the gross income from the business use of your home equals or exceeds your total business expenses (including depreciation), you can deduct all your business expenses related to the use of your home. If your gross income from the business use of your home is less than your total business expenses, your deduction for certain expenses for the business use of your home is limited.

Where to deduct. If you qualify to deduct expenses for the business use of your home, you must figure your deduction on Form 8829 and attach it to Form 1040. You deduct the expenses on Schedule C (Form 1040).

More information. For more information, including how to figure the deduction, see Publication 587.

Travel and Transportation

Travel expenses generally are those business-related expenses for trips that require you to sleep or rest while traveling away from your **tax home**, explained later, for substantially longer than an ordinary day's work—for example, the cost of travel to a distant city to attend a business-related function or convention. Transportation expenses generally are those business-related expenses for trips you make in the area of your tax home—for example, the cost of transportation to call on customers or make deliveries in the city where you work and its suburbs.

You must be able to prove your expenses for travel and transportation. Deductions for travel and transportation are looked at closely when the IRS examines returns. For more information, see *Recordkeeping*, later.

Travel

Generally, your **tax home** is your regular place of business or post of duty, regardless of where you maintain your family home.

If you temporarily travel away from your tax home on business, you generally can deduct your ordinary and necessary travel expenses. You cannot deduct lavish or extravagant expenses or those for personal or vacation purposes.

You can deduct all your ordinary and necessary travel expenses, subject to certain limits, discussed later, if your trip was entirely business related. This includes expenses for attending a seminar, meeting, convention, or other function if you can show that your attendance benefits your business. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a nonbusiness side trip, or had other nonbusiness activities, you can deduct only your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example. You live in and conduct your direct selling business from Atlanta and take a business trip to New Orleans. On your way home, you stop in Mobile to visit your parents. You spend \$830 for the 9 days you are away from home for transportation, meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been \$730. You can deduct \$730 for your trip, including the cost of round-trip transportation to and from New Orleans. The cost of your meals is subject to the 50% limit on meals explained later.

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

For more information, see Publication 463.

Transportation

You can deduct transportation expenses for your business when you are not traveling away from home. Transportation expenses include the costs of getting from one workplace to another in the course of your business when traveling within the city or general area that is your tax home, and of getting from your home to a temporary work location. They also include the following kinds of trips you make in the area where you live and work.

- Visiting clients or customers.
- Attending business meetings away from your workplace.

Transportation expenses include train, bus, and cab fares, car rental fees, and the cost of driving and maintaining your car for business transportation. Meals and lodging are not included in transportation expenses.

Commuting expenses. You cannot deduct the cost of transportation between your home and your main or regular place of work. The cost of commuting is a nondeductible personal expense, regardless of the distance or whether work is performed during the trip.

Example. Elaine works full time as a bank teller. She also sells cosmetics part time to her co-workers at the bank. After her customers select items from a catalog, she sends the orders to the cosmetics company. She delivers the items to the bank when she receives them from the company.

Elaine's expense of delivering items is not deductible. Her cost of getting to the bank is a commuting expense. The fact that she carries cosmetics does not make her commuting expense a deductible business expense.

Two places of work. If you work at two places in one day, you can deduct the expense of getting from one workplace to the other. However, if you do not go directly from one location to the other, deduct only the amount it would have cost you to go directly from the first location to the second.

Deductible expenses. If you use your vehicle in your business, see Publication 463 for information on how to figure your expenses for business transportation.

Meals and Entertainment

Because you are in the selling business, you may take business associates to lunch or otherwise entertain them. The cost can be a deductible business expense. However, certain conditions must be met before you can take a deduction for business meals and entertainment, and you generally can deduct only 50% of the cost. This section discusses those rules.

Meals. Include as meals the amounts spent on food and beverages and the taxes and tips on those amounts. Generally, no deduction is allowed for an entertainment-related meal unless you or your employee is present when the food or beverages are provided.

Entertainment. Include as entertainment any activity generally considered to provide entertainment, amusement, or recreation. This includes entertaining guests at nightclubs; at social, athletic, and sporting clubs; at theaters; at sporting events; on yachts; and on hunting, fishing, and vacation trips or on similar outings. It can also include meeting your customers' personal, living, or family needs, such as providing meals, a hotel suite, or a car. However, see *Not directly related*, later.

Directly Related or Associated

To be deductible, meal and entertainment expenses must be ordinary and necessary expenses of carrying on your direct-selling business and you must be able to prove them as explained later under *Proving Your Deductions*. Unless certain exceptions apply, you must be able to show that entertainment expenses (including expenses for entertainment-related meals) are **directly related** to or **associated** with the active conduct of your business.

For more information, see chapter 2 of Publication 463.

Directly related. For entertainment expenses to meet the directly-related test, **all** the following must apply.

- You had more than a general expectation of getting income or some other specific business benefit from the expense.
- You engaged in business with the person during the entertainment period.
- The main purpose of the combined business and entertainment was the active conduct of business.



You do not have to show that business income or another business benefit actually resulted from each entertainment expense.

It is not necessary to devote more time to business than to the entertainment. However, if the business discussion is only incidental to the entertainment, it does not qualify as directly related.

Example. You are a direct seller of women's cosmetics. A state women's organization is holding its annual convention in a local hotel and you decide to display your products in a hospitality room in the hotel. You also provide entertainment and give out product samples. You can deduct the cost of the hospitality room and entertainment provided.

Not directly related. Generally, expenses are not directly related if you are not there, or there are substantial distractions that prevent you from actively conducting business. The following are situations where there are substantial distractions.

1. A meeting or discussion at a nightclub, theater, or sporting event.
2. A meeting or discussion during what is essentially a social gathering, such as a cocktail party.

3. A meeting with a group that includes persons who are not business associates at places such as cocktail lounges, country clubs, golf clubs, athletic clubs, or vacation resorts.

You may prove the entertainment is directly related by clearly establishing you had a substantial business discussion during the entertainment.

When entertainment takes place on a hunting or fishing trip, or on a yacht or pleasure boat, the conduct of business is not considered the main reason for the combined business and entertainment unless you clearly show otherwise.

Associated. You can deduct entertainment expenses (including expenses for entertainment-related meals) that do not meet the directly-related test if both the following apply.

- The expenses are associated with your direct-selling business.
- The entertainment is directly before or after a substantial business discussion.

An ordinary and necessary entertainment expense is generally associated with your direct-selling business if you can show you had a clear business purpose for the expense. The purpose may be to get new business or to encourage the continuation of an existing business relationship.

Substantial business discussion. Whether a business discussion is substantial depends upon the facts and circumstances in each case. You must show that you actively engaged in a discussion, meeting, negotiation, or other business transaction to get income for your business or another specific business benefit.

The meeting does not have to be for a specified length of time. However, you must show that the business discussion was substantial in relation to the entertainment. It is not necessary to devote more time to business than to the entertainment and you do not have to discuss business during the meal or entertainment.

Business and nonbusiness guests. You must divide your entertainment expenses between business and nonbusiness expenses. You can deduct only the business part. If you cannot establish the part of the expense for each person participating, you can allocate the expense to each participant on a pro rata basis. For example, if you entertain a group of 11 (including yourself)—three business prospects and seven social guests—deduct only four-elevenths of the expense.

Expenses for spouses. You generally cannot deduct the cost of entertainment for your spouse or for the spouse of a business customer. However, you can deduct these costs if you can show that you had a clear business purpose, rather than a personal or social purpose, for providing the entertainment.

Example. You entertain a business customer. The cost is an ordinary and necessary business expense and is allowed under the entertainment rules. The customer's spouse joins you because it is impractical to entertain the customer without the spouse. You can deduct

the cost of entertaining the customer's spouse as an ordinary and necessary business expense. Furthermore, if your spouse joins the party because the customer's spouse is present, the cost of the entertainment for your spouse also is deductible as an ordinary and necessary business expense.

Lavish or extravagant expenses. You cannot deduct expenses for meals and entertainment to the extent they are lavish or extravagant. An expense is not considered lavish or extravagant if it is reasonable considering the facts and circumstances. Expenses will not be disallowed merely because they are more than a fixed dollar amount or take place at a deluxe restaurant, hotel, nightclub, or resort.

Your meals. Generally, you can deduct your business meal expenses while traveling away from home for business (other than lavish or extravagant amounts). However, if you entertain a business customer locally and the conditions discussed earlier are met, the cost of your own meal is deductible only to the extent the cost exceeds the amount you would normally have spent for personal purposes.

Limit

You usually can deduct only 50% of your unreimbursed business-related meal and entertainment expenses. The 50% limit applies, for example, to expenses you incur while traveling away from home on business (whether eating alone or with others), entertaining business customers at your place of business or a restaurant, or attending a business function, convention, or reception.

Taxes and tips related to a business meal or entertainment activity are included in the amount subject to the 50% limit. Expenses such as cover charges to a nightclub, rent for a room where you hold a dinner or cocktail party, or the amount paid for parking at a sports arena are subject to the 50% limit. However, the cost of transportation to and from an otherwise allowable business meal or entertainment activity is not subject to the 50% limit.

If you have one expense that includes the costs of meals, entertainment, and other services (such as lodging or transportation), you must reasonably allocate the expense between the cost of meals and entertainment and the cost of other services. For example, you must make an allocation if a hotel includes one or more meals in its room charge.

Apply the 50% limit after figuring the amount that would otherwise qualify for a deduction. First determine the amount of meal and entertainment expenses that would be deductible under the rules discussed earlier. Then apply the 50% limit to figure the deductible amount.

Example. You spend \$100 for a business-related meal. If \$40 of that amount is not allowable because it is lavish and extravagant, the remaining \$60 is subject to the 50% limit. You cannot deduct more than \$30 (50% of \$60).

Exceptions to the 50% limit are discussed in Publication 463.

Business Gifts

Giving prizes, awards, and gifts may be an ordinary and necessary part of doing business as a direct seller. In each of the following situations you can deduct the cost as a business expense.

Situation 1. You do your direct selling on the sales party plan. As an incentive for people to host your parties, you offer them a variety of gifts. The choice of gift depends on the success of the party—the higher the volume of sales, the more valuable the gift.

In this situation, your gift to the host or hostess is actually payment for hosting the party, and the host or hostess must report the fair market value of the gift as income.

You can deduct the cost of the gift. If you give hosts and hostesses items from your inventory or items you purchase from the company at the same time you purchase goods you sell, their cost will be included in the cost of goods sold. You cannot deduct their cost again as a business expense. However, if you purchase the gifts separately from the goods you sell, deduct their cost as an ordinary and necessary business expense.

Situation 2. You have several direct sellers working under you. Because your income depends in part on their sales, you regularly meet with them, encourage them, and provide them with incentives and support. As an incentive to make sales, you sometimes offer a prize, such as an evening on the town or tickets to a sporting event, to the person who sells the most during the month.

In this situation, the prizes you give are actually payments for the winners' selling efforts. You can deduct the cost of the prizes as ordinary and necessary business expenses. The direct sellers who receive your incentive prizes must report them as income at their fair market value. For more information, see *Other Income*, earlier.

Situation 3. You sell cosmetics door-to-door. To spur sales, you often give away small samples.

In this situation, you can deduct the cost of the samples. If you purchase samples separately from the products you sell, you can deduct their cost as an ordinary and necessary business expense.

Do not deduct the cost of the same item twice. If the item was included in inventory, you cannot later deduct it as a business expense. The item will already be part of the cost of goods sold.

Gift limit. You cannot deduct more than \$25 for business gifts you give directly or indirectly to any one person during the year (see the exceptions discussed later). Personal gifts are not deductible.

Figuring the limit. A gift to the spouse (or family member) of a customer is generally considered an indirect gift to the customer. However, if you have bona fide independent business connections with the spouse (or family member) and the gift is not intended for the customer's eventual use, this rule does not apply.

If you and your spouse both give gifts, you are treated as one taxpayer for the \$25 limit. It does not matter whether you have separate

businesses or independent connections with the recipient.

Incidental cost. Costs that do not add substantial value to a gift, such as engraving on jewelry, packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the \$25 limit. For example, the cost of gift wrapping is considered an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not considered an incidental cost if the basket's value is substantial in relation to the value of the fruit.

Exceptions. The following items are not included in the \$25 limit for business gifts.

- Items that cost \$4 or less, on which your business name is clearly and permanently imprinted, and which are part of a number of identical items you widely distribute. This includes such items as pens, desk sets, and plastic bags and cases.
- Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or entertainment will generally be considered entertainment and not subject to the \$25 limit. However, if you give a customer packaged food or beverages to be used later, they are gifts.

If you provide business associates with tickets to a theater performance or a sporting event and you do not accompany them, you may treat the tickets as either a gift or entertainment, whichever is to your advantage. However, if you go to the event with them, you must treat the cost of the tickets as an entertainment expense.

Not-for-Profit Limit

If you do not carry on your direct-selling activity to make a profit, there is a limit on the deductions you can take. If the not-for-profit limits apply, you cannot use a loss from direct selling to offset any other income.

This limit applies, for example, if you go into direct selling primarily for the business deductions you can take. It also applies if you become a direct seller only so you and your friends can buy products at reduced rates.

If the not-for-profit limit applies, you can take the deductions allowed only if you itemize them on Schedule A (Form 1040). See *Limit on Deductions and Losses* under *Not-for-Profit Activities* in chapter 1 of Publication 535 for information on how to figure your allowable deductions. Do not use a business tax return, such as Schedule C (Form 1040).

Not for profit. In deciding whether your direct selling is carried on for profit, take into account all facts about the activity. No one factor alone is decisive. The following are factors to consider.

- Whether you carry on your direct selling in a businesslike manner and maintain complete and accurate books and records.
- Whether the time and effort you put into direct selling indicates you intend to make it profitable.

- Whether you are depending on income from direct selling for your livelihood.
- Whether your losses are due to circumstances beyond your control (or are normal in the start-up phase of direct selling).
- Whether you change your methods of operation in an attempt to improve profitability.
- Whether you, or your advisors, have the knowledge needed to carry on direct selling as a successful business.
- Whether you were successful in making a profit in similar activities in the past.
- Whether your direct selling makes a profit in some years, and how much profit it makes.
- Whether you can expect to make a future profit from the appreciation of the assets used in your direct-selling business.

If the IRS inquires about your tax return, you may be asked to provide proof that your direct-selling activity is carried on for profit. However, your direct selling is presumed to be carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year, unless the IRS establishes otherwise.

If you are starting a business and do not have 3 years showing a profit, you may want to elect to have the presumption made after you have the 5 years of experience allowed by the test. For more information on postponing any determination that your direct selling is not carried on for profit, see *Using the presumption later* under *Not-for-Profit Activities* in chapter 1 of Publication 535.

Recordkeeping



You must keep records to correctly figure your taxes. Your records must be permanent, accurate, complete, and clearly establish your income, deductions, and credits. The law does not require you to keep records in any particular way. But if you have more than one business, you should keep a complete and separate set of books and records for each business.

Publication 583 provides information about setting up a recordkeeping system, the types of books and records included in a typical system for a small business, and sample records.

Publication 463 provides information on the records to keep if you use your car in your business.

The following are suggestions for keeping adequate business records.

- **Keep a business bank account.** Deposit all business receipts in a separate bank account. Make all payments by check, if possible. Then business income and business expenses will be well documented.
- **Make a record.** Record all your business transactions in separate account books and keep a monthly summary of your business income and expenses.

- **Keep your records.** You must keep your business books and records available at all times for inspection by the IRS. You must keep the records as long as they may be needed in the administration of any Internal Revenue law. You should also keep copies of your tax returns to help prepare future returns or file claims for refunds.
- **Support your entries.** File cancelled checks, paid bills, duplicate deposit slips, and other items that support entries in your books and on your tax return in an orderly manner and store them in a safe place. For instance, organize them by year and type of expense.

If you cannot provide a cancelled check to prove payment of an expense item, you may be able to prove it with certain financial account statements prepared by financial institutions. These include account statements prepared for the financial institutions by a third party. These account statements must be highly legible. The following table lists acceptable account statements.

IF payment is by...	THEN the statement must show the...
Check	<ul style="list-style-type: none"> • Check number. • Amount. • Payee's name. • Date the check amount was posted to the account by the financial institution.
Electronic funds transfer	<ul style="list-style-type: none"> • Amount transferred. • Payee's name. • Date the transfer was posted to the account by the financial institution.
Credit card	<ul style="list-style-type: none"> • Amount charged. • Payee's name. • Transaction date.



Proof of payment alone does not establish that you are entitled to a tax deduction. You should also keep other documents as discussed in Proving Your Deductions, next.

Proving Your Deductions

The IRS may ask you to prove your deductions for business expenses.

Travel Expenses

For travel expenses, you must be able to prove the following items.

- Each separate amount you spent for travel away from home, such as the cost of your transportation or lodging. A receipt, bill, or other documentary evidence generally is required for all lodging expenses. You can total the daily cost of your breakfast, lunch, dinner, and other incidental travel

costs if they are listed in reasonable categories, such as meals, gas and oil, and taxi fares.

- The dates you left and returned home for each trip, and the number of days spent on business while traveling away from home.
- The destination or area of your travel, described by the name of the city or town.
- The business reasons for your travel or the business benefit you gained or expected to gain from it.

Entertainment Expenses

For entertainment expenses, including expenses for entertainment-related meals, you must be able to prove the following.

1. The amount of each separate entertainment expense. You can total incidental expenses, such as taxi fares and telephone calls, on a daily basis.
2. The date the entertainment took place.
3. The name and address or location of the place of entertainment. Include the type of entertainment, such as dinner or the theater, if the information is not clear from the name or designation of the place.
4. The occupation or other information about the persons for whom you are claiming an entertainment expense. Include their names, titles, or other information sufficient to establish their business relationship to you.
5. The business reason for the entertainment or the business benefit you gained or expected to gain from it and the nature of any business discussion or activity that took place.
6. The presence of you or your employee if the entertainment was a business meal given for a client.

Business discussion. If the entertainment took place before or after a substantial and bona fide business discussion, in addition to the information in (1), (2), (3), (4), and (6) above, you must be able to prove the following.

- The date, place, and duration of the business discussion.
- The nature of the business discussion.
- The business reason for the entertainment or the business benefit you gained or expected to gain from entertaining.
- The identification of the persons who participated in both the business discussion and the entertainment activity.

Business relationship. If you entertain a readily identifiable group of people, you do not have to record the name of each person. It is enough to designate the group. For example, if you entertain all the members of a garden club, an entry such as “members of the Hillcrest Garden Club” is enough.

Gift Expenses

For gift expenses, you must be able to prove the following.

- The cost of the gift.
- The date you gave the gift.
- A description of the gift.
- Your reason for giving the gift or any business benefit you gained (or expected to gain) from giving it.
- The occupation or other information about the person receiving the gift, including name, title, or other information establishing a business relationship to you.

The name of each recipient of a business gift does not always have to be recorded. A general listing will be enough if it is evident that you are not trying to avoid the \$25 annual limit on the deduction for gifts to any one person. For example, if you buy a large number of tickets to local high school basketball games and give one or two tickets to each of many customers, it is usually enough to record a general description of the recipients.

Records

You should keep proof of travel, meal, entertainment, and gift expenses in an account book, diary, statement of expense, or similar record. You should also keep adequate documentary evidence to support each element of an expense.

You do not have to record information shown on a receipt if your records and receipts complement each other in an orderly manner.

Keep your records up to date. Record your expenses in your account book at or near the time of the expense. Entries made later, when you may not remember them accurately, do not have as much value as entries made at or near the time of the expense.

Separating expenses. Usually, each separate payment you make must be recorded as a separate expense. For example, if you entertain someone at dinner and then go to the theater, the dinner expense and the cost of the theater tickets are separate expenses. You must record them separately in your records.

Expenses of a similar nature occurring during the course of a single event will be considered a single expense. For example, if during entertainment at a cocktail lounge you pay separately for each serving of refreshments, treat the total expense for the refreshments as a single expense.

Some items can be totaled in categories. You can make one daily entry for such categories as taxi fares, telephone calls away from home, gas and oil, and other incidental travel costs. Meals should be a separate category. Include tips for meal-related services with the costs of the meals.

Documentary evidence. A receipt or bill is often the best evidence to prove the amount of an expense. Documentary evidence is needed for all your lodging expenses unless, under an accountable plan, your employer pays you a per diem reimbursement of no more than the government rate in effect at that time and in that area. It is also generally needed for any other expense of \$75 or more.

Documentary evidence will ordinarily be considered adequate if it shows the amount, date, place, and essential character of the expense. For example, a hotel receipt is enough to support expenses for business travel if it has the name and location of the hotel, the dates you stayed there, and separate amounts for charges such as lodging, meals, and telephone calls. A restaurant receipt is enough to prove an expense for a business meal if it has the name and location of the restaurant, the number of people served, and the date and amount of the expense. If a charge is made for items other than meals and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, usually establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show a business purpose.

Incomplete records. If you do not have adequate records to prove an element of an expense, you must prove the element by providing both of the following.

- Your own statement, whether written or oral, containing specific information about the element.
- Other supporting evidence sufficient to establish the element.

Additional proof. You may be required to provide additional information to the IRS to clarify or establish the accuracy or reliability of the information in your records, statements, testimony, or documentary evidence.

Sample Filled-In Forms

This section will familiarize you with Schedule C (Form 1040), used to report business income or loss, and Schedule SE (Form 1040), used to figure self-employment tax. The line numbers in bold type follow the line numbers on the form being discussed.

Schedule C

If you are the sole owner of an unincorporated trade or business, report business income and expenses on Schedule C (Form 1040) or Schedule C-EZ (Form 1040). If you and your spouse each own one separate business, file a separate Schedule C or C-EZ for each business. If a person, as a sole owner, has more than one business, that person must file a Schedule C for each separate business.

Samples of Schedule C and Schedule SE for Kathleen Woods are illustrated on the following pages. (Amounts have been rounded to the nearest dollar.)

Kathleen Woods is a secretary for a small firm. She reports her salary of \$25,000 on line 7 of Form 1040.

Kathleen is also a direct seller of household cleaning products manufactured and distributed by Spotless, Inc. She reports the income and expenses of her selling business on Schedule C because she is self-employed.

Kathleen uses the cash method of accounting and files her return on a calendar-year basis. She has no employees and does not keep an inventory of the products she sells. Any products ordered for personal use are not shown in purchases, sales, cost of goods sold, or inventory.

Kathleen's customers select the products they want from a catalog listing retail prices for each item. She places an order with Spotless every 10 days, at which time she also pays for her prior order. She receives the items ordered with an invoice payable within 10 days or, if sooner, with the next order. When she delivers the merchandise, she collects the retail (catalog) price for each item. She can get full credit for any items returned to Spotless within 10 days.

Kathleen's cost for each item is 65% of the retail price. During 2003, she had total retail sales of \$14,600. She paid Spotless \$9,490 for the merchandise she received in 2003. She also received an award of \$200 in January for having over \$20,000 in total sales in 2002.

Lines 1–3. Kathleen reports \$14,600 as her gross sales on line 1. On line 2, she would enter any refunds she had to give on merchandise, as well as adjustments made to customers' purchases. Since she has no entry on line 2, she enters \$14,600 on line 3.

Line 4. Kathleen uses Part III to figure her cost of goods sold for the year. She has no inventory at the beginning or end of the year. Therefore, she has no entry on line 35 or line 41 of Part III. She purchased \$10,000 worth of household products during 2003 for \$9,490. (She received trade discounts of \$510.) She enters her net cost of \$9,490 (\$10,000 – \$510) on line 36. She also enters this amount on lines 40 and 42 of Part III and on line 4 of Part I.

Line 5. Gross profit, \$5,110, is the difference between Kathleen's net receipts of \$14,600 on line 3 and the cost of goods sold of \$9,490 on line 4.

Line 6. Kathleen reports the \$200 received as a bonus on line 6. She does not include on Schedule C any income not related to her direct-selling business, such as income from investments or her salary. She reports such income on other lines of Form 1040.

Line 7. Kathleen's gross income from direct selling is \$5,310, the sum of her gross profit of \$5,110 on line 5 and the bonus of \$200 on line 6.

Line 8. Kathleen gave her customers samples that cost \$48. This amount was not included in the cost of goods sold on line 4.

Line 9. Kathleen's business mileage was 2,100 miles, and her total 2003 mileage was 6,000 miles. She used her car 35% for business. She uses the standard mileage rate to figure the deduction of \$756 (2,100 × .36).

Kathleen must also complete Part IV of Schedule C.

Line 16b. \$280 is 35% of the total interest of \$800 paid during the year on Kathleen's car loan.

Line 18. Kathleen spent \$260 for various office supplies and postage for her direct-selling business.

Line 22. Kathleen paid \$392 in 2003 for order blanks, bags, and miscellaneous selling supplies.

Line 23. \$168 is 35% of the personal property tax of \$480 Kathleen paid on her car in 2003.

Line 24. Kathleen attended two direct-selling seminars during 2003. Her travel expenses, including lodging, were \$515, which she entered on line 24a. Her meals and entertainment, subject to the 50% limit, were \$200 and were entered on line 24b. The nondeductible amount of \$100 is shown on line 24c and the net deduction of \$100 is shown on line 24d.

Line 25. Kathleen uses her second telephone 100% for business purposes. She paid \$264 for local service on her second phone and \$62 for long-distance calls. She enters the total of \$326 on this line. She has no deduction for other utilities because she does not use any part of her home exclusively for business.

Line 27. This line is for other direct-selling expenses not listed separately on the schedule. These expenses are listed in Part V on page 2. Kathleen paid \$35 to her bank for check printing and account charges for her separate business bank account. She paid membership dues of \$30 to a local business association and \$38 for a 1-year subscription to a retail sales magazine. She enters these expenses, along with the \$199 she paid for catalogs, in Part V. She totals the expenses, \$302, on line 48 and enters the total on line 27.

Line 28. Kathleen adds all her business deductions listed on lines 8 through 27 and enters the total of \$3,147 on this line.

Line 29. Kathleen subtracts her total deductions on line 28 from her Schedule C gross income on line 7. Because her gross business income is greater than her total deductions, she has a tentative profit of \$2,163.

Line 30. Kathleen did not use any part of her home for business, so she does not make an entry here.

Line 31. Kathleen has a net profit of \$2,163 (line 29 – line 30). She enters her net profit here, on line 12 of Form 1040, and on line 2, Section A of Schedule SE (Form 1040).

Line 32. Kathleen does not have a loss, so she skips this line. If she had a loss and was not **at risk** for all her investment in the business, she would have to attach Form 6198. See the Schedule C instructions for the meaning of **at risk**.

Short Schedule SE

Kathleen uses Short Schedule SE (Form 1040), because her net earnings from self-employment are more than \$400 and the total of her net earnings plus her wages subject to social security and Medicare taxes (FICA) are not more than \$87,000.

Line 2. Kathleen enters \$2,163, the amount from line 31 of Schedule C (Form 1040).

Line 3. Kathleen enters the amount from line 2, \$2,163.

Line 4. Kathleen multiplies her net profit by .9235 and enters the result, \$1,998.

Line 5. Kathleen multiplies \$1,998 (line 4) by .153 and enters \$306 as her self-employment tax. She also enters this amount on line 55 of Form 1040.

Line 6. Kathleen enters one-half of the amount from line 5. She also enters this amount on line 28 of Form 1040 as an adjustment to income.

**SCHEDULE C
(Form 1040)**

Department of the Treasury
Internal Revenue Service

Profit or Loss From Business

(Sole Proprietorship)

► Partnerships, joint ventures, etc., must file Form 1065 or 1065-B.
► Attach to Form 1040 or 1041. ► See Instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2003

Attachment
Sequence No. **09**

Name of proprietor Kathleen Woods Social security number (SSN) 123 00 6789

A Principal business or profession, including product or service (see page C-2 of the instructions) Sales -- Household Cleaning Products **B** Enter code from pages C-7, 8, & 9 4 5 4 3 9 0

C Business name. If no separate business name, leave blank. **D** Employer ID number (EIN), if any

E Business address (including suite or room no.) ► 1111 Lake Forest Ave., Hometown, VA 22315
City, town or post office, state, and ZIP code

F Accounting method: (1) Cash (2) Accrual (3) Other (specify) ►

G Did you "materially participate" in the operation of this business during 2003? If "No," see page C-3 for limit on losses Yes No

H If you started or acquired this business during 2003, check here

Part I Income

1 Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-3 and check here <input type="checkbox"/>	1	14,600	
2 Returns and allowances	2		
3 Subtract line 2 from line 1	3	14,600	
4 Cost of goods sold (from line 42 on page 2)	4	9,490	
5 Gross profit. Subtract line 4 from line 3	5	5,110	
6 Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6	200	
7 Gross income. Add lines 5 and 6	7	5,310	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising	8	48		19 Pension and profit-sharing plans	19		
9 Car and truck expenses (see page C-3)	9	756		20 Rent or lease (see page C-5):	20		
10 Commissions and fees	10			a Vehicles, machinery, and equipment	20a		
11 Contract labor (see page C-4)	11			b Other business property	20b		
12 Depletion	12			21 Repairs and maintenance	21		
13 Depreciation and section 179 expense deduction (not included in Part III) (see page C-4)	13			22 Supplies (not included in Part III)	22	392	
14 Employee benefit programs (other than on line 19)	14			23 Taxes and licenses	23	168	
15 Insurance (other than health)	15			24 Travel, meals, and entertainment:	24		
16 Interest:				a Travel	24a	515	
a Mortgage (paid to banks, etc.)	16a			b Meals and entertainment		200	
b Other	16b	280		c Enter nondeductible amount included on line 24b (see page C-5)		100	
17 Legal and professional services	17			d Subtract line 24c from line 24b	24d	100	
18 Office expense	18	260		25 Utilities	25	326	
28 Total expenses before expenses for business use of home. Add lines 8 through 27 in columns	28			26 Wages (less employment credits)	26		
29 Tentative profit (loss). Subtract line 28 from line 7	29			27 Other expenses (from line 48 on page 2)	27	302	
30 Expenses for business use of your home. Attach Form 8829	30			28	28	3,147	
31 Net profit or (loss). Subtract line 30 from line 29.	31			29	29	2,163	
<ul style="list-style-type: none"> • If a profit, enter on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If a loss, you must go to line 32. 				30	30		
32 If you have a loss, check the box that describes your investment in this activity (see page C-6).				31	31	2,163	
<ul style="list-style-type: none"> • If you checked 32a, enter the loss on Form 1040, line 12, and also on Schedule SE, line 2 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • If you checked 32b, you must attach Form 6198. 				32a	32a		<input type="checkbox"/> All investment is at risk.
				32b	32b		<input type="checkbox"/> Some investment is not at risk.

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11334P

Schedule C (Form 1040) 2003

Part III Cost of Goods Sold (see page C-6)

33 Method(s) used to value closing inventory: a Cost b Lower of cost or market c Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation Yes No

35 Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35		
36 Purchases less cost of items withdrawn for personal use . . . \$10,000 - \$510 (Trade Discounts)	36	9,490	
37 Cost of labor. Do not include any amounts paid to yourself	37		
38 Materials and supplies	38		
39 Other costs	39		
40 Add lines 35 through 39	40	9,490	
41 Inventory at end of year	41		
42 Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	9,490	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-4 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 6 / 1 / 01

44 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:

a Business 2,100 b Commuting c Other 3,900

45 Do you (or your spouse) have another vehicle available for personal use? Yes No

46 Was your vehicle available for personal use during off-duty hours? Yes No

47a Do you have evidence to support your deduction? Yes No

b If "Yes," is the evidence written? Yes No

Part V Other Expenses. List below business expenses not included on lines 8-26 or line 30.

Bank Service Charges		35	
Dues		30	
Publications		38	
Catalogs		199	
48 Total other expenses. Enter here and on page 1, line 27	48	302	

SCHEDULE SE
(Form 1040)

Department of the Treasury
Internal Revenue Service

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074

2003

Attachment
Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)

Kathleen Woods

Social security number of person
with **self-employment** income ▶

123 : 00 : 6789

Who Must File Schedule SE

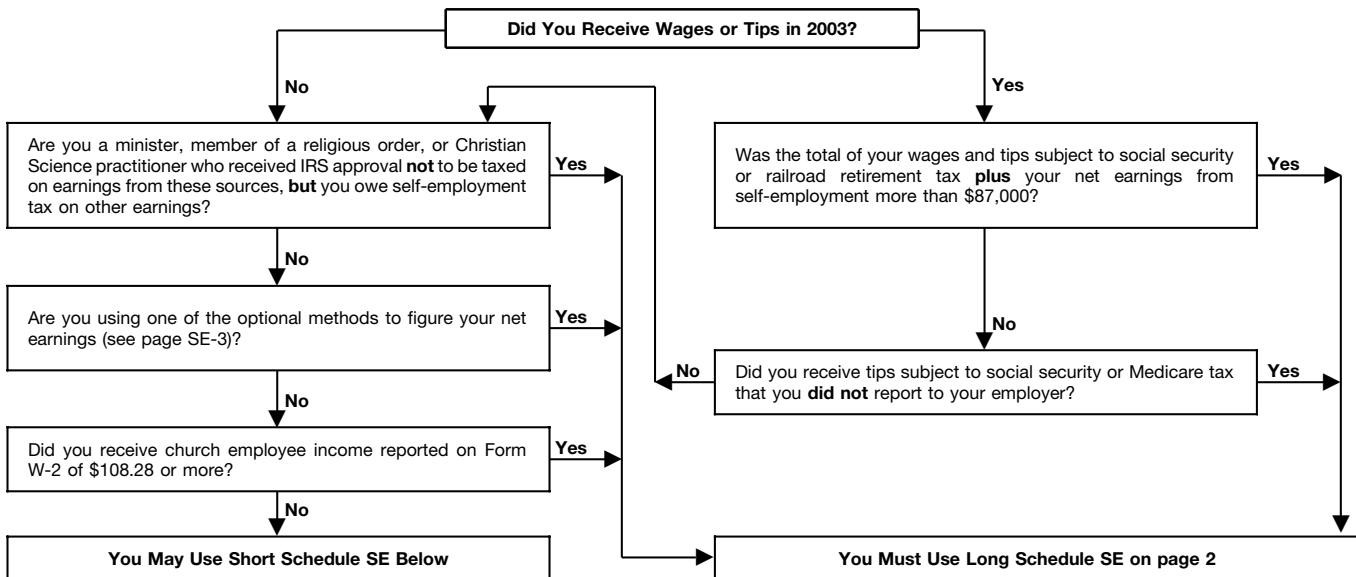
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-3).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 55.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	2,163	
3 Combine lines 1 and 2	3	2,163	
4 Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ▶	4	1,998	
5 Self-employment tax. If the amount on line 4 is: • \$87,000 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 55. • More than \$87,000, multiply line 4 by 2.9% (.029). Then, add \$10,788.00 to the result. Enter the total here and on Form 1040, line 55.	5	306	
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 28.	6		153

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 2003

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.


The Taxpayer Advocate independently represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate toll free at **1-877-777-4778**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.
- Visit the website at **www.irs.gov/advocate**.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services.

 **Internet.** You can access the IRS website 24 hours a day, 7 days a week, at **www.irs.gov** to:

- **E-file.** Access commercial tax preparation and e-file services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on "Where's My Refund." Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products online.
- See answers to frequently asked tax questions.
- Search publications online by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.

- Send us comments or request help by email.
- Sign up to receive local and national tax news by email.
- Get information on starting and operating a small business.

You can also reach us using File Transfer Protocol at **ftp.irs.gov**.



Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703-368-9694** from your fax machine. When you order forms, enter the catalog number for the form you need.

For help with transmission problems, call **703-487-4608**.

Long-distance charges may apply.



Phone. Many services are available by phone.

- **Ordering forms, instructions, and publications.** Call **1-800-829-3676** to order forms, instructions, and publications. You should receive your order within 10 days.
- **Asking tax questions.** Call the IRS with your tax questions at **1-800-829-4933**.
- **Solving problems.** You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."
- **TTY/TDD equipment.** If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax or account questions or to order forms and publications.
- **TeleTax topics.** Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.
- **Refund information.** If you would like to check the status of your 2003 refund, call **1-800-829-4477** for automated refund information and follow the recorded instructions or call **1-800-829-1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- **Products.** You can walk in to many post offices, libraries, and IRS offices to pick up

certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county government offices, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs.

- **Services.** You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Use the address that applies to your part of the country.

- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current-year forms, instructions, and publications.
- Prior-year forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.

Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at **www.irs.gov/cdorders** for \$22 (no handling fee) or call **1-877-233-6767** toll free to buy the CD-ROM for \$22 (plus a \$5 handling fee). The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide*, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer. It is available in early April. You can get a free copy by calling **1-800-829-3676** or by visiting the website at **www.irs.gov/smallbiz**.



To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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