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# Direct Sellers

For use in preparing  
**1996** Returns

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## Important Changes for 1996

**Business use of home.** For tax years starting after 1995, the exception to the exclusive use test for business-use-of-home expenses is expanded to include storage of product samples in addition to storage of inventory. See Use Tests under *Business Use of Your Home*, later.

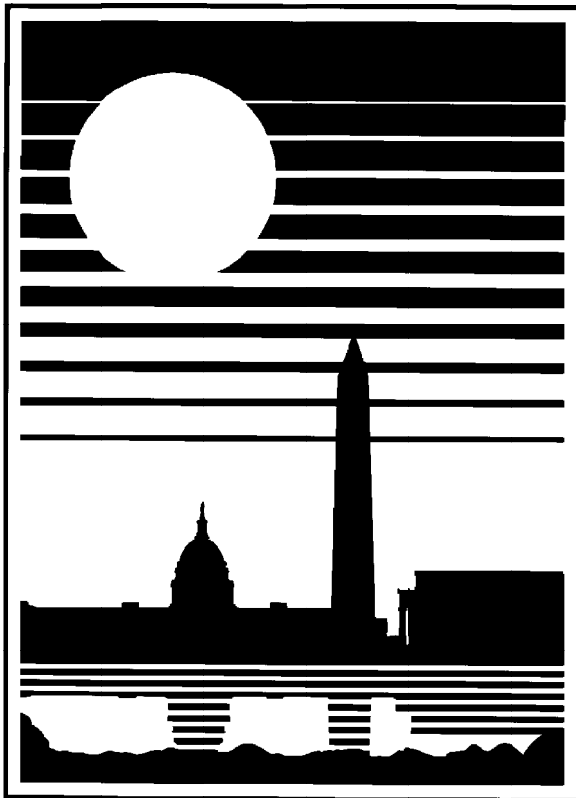
**Newspaper distributors and carriers.** Certain newspaper distributors and carriers are direct sellers for work performed after 1995. See Newspaper distributors and carriers under *Direct Sellers*, later.

**Individual Taxpayer Identification Number (ITIN).** The IRS will issue an ITIN to an alien who does not have and is not eligible to get a social security number (SSN). To apply for an ITIN, file Form W-7 with the IRS. It usually takes about 30 days to get an ITIN. Enter the ITIN wherever an SSN is requested on a tax return. If you must include another person's SSN on your return and that person does not have and cannot get an SSN, enter that person's ITIN.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

**Standard mileage rate.** The standard mileage rate for 1996 is 31 cents a mile for all business miles on a passenger automobile (including vans, pickups, or panel trucks).

**Substantiation requirements for travel and entertainment expenses.** The threshold for



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needing documentary evidence to substantiate travel and entertainment expenses other than lodging has increased from \$25 to \$75.

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## Introduction

This publication provides general tax information for direct sellers. It discusses the tax treatment of income, expenses, and other items related to your direct selling business.

This publication is not intended for the salesperson who works in a store, sells through a retail sales outlet, or sells the employer's product away from the employer's place of business.

## Useful Items

You may want to see:

### Publication

- 15** Circular E, Employer's Tax Guide
- 15A** Employer's Supplemental Tax Guide
- 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 More Information*, near the end of this publication for information about getting these publications and forms.

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## Direct Sellers

As a direct seller, you sell consumer products to others on a person-to-person basis, usually working out of your own home. You may sell door-to-door, through the sales party plan, or by appointment in someone else's home. Your customers may be coworkers, friends, relatives, or neighbors. You may sell on a regular basis or only occasionally. You may sell as full-time work or as a sideline to a regular job.

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

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

**Self-employed.** You are self-employed as a direct seller if you meet all of the following conditions:

- 1) You are engaged in the trade or business of selling or soliciting the sale of consumer products, either—
  - a) In a home or other place that is not a permanent retail establishment, or
  - b) To any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis for resale by the buyer or any other person in a home or other place that is not a permanent retail establishment.
- 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.

**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 if you attempt to increase the sales of direct sellers who work under you and your pay depends on how much they sell. Recruiting, motivating, and

training are examples of attempts to increase sales activities.

**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:

- 1) 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.
- 2) Your out-of-pocket party expenses are subject to the 50% limit for meal and entertainment expenses, discussed later. These expenses are deductible as miscellaneous itemized deductions subject to the 2% 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.

**Newspaper distributors and carriers.** You are a direct seller if:

- 1) You are in the business of delivering newspapers or shopping news, including directly related services such as soliciting customers and collecting receipts,
- 2) Substantially all your pay for these delivery services directly relates to sales or other output rather than to number of hours worked, and
- 3) You perform the delivery services under a written contract between you and the service recipient that provides you will not be treated as an employee for federal tax purposes.

This rule applies even if you hire others to help you make the deliveries. It also applies whether you buy the papers from the publisher or are paid based on the number of papers you deliver.

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## 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, get Publication 583.

## Employer Identification Number (EIN)

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

If you do not already have an EIN, you need to get one if you:

- 1) Have employees,
- 2) Have a Keogh plan,
- 3) Operate your business as a corporation or partnership, or
- 4) File any of these returns:
  - a) Employment.

- b) Excise.
- c) Alcohol, tobacco, and firearms.

Use Form SS-4 to apply for an EIN.

## Business Taxes

Three kinds of business taxes may apply to direct sellers:

- 1) Income tax.
- 2) Self-employment tax.
- 3) Employment taxes.

**Income tax.** Each business must file an annual income tax return. For example, if you operate your direct-selling business as a sole proprietor, you must file Schedule C (Form 1040) or C-EZ (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 the social security and Medicare tax for those who work for themselves. It is like the social security and Medicare taxes withheld from the pay of wage earners. You may have to pay this tax on income from direct selling if you are either the sole proprietor of your business or a partner in a partnership. Use Schedule SE (Form 1040) to figure and report self-employment tax. For more information on self-employment tax, see Publication 533.

**Employment taxes.** If you have employees in your business, you generally withhold and pay employment taxes. These taxes include:

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

For more information, see Publication 15.

**Other taxes.** For information on deducting personal property and other 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:

- 1) **Withholding.** If you are an employee, your employer probably withholds income tax from your pay. You can ask your employer to increase the amount withheld to cover the income both from your job and from direct selling.
- 2) **Estimated tax.** If you do not pay tax through withholding, or do not pay enough tax that way, you may have to pay estimated tax.

Estimated tax is used to pay both income and self-employment taxes (and certain other taxes and amounts reported on Form 1040). Estimated tax is discussed in Publication 505.

**\$500 minimum.** You do not have to pay estimated tax if your total expected taxes, minus any expected tax credits and withholding, will be less than \$500 for the year or you had zero tax liability last year.

**Form 1040-ES.** Use Form 1040-ES to figure your estimated tax and make estimated tax payments.

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

## Information Returns

If you have other direct sellers working under you and you sell \$5,000 or more in goods during the year to any one of those sellers, you must report the sales on an information return. The information return, Form 1099-MISC, must show the name, address, and identification number of the seller placing the orders. Check Box 9 of Form 1099-MISC to show these sales. Do not enter a dollar amount. You must give Copy B or a qualified statement (such as a letter showing this information along with commissions, prizes, awards, etc.) to the seller by January 31, 1997.

You must file Copy A of Form 1099-MISC with the Internal Revenue Service by February 28, 1997. Use Form 1096 to summarize and transmit Form 1099-MISC. See the instructions to Form 1096 for the address where you must file Form 1096 and the accompanying Forms 1099-MISC.

## Penalties

The law imposes penalties to ensure that all taxpayers pay their fair share of taxes. Some of these penalties are discussed below. If you do not file a return when required or you provide fraudulent information, you may be subject to a civil fraud penalty. In certain cases, you may 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 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 be more than 25% of your tax, but it is reduced by the failure-to-pay penalty (discussed next) for any month both penalties apply. However, if your return is more than 60 days late, the penalty will not be less than \$100 or 100% of the tax balance, whichever is less. You will not have to pay the penalty if you can show reasonable cause for not filing on time.

**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 for tax 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 tax on time. This failure-to-pay penalty is in addition to the failure-to-file 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 shows an incorrect tax amount due to:

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

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

**Accuracy-related penalties.** An accuracy-related penalty of 20% applies to any underpayment due to:

- 1) Negligence or intentional disregard of rules or regulations, or
- 2) Substantial understatement of income tax.

This penalty also applies to conditions not discussed here.

Only one of these penalties can apply to an underpayment. Even though the same underpayment may be subject to both the negligence and substantial underpayment penalties, the total accuracy-related penalty cannot exceed 20% of the underpayment. Neither penalty may be imposed if there is reasonable cause accompanied by good faith.

**Negligence.** Negligence includes the lack of any reasonable attempt to comply with provisions of the Internal Revenue Code.

**Disregard.** Disregard includes 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 omitted amount exceeds the greater of:

- 1) 10% of the correct tax, or
- 2) \$5,000.

**Information reporting penalties.** Any person who does not file an information return or a complete and correct information return with the IRS by the due date is subject to a penalty for each failure. A penalty applies to information returns as follows:

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

Maximum limits apply to all these penalties.

**Failure to furnish correct payee statements.** Any person who does not provide a taxpayer with a complete and correct copy of an information return (payee statement) by the due date is subject to a penalty of \$50 for each statement. If the failure is due to intentional disregard of the requirement, the penalty is the greater of:

- 1) \$100 per statement, or
- 2) 10% or 5% (depending on the type of statement) of the amount to be shown on the statement.

**Identification numbers and other information.** Any person who does not comply with other specified reporting requirements, including the use of correct identification numbers (employer identification numbers and social security numbers), is subject to a penalty of \$50 for each failure. This includes failures to:

- 1) Use correct identification numbers for yourself, your spouse, and your dependents on returns and statements.
- 2) Use correct identification numbers for other taxpayers where required.
- 3) Supply correct identification numbers when required by another taxpayer, such as a bank.

## Accounting Periods and Methods

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

### Accounting Periods

You must figure your taxable income and file a federal income tax return on the basis of an annual accounting period called a "tax year." The accounting periods you may use are:

**A calendar year** which begins on January 1 and ends on December 31, or

**A fiscal year** (including a period of 52 or 53 weeks). A regular fiscal year is 12 months in a row ending on the last day of any month except December.

You establish a tax year when you file your first income tax return. If you filed your first return as a wage earner using the calendar year, you must use the calendar year as your business tax year. You cannot change your tax year without the consent of the IRS. For more information, get Publication 538.

### Accounting Methods

An accounting method is a set of rules used to report income and deduct expenses. The two most common accounting methods are the cash method and an accrual method.

The text and examples in this publication generally assume that you use the calendar year as your tax year and either the cash method or a hybrid method (a combination of cash and accrual) as your accounting method. If inventories are needed to account for your

income, you must use an accrual method, discussed later, for your sales and purchases. If you use a fiscal year or an accrual method, you must make adjustments. For more information on accounting methods, get 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 you incurred them in an earlier year.

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

**Accrual method.** Generally, you report an item of income in the tax year when all events have happened 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 you become liable for them, whether or not you pay them in the same year.

**Prepaid expenses.** Expenses paid in advance can be deducted only in the year to which they apply under either the cash or an accrual method. For example, suppose you have a subscription to a direct-selling journal that runs out at the end of 1996. 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 1996. You cannot deduct the \$54 on your 1996 return, even if you use the cash method of accounting. However, you can deduct half of the \$54 in 1997 and the other half in 1998.

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## Business Income

You must report on your tax return all income you receive as a direct seller. This income includes any of the following:

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

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 your customers buy their products from a company, you, as the sales agent, do not have any income from sales. You will generally receive a commission for making the sale, but

will have no direct income from the sale itself. In that case, the rules in this section do not apply to you. Report your commissions as other business income. For more information, see *Other Income*, later.

**Example 1.** Your customers pay you the retail price for goods they order. You send the orders and payments to a company. The company sends the merchandise to fill the orders. The company also sends your share of the retail price.

You are acting as a sales agent for the company. You did not purchase the products you sold to your customers. Your payment from the company is a commission, not income from sales. Include the commissions in the gross receipts of your business. Do not include the full amount your customers pay for the goods they order.

**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 customers. The customers pay the company the rest of the retail price (usually cash on delivery).

You are acting as a sales agent for the company. The deposit is your commission. 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 a company (or from a direct seller you work under). You either send the money for the goods 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. You have income from sales to report on your return.

**Example 4.** You keep a supply of goods 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 specifically ask for them.

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

## Gross Profit on Sales

Gross receipts minus cost of goods sold equals gross profit for the year.

If you have income from sales, 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 business receipts you report on your return.
- 2) Next, 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 your tax return.
- 3) Finally, subtract the cost of the goods you sold. To figure the cost of goods sold, you

must know the value of the inventory of goods you had 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 the cost of goods sold during the year, follow these steps:

- 1) Start with the value of your inventory at the beginning of your tax year. This should be 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, but it can include the cost of merchandise you use to demonstrate your product line. See *Demonstrators* under *Capital Expenses*, later.
- 3) Subtract from this total your inventory at the end of the year. The difference is your cost of goods sold during the year.

**Example 1.** Janet Smith sells cookware on the sales-party plan. On December 31, 1995, she did not have any cookware on hand that she would sell, or had sold, to customers. However, she did have items of cookware that she used in demonstrations. The cost of these demonstrators was \$80. She does not have a beginning inventory for 1996.

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 personal use. She purchased \$5,100 [\$5,270 – (\$130 + \$40)] worth of goods to sell to customers.

On December 31, 1996, Janet had only one demonstrator set on hand. She also had several sets of cookware in boxes awaiting 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 1996 is \$4,880 (\$0 beginning inventory + \$5,100 purchases – \$220 ending inventory).

**Example 2.** Lisa Marie 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 an extra quantity for future sales. She had merchandise costing \$200 on hand at the end of 1995 (which would be her beginning inventory for 1996) and merchandise costing \$175 at the end of 1996. She figures her cost of goods sold for 1996 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 .....	<u>200</u> <u>3,000</u>
Goods available for sale .....	\$3,200
Subtract: Ending inventory.....	<u>175</u>
<b>Cost of goods sold</b>	<b><u>\$3,025</u></b>

Lisa figures her gross profit by subtracting the cost of goods sold from her gross receipts for the year as follows:

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

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

Figure your purchases at the actual price you pay. If you receive a **trade discount**, use it to figure your purchases, not the stated selling price. A trade discount is the difference between the stated selling price and the actual price you have to pay.

**Purchase returns and allowances.** You must 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 selling price. It also includes any credit you received for merchandise you returned.

**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 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.

## Inventory

Many direct sellers have little or no inventory. Others keep a considerable inventory of goods on hand. In either case, if you have income from sales, you should know how to figure your inventory at the end of each tax 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 ending inventory of the year before. 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 you have title to at the end of the year. This will generally be any goods you have on hand and have not yet sold to customers.

Include merchandise you have purchased, even if you have not yet physically received it. You may also have title to goods that were shipped to you but not yet received. If the risk of loss during shipment is yours, you 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 not yet paid for. If you are billed for merchandise that is sent to you, you must usually pay the bill within a certain time, whether or not you sell the goods. In this case, you have title to the goods and must include them in inventory if they are unsold or undelivered at 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 inventory items with their costs. The specific identification method is used when you can identify and match the actual cost of 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 or removed from inventory first.

**Valuing the inventory.** The third step in figuring your inventory is to value the items you have in inventory.

The two common methods to value non-LIFO inventory are the **cost method** and the **lower of cost or market method**.

**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, or other necessary charges in getting the items. Subtract discounts you received from the invoice price.

If any of the goods you have on hand at the end of the year were also in your inventory at the beginning of the year, they have the same value at the end of the year as they had at the beginning.

**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 consent from the IRS.

## Other Income

The full amount of everything you receive in your selling business is business income. You must report all business income on your tax return. Take no deduction from your income before entering it on the return.

### Commissions, bonuses, and percentages.

Many direct sellers receive a commission on their sales. 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.

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 usually can deduct the part you pay 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, you must report their full value as business income. Examples include:

- 1) Cash.
- 2) Free merchandise.
- 3) Expense-paid trips.
- 4) Use of a car.
- 5) Jewelry signifying your level of achievement as a direct seller.
- 6) Memberships in organizations or clubs.
- 7) Tickets to sports events, shows, or concerts.

**Value of goods or services received.** You must report income received in the form of goods or services at their “fair market value” on your tax return. Fair market value is the price agreed on between a buyer and a seller when both have all the necessary information 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, get Publication 463, *Travel, Entertainment, Gift, and Car Expenses*, and Publication 525, *Taxable and Nontaxable Income*.

## Capital Expenses

You must capitalize, rather than deduct, some costs. These costs are a part of your investment in your business and are called “capital expenses.”

Although you generally cannot directly deduct a capital expense, you may be able to take deductions for these costs as explained later under *Cost Recovery*.

## Kinds of Capital Expenses

You must capitalize the following costs:

- 1) **Going into business.** The costs of getting started in business, before you are authorized to start selling your company’s products, are all capital expenses. These 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.
- 2) **Business assets.** The cost of any asset (property) that will last for more than one year is a capital expense. Examples of business assets include: office furniture, business vehicles, and storage shelves.
- 3) **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, maintenance and repair costs, such as tune-ups, new headlights, or brake repairs, are business expenses. The cost of overhauling the engine, however, is 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 her 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 the 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 deductions 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.

**One year or less of use.** If you have a product that 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. See *Business Expenses*, later.

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

**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 her personal use. She subtracts the cost of the item from her purchases for the year, as discussed 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. If someone wants a book, he takes a deposit and delivers the book at a later time.

Because his product line changes little from year to year, 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*. Unlike him, 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” your cost for capital expenses—subtract them from income—over a number of years. This is done by deducting each year a part of the basis (usually your cost) using depreciation or amortization. Depreciation is used to recover capital expenses

for most tangible business assets. Amortization is used to recover only certain kinds of capital expenses, including business start-up costs. Amortization is discussed in chapter 12 of Publication 535, Business Expenses.

If you choose, you can treat a limited amount of the cost of certain qualifying property as a current expense rather than a capital expense. This choice is called the "section 179 deduction."

**Form 4562.** Generally, use Form 4562 to report depreciation, amortization, and the section 179 deduction. Form 4562 is illustrated in an example in Publication 946, How To Depreciate Property.

## Section 179 Deduction

You can choose to treat all or part of the cost of certain qualifying property as a current expense rather than as a capital expense. If you make the choice, you can deduct a limited amount of the cost of qualifying property you buy for use in your direct selling business only in the first year you place the property in service.

**Placed in service.** Property is placed in service when it is first ready and available for a specific use. When property is placed in service is important for both the section 179 deduction and depreciation.

**Qualifying property.** Qualifying property includes tangible personal property for which depreciation or amortization is allowable.

**Maximum dollar limit.** The total cost you can choose to deduct for the tax year cannot exceed \$17,500.

If the total cost of qualifying property is less than \$17,500, your section 179 deduction is limited to the cost of the qualifying property placed in service in the tax year.

**Example.** You buy one item of qualifying property in 1996 for \$900. Your section 179 deduction for 1996 is limited to \$900.



*The maximum amount you can take as a section 179 deduction increases to \$18,000 for tax year 1997. This amount increases further for each later year until it reaches \$25,000 for tax year 2003.*

**Taxable income limit.** The total cost that can be deducted in each year is limited to the taxable income from the active conduct of any trade or business during the tax year.

For more information, get Publication 946, How To Depreciate Property.

## Depreciation

If you do not choose a section 179 deduction or you choose a section 179 deduction and do not deduct part of your cost, you can take a depreciation deduction for part or all of the cost you did not deduct as a section 179 deduction.

Property for which you can recover the cost through depreciation is called depreciable property. Depreciable property may be tangible or intangible.

- 1) Tangible property is any property that can be seen or touched and includes both real and personal property.
  - a) Real property is land and generally anything that is built on, growing on, or attached to land. However, land itself is never depreciable.
  - b) Personal property is property that is not real estate, such as a car, truck, or office equipment.
- 2) Intangible property is property such as a copyright or franchise.

Property is depreciable if it meets these requirements:

- 1) It is used in business or held for the production of income (for example, to earn rent or royalty income) for more than one year.
- 2) It is something that wears out, decays, gets used up, becomes obsolete, or loses value from natural causes.
- 3) It has a determinable useful life longer than one year.

In general, if property does not meet all of these requirements, it is not depreciable.

The modified accelerated cost recovery system (MACRS) is the depreciation system that must be used for most tangible depreciable assets placed in service after 1986.

For more information about depreciation, get Publication 946. It contains a detailed discussion of MACRS and its depreciation methods.

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## Business Expenses

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

You must keep business expenses separate from personal expenses. If you have an expense that is partly for business and partly personal, you can deduct only the business part.

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

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

## Salaries and Wages

The reasonable salaries, wages, and other forms of compensation you pay to your employees for their services are deductible business expenses.

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, get Publications 15 and 535.

## Taxes

You can deduct as business expenses various federal, state, and local taxes for your direct-selling business. Some of these taxes are discussed under *Business Taxes*, earlier, and others are discussed below.

**Income taxes.** You cannot deduct any income taxes as business expenses. However, you can deduct state and local income taxes as personal expenses if you itemize deductions on Schedule A (Form 1040). You cannot deduct federal income taxes at all.

**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 also may deduct as a business expense 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, the sales tax is added to the basis for depreciation. Get Publication 551 for information on the basis of property.

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. These taxes are not included 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 itself and are not deducted as a separate item.

## Interest

Interest is the amount you pay to use borrowed money. You can generally deduct as a business expense all interest you pay or accrue in the tax year on a debt related to your business. To take the deduction, you must have a true obligation to pay a fixed or determinable sum of money.

No deduction is allowed for interest paid or accrued on personal loans. If a loan is part business and part personal, you must divide the interest between the personal part and the business part. For more information, see chapter 8 in Publication 535.

**Example.** During the tax year, you paid \$600 interest on a car loan and used the car 60% for business and 40% for personal purposes. You are claiming actual expenses on the car. You can only deduct \$360 (60% of \$600) as a business expense on your Schedule C (Form 1040) or Schedule C—EZ (Form 1040). The remaining interest of \$240 is a non-deductible personal expense.

## Insurance

You generally can deduct premiums you pay for the following kinds of insurance related to your trade or business:

- 1) Fire, theft, flood, or similar insurance.
- 2) Merchandise and inventory insurance.
- 3) Car and truck insurance that covers vehicles used in your business if you do not use the standard mileage rate to figure your car expenses.
- 4) Credit insurance to cover losses from unpaid debts.
- 5) Liability insurance that covers your liability for bodily injuries suffered by persons who are not your employees and for property damage to others.
- 6) Use and occupancy and business interruption insurance. This insurance pays you 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 10 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, you can deduct only the part that pays for business coverage. For example, if you use your car 25% in your direct-selling business and 75% for personal transportation, you can deduct only 25% of your car insurance premiums.

**When to deduct.** Under the cash method of accounting, premiums are not deductible until paid. If you wait until a later tax year to pay an insurance premium due in an earlier year, you cannot deduct the premium until the year you pay it.

Otherwise, premiums are ordinarily deductible only in the tax year to which they apply. If you make an advance payment on an insurance policy that covers more than one tax year, you can only deduct the part that buys insurance for the current tax year. You must wait until the next year to deduct the part that buys insurance for that year, and so on.

**Example.** You are a direct seller. In June 1996, you pay \$1,200 in premiums for merchandise insurance effective July 1996 through June 1998 (\$50 per month). You can deduct \$300 in 1996 ( $\$50 \times 6$  months), \$600 in 1997 ( $\$50 \times 12$  months), and \$300 in 1998.

**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, you must report all or part of the dividend as business income on your return. For more information, see *Recovery of amount deducted* in chapter 1 of Publication 535.

## Telephone

You can deduct the cost of business telephone calls made on your own phone, including:

- 1) Business calls on a second line.
- 2) Long-distance business calls on any phone.
- 3) A pro-rata portion (the business part) of special services on any line.
- 4) A pro-rata portion (the business part) of basic local services on a second line.

You cannot deduct any charges (including taxes) for basic local services on the first telephone line in your home.

**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, federal excise tax, etc., 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 too.

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.

**Business licenses.** License fees and regulatory fees paid each year to state and local governments are generally deductible business expenses.

**Catalogs.** The cost of catalogs you keep and 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 useful in your selling business for a 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 the amount you pay. Report the full amount of any commissions you receive as business income, and deduct the commissions you pay out 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 take a section 179 deduction, depreciation, or both, if more than 50% of its use is in your business. For more information, see chapter 4, *Listed Property*, in Publication 946.

**Home meetings.** If you have business meetings in your home, you can deduct your expenses for the meeting only when they meet certain tests:

- 1) The expenses of entertaining business associates in your home are deductible



only if they meet the tests discussed under *Meals and Entertainment*, later, and only if you can prove your expenses as discussed under *Recordkeeping*, later.

- 2) The expenses of maintaining your home as a place of business are deductible only 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 *Limit*, under the section, *Meals and Entertainment*, later. 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.

**Membership fees or club dues.** 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 business, social, athletic, luncheon, sporting, airline, and hotel clubs.

**Exception.** 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, the following organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose:

- 1) Boards of trade,
- 2) Business leagues,
- 3) Chambers of commerce,
- 4) Civic or public service organizations,
- 5) Professional associations, and
- 6) Trade associations.

**Legal and professional fees.** You can deduct as a business expense professional fees, such as fees charged by accountants, that are directly related to your business and are ordinary and necessary in the operation of your business. However, if the charges include payments for work of a personal nature (such as making out a will), you can deduct only the part of the fee related to your business as a business expense.

**Tax return preparation fees.** You can deduct as a business expense on Schedule C (Form

1040) or Schedule C-EZ (Form 1040) the cost of preparing that part of your tax return relating to your business as a sole proprietor. You can deduct the remaining cost on Schedule A (Form 1040) if you itemize your deductions.

You also can take a business deduction on Schedule C or Schedule C-EZ for the amount you pay or incur in resolving asserted tax deficiencies for 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 based on the amount you order or on the number of customers for whom you order.

**Supplies.** You can deduct the cost of order forms, bags, business cards, and other supplies you use in your business. However, if you stock supplies to be used largely in later tax years, you can deduct only the cost of supplies you use during the current year. You must wait until the years you actually use the supplies to deduct the rest of their cost.

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:

- 1) You do not keep a record of when they are used,
- 2) You do not take an inventory of the amount on hand at the beginning and end of the tax year, and
- 3) This method does not distort your income.

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## Business Use of Your Home

Most direct sellers work out of their own homes and have business expenses for using their homes. However, you cannot deduct any expenses for using your home in business unless you meet the use tests discussed in this section.

If you use part of your home for your trade or business and can deduct the expenses on Schedule C (Form 1040) or Schedule C-EZ (Form 1040), you must figure your deduction on Form 8829 and attach it to Form 1040. For more information, get Publication 587.

### Use Tests

You can take a limited deduction for the business use of your home **only** if you use a specific part of it both **exclusively** and **regularly**:

- 1) As the principal place of business for your direct-selling business, or

- 2) As a place of business where you meet or deal with customers or clients in the normal course of your direct-selling business, or
- 3) In connection with your direct-selling business, if the structure is not attached to your home.

**Regular use.** "Regular use" means that 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.

**Exclusive use.** "Exclusive use" means that you use a specific part of your home only for carrying on your direct-selling business. If you use part of your home as your business office and also for a study, guest room, or other personal purpose, you have not met the exclusive use test.

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

**Exception.** There is an exception to the exclusive use test if you use part of your home for storing inventory or product samples (or both). You can deduct expenses from using part of your home for storing inventory or product samples or if you meet all the following tests.

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

If your storage space meets these tests, it does not matter whether you use it exclusively for business.

**Example.** Your home is the sole fixed location for your business of selling cookware. You regularly use half your basement for storing inventory and occasionally for personal purposes. You can deduct your expenses for the storage space even though this part of your basement is not used exclusively for business.

**Separate structures.** 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 business. This structure does not have to be your principal place of business or a place where you meet clients or customers.

For more information, including how to figure your deduction, see *Deduction Limit* in Publication 587.

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## Travel and Transportation

Transportation refers to trips you make in the area where you live and work—for example, transportation to call on customers or make deliveries in your city and its suburbs. In contrast, travel refers to trips you take to places where you need to spend the night away from home—for example, travel to a distant city to attend a convention.

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

If you travel away from home on business, you can deduct your ordinary and necessary travel expenses. However, you cannot deduct lavish or extravagant expenses or those for personal or vacation purposes. For more information, get Publication 463.

### Transportation

You can deduct transportation expenses for your business. Generally, business transportation is traveling between two or more workplaces in the same day or between your home and a temporary work location. It includes trips you make in the area where you live and work to:

- 1) Call on customers.
- 2) Make deliveries.
- 3) Pick up goods.
- 4) Attend business meetings.

Transportation expenses can 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 Eden works full time as a bank teller. She also sells cosmetics part time to her coworkers 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 a day, you can deduct the expense of getting from one to the other. However, if for some personal reason you do not go directly from one location to the other, you can 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, get Publication 463 for information on how to figure your expenses for business transportation.

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## Meals and Entertainment

Because you are in the selling business, you may take business associates to lunch or entertain them. The cost can be a deductible business expense. However, there are certain conditions that must be met before you can take a deduction for business meals and entertainment. This section discusses these rules. There are also certain records you must keep. For more information, see *Recordkeeping*, later.

**Meals.** Include as meals amounts spent on food, beverages, and the taxes and tips on those meals. Generally, no deduction is allowed 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; social, athletic, and sporting clubs; theaters; sporting events; on yachts; and on hunting, fishing, and vacation trips or on similar outings. It can also include meeting personal, living, or family needs, such as furnishing a hotel suite or a car to business customers or their families. However, see *Not directly related*, later, for more information.

### 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 they are:

- 1) Directly related to the active conduct of your business, or
- 2) Associated with the active conduct of your business.

For more information, see *Exceptions to the 50% Limit* in chapter 2 of Publication 463.

**Directly related.** For meal and entertainment expenses to meet the directly related test, all of the following must apply:

- 1) You had more than a general expectation of getting income or some other specific business benefit from the expense.
- 2) You engaged in business with the person during the meal or entertainment period.

- 3) The main purpose of the combined business and meal or entertainment was the active conduct of business.

You do not have to show that business income or another business benefit actually resulted.

It is not necessary to devote more time to business than to the meal or entertainment. However, if the business discussion is only incidental to the meal or 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 there is little or no possibility that you will actively conduct business. Examples are:

- 1) Meetings at nightclubs, theaters, or sporting events.
- 2) Meetings at essentially social gatherings, such as cocktail parties.
- 3) Meetings with a group that includes people who are not business associates at a place such as a cocktail lounge, country club, athletic club, or resort.

You may prove that the meal or entertainment is directly related by showing that you did have a substantial business discussion during the meal or entertainment.

When meals and entertainment take 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 show otherwise. Even if you show that business was the main reason, you generally cannot deduct expenses for the use of an entertainment facility. For more information, see *Entertainment facilities* in Publication 463.

**Associated.** You can deduct meal and entertainment expenses that do not meet the directly related test if they are:

- 1) Associated with your direct-selling business, and
- 2) The meal or entertainment is directly before or after a substantial business discussion.

A meal or entertainment expense is generally associated with your direct-selling business if you can show that 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 on all the facts 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 other 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 meal or entertainment. It is not necessary to devote more time to business than to the meal or 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. For example, if you entertain a group of 11 (including yourself)—three business prospects and seven social guests—you can deduct only four-elevenths of the expense.

**Expenses for spouses.** You cannot deduct the cost of meals or entertainment for your spouse or the spouse of a business associate unless you can show a clear business purpose for providing the meal or entertainment.

**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.** You can generally deduct the cost of your own meals while entertaining for business purposes, if you do not claim deductions for substantial personal living expenses.

## 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 convention or reception. Exceptions to the 50% limit are discussed in Publication 463.

Taxes and tips related to a 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 a business meal or entertainment activity that is otherwise allowable is not subject to the 50% limit.

If you pay or have an expense for goods and services consisting of meals, entertainment, and other services (such as lodging or transportation), you must make a reasonable allocation of that 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).

## 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 three situations illustrated below, 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 should 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 along with 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 sports 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 deduct it as a business expense. The item will already be a part of the cost of goods sold.

**Gift limit.** Do not deduct more than \$25 for business gifts to any one person during the year (see the exceptions discussed later). You can deduct only business gifts. Personal gifts are not deductible.

**Figuring the limit.** A gift to the spouse of a person with whom you are doing business is considered a gift to that person. However, if you have independent business connections with both spouses, a gift to one spouse is generally not considered a gift to the other. It will, however, be considered an indirect gift to the other spouse if it is intended for that spouse’s eventual use or benefit. These rules also apply to gifts you give to any other family member of a person with whom you have a business connection.

If you and your spouse both give gifts, both of you are treated as one taxpayer. 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 considered gifts subject to the \$25 limit:

- 1) 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.
- 2) Signs, display racks, or other promotional material to be used on the business premises of the recipient.
- 3) “Gifts” that must be included in the income 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. You cannot use a loss from direct selling to offset any other income you have.

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

If the not-for-profit limit applies, you must take the deductions allowed 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 of the facts about the activity. No one factor alone is decisive. Among the factors to consider are:

- 1) Whether you carry on your direct selling in a businesslike manner.
- 2) Whether the time and effort you put into direct selling indicate that you intend to make it profitable.
- 3) Whether you are depending on income from direct selling for your livelihood.
- 4) Whether your losses are due to circumstances beyond your control (or are normal in the start-up phase of direct selling).
- 5) Whether you change your methods of operation in an attempt to improve profitability.
- 6) Whether you, or your advisors, have the knowledge needed to carry on direct selling as a successful business.
- 7) Whether you were successful in making a profit in similar activities in the past.
- 8) Whether your direct selling makes a profit in some years, and how much profit it makes.
- 9) Whether you can expect to make a future profit from the appreciation of the assets used in your direct selling business.

Your direct selling is presumed 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 to the contrary.

If you are starting a business and do not have 3 years showing a profit, you may want to take advantage of this presumption at a later time, such as after you have the 5 years of experience allowed by the test. For more information, see 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 both 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.
- **Support your entries.** File canceled checks, paid bills, duplicate deposit slips, and other items that support entries in your books in an orderly manner and store them in a safe place.

If you cannot provide a canceled check to prove payment of an expense item, you may be able to prove it with certain financial account statements. These statements must show either a check clearing, a credit card charge, or an electronic funds transfer. If the account statement shows a check clearing, it must indicate the check number, amount, payee's name, and the date the check amount was posted to the account. If the account statement shows a credit card charge, it must indicate the amount charged, payee's name, and the date charged. If the account statement shows an electronic funds transfer, it must indicate the amount transferred, the payee's name, and the date of transfer.

However, 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*, later.

- **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.

## 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:

- 1) 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.
- 2) The dates you left and returned home for each trip, and the number of days spent on business while traveling away from home.
- 3) The destination or area of your travel, described by the name of the city or town.
- 4) The business reasons for your travel or the business benefit you gained or expected to gain from it.

### Entertainment Expenses

For entertainment expenses, including entertainment-related meals, you must be able to prove:

- 1) The amount of each separate entertainment expense. You may 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 you went. Include the type of entertainment, such as dinner or theater, if the information is not clear from the name or designation of the place.
- 4) The occupation or other information about the people for whom you are claiming a meal or 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 at 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:

- 1) The date, place, and duration of the business discussion.
- 2) The nature of the business discussion.
- 3) The business reason for the meal or entertainment or the business benefit you

gained or expected to gain from entertaining.

- 4) The identification of the people 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:

- 1) The cost of the gift.
- 2) The date you gave the gift.
- 3) A description of the gift.
- 4) Your reason for giving the gift or any business benefit you gained (or expected to gain) from giving it.
- 5) 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 the 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 amount you can deduct 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 a number of customers, it is usually enough to record a general description of the recipients.

## Records

You should keep the proof you need for your travel, meal, entertainment, and gift expenses in an account book, diary, statement of expense, or similar record supported by adequate documentary evidence that together will support each element of an expense.

You do not have to record information in your account book that duplicates 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 with the costs of the services you received.

**Documentary evidence.** A receipt is often the best evidence to prove the amount of an expense. A receipt, bill, or other 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. 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 that it was for 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:

- 1) Your own statement, whether written or oral, containing specific information about the element, and
- 2) Other supporting evidence that is sufficient to establish the element.

**Additional proof.** You may have to provide to the IRS additional information to clarify or establish the accuracy or reliability of information contained 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, below, follow the line numbers on the form being discussed.

## Schedule C

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

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 \$15,000 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 1996, she had total retail sales of \$14,600. She paid Spotless \$9,490 for the merchandise she received in 1996. She also received an award of \$200 in January for having over \$20,000 in total sales in 1995.

**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 1996 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 this 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 10.** Kathleen's actual business mileage was 2,100 in 1996 and the total mileage in 1996 of her 1995 passenger car was 6,000 miles. She used her car 35% for business. She uses the standard mileage rate to figure the deduction of \$651 ( $2,100 \times .31$ ).

Kathleen must also complete Part IV of Schedule C.

**Line 16b.** This 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 1996 for order blanks, bags, and miscellaneous selling supplies.

**Line 23.** This is 35% of the personal property tax of \$480 Kathleen paid on her car in 1996.

**Line 24.** Kathleen attended two direct-selling seminars during 1996. 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 limit 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 installed for her business 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 other 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 \$30 to a local business association and \$38 for a one-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 \$3,042 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 \$2,268.

**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 \$2,268 (line 30 from line 29). 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 less than \$62,700.

**Line 2.** Kathleen enters \$2,268, the amount from line 31 of Schedule C (Form 1040).

**Line 3.** Kathleen enters the amount from line 2, \$2,268.

**Line 4.** Kathleen multiplies her net profit by .9235 and enters this amount, \$2,094.

**Line 5.** Kathleen multiplies \$2,094 (line 4) by .153 and enters \$320 as her self-employment tax. She also enters this amount on line 45 of Form 1040.

**Line 6.** Kathleen enters one-half of the amount from line 5. She also enters this amount on line 25 of Form 1040 as an adjustment to income.

**SCHEDULE C  
(Form 1040)**

**Profit or Loss From Business**

(Sole Proprietorship)

Partnerships, joint ventures, etc., must file Form 1065.

OMB No. 1546-0074

**1996**

Attachment  
Sequence No. 09

Department of the Treasury  
Internal Revenue Service (99)

Attach to Form 1040 or Form 1041. See instructions for Schedule C (Form 1040).

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

A Principal business or profession, including product or service (see page C-1): SALES - HOUSEHOLD CLEANING PRODUCTS B Enter principal business code (see page C-6) ▶ 131012

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.) ▶ 111 LAKEFOREST 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 1996? If "No," see page C-2 for limit on losses.  Yes  No

H If you started or acquired this business during 1996, 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-2 and check here	1	14,600
2	Returns and allowances	2	0
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-2)	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	Bad debts from sales or services (see page C-3)	9		20	Rent or lease (see page C-4):	20a	
10	Car and truck expenses (see page C-3)	10	651	a	Vehicles, machinery, and equipment	20b	
11	Commissions and fees	11		b	Other business property	21	
12	Depletion	12		21	Repairs and maintenance	22	392
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13		22	Supplies (not included in Part III)	23	168
14	Employee benefit programs (other than on line 19)	14		23	Taxes and licenses	24	
15	Insurance (other than health)	15		24	Travel, meals, and entertainment:	24a	515
16	Interest:			a	Travel		
a	Mortgage (paid to banks, etc.)	16a		b	Meals and entertainment		200
b	Other	16b	280	c	Enter 50% of line 24b subject to limitations (see page C-4)		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
26	Total expenses before expenses for business use of home. Add lines 8 through 27 in columns	26		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	3,042
31	Net profit or (loss). Subtract line 30 from line 29.	31		29		29	2,268
	• If a profit, enter on Form 1040, line 12, and ALSO on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.						
	• If a loss, you MUST go on to line 32.						
32	If you have a loss, check the box that describes your investment in this activity (see page C-5).						
	• If you checked 32a, enter the loss on Form 1040, line 12, and ALSO on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.						
	• If you checked 32b, you MUST attach Form 8198.						
		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) 1996

**Part III Cost of Goods Sold (see page C-5)**

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 <i>\$10,000 - \$510 (TRADE DISCOUNTS)</i>	36	9,490
37 Cost of labor. Do not include salary 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 10 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-3 to find out if you must file.**

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ *6.1.1995*

44 Of the total number of miles you drove your vehicle during 1996, enter the number of miles you used your vehicle for:

a Business *2,100*            b Commuting *2,400*            c Other *1,500*

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

46 Was your vehicle available for 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.**

<i>BANK SERVICE CHARGES</i>	35	
<i>DUES</i>	30	
<i>PUBLICATIONS</i>	38	
<i>CATALOGS</i>	199	
48 Total other expenses. Enter here and on page 1, line 27 . . . . .	48	302





**SCHEDULE SE  
(Form 1040)**

**Self-Employment Tax**

OMB No. 1545-0074

**1996**

Attachment  
Sequence No. 17

Department of the Treasury  
Internal Revenue Service (99)

▶ See Instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

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**

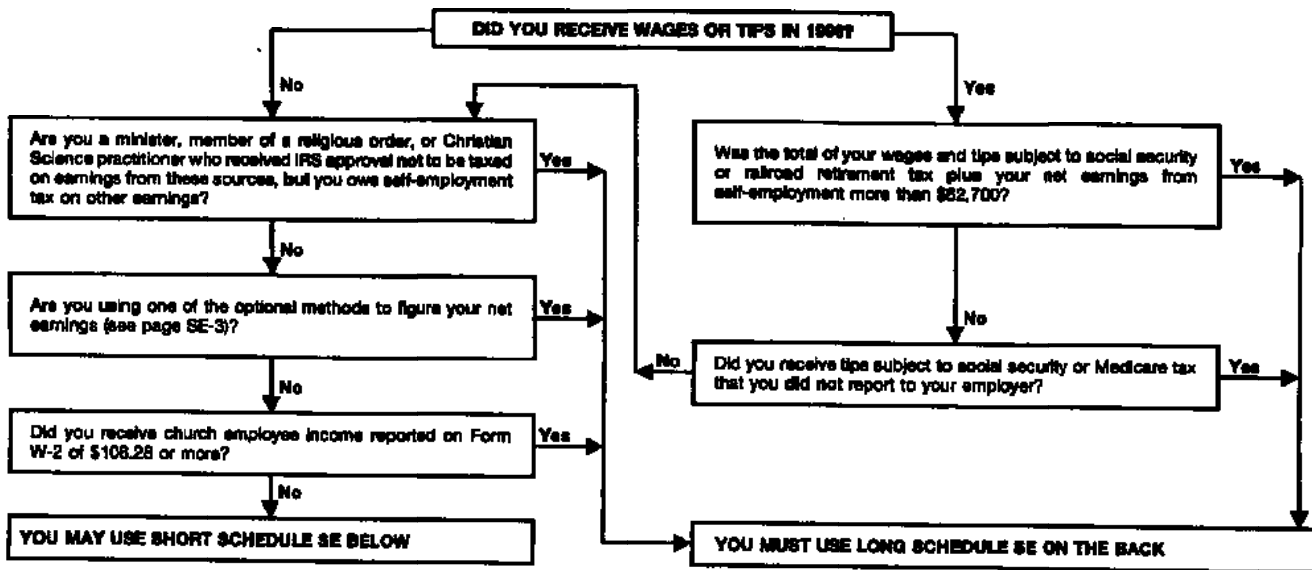
You must file Schedule SE if:

- 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 45.

**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 38, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1	
2	Net profit or (loss) from Schedule C, line 31; Schedule G-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). 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	2,268
3	Combine lines 1 and 2	3	2,268
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	2,094
5	Self-employment tax. If the amount on line 4 is: • \$82,700 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 45. • More than \$82,700, multiply line 4 by 2.9% (.029). Then, add \$7,774.80 to the result. Enter the total here and on Form 1040, line 45.	5	320
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25	6	160

For Paperwork Reduction Act Notice, see Form 1040 Instructions.

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## How To Get More Information



You can get help from the IRS in several ways.

**Free publications and forms.** To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details. If space permitted, this information is at the end of this publication.

**Tax questions.** You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number or you can call 1-800-829-1040.

**TTY/TDD equipment.** If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

