Tax Tips for Direct Sellers

Some people's income is based on their sales and not on the number of hours they work. They are known as direct sellers. Sometimes there is confusion regarding the special set of tax rules that applies to direct sellers.

Direct sellers include any of the following:

- A person who sells consumer products in the home or a place of business other than a permanent retail establishment,
- A person who sells consumer products on a deposit or commission basis, or to other persons who will sell the products in the home or place of business,
- A person who delivers and/or distributes newspapers or shopping guides.

Direct sellers have certain things in common. Their compensation is related to sales rather than to the number of hours worked. Services are performed under a written contract between the seller and the person for whom the seller performs the services.

And the contracts involved provide that sellers are not treated as employees for federal tax purposes.

Income Sources

The various forms of income a direct seller may need to report might include:

- Sales,
- Commissions, bonuses, or percentages of income received for sales and the sales of others who work for the seller,
- Prizes, awards, and gifts received from the selling business,
- Products received for meeting certain sales quotas.

A direct seller must include all income received on the tax return regardless of whether or not he or she received an information return, usually a Form 1099-MISC reporting that income. A seller who sells at least $5,000 in the aggregate of consumer products to a buyer for resale anywhere other than a permanent retail establishment is required to report the sale by checking item 9 on Form 1099-MISC.

Expense Issues

Direct sellers can generally deduct ordinary and necessary business expenses. However, start-up expenses are capital expenses and are not deductible unless the seller elects to deduct the expenses. The seller makes an election by attaching a statement to his or her income tax return prepared for the year the business begins and filed by the due date.

Start-up expenses may include the following costs: exploring different direct-selling opportunities; training to be a seller for a product line; fees paid to the company to become a direct seller; and purchasing a starter kit from the company.

Start-up expenses paid or incurred after Oct. 22, 2004, may be deductible the year the business begins by an amount equal to the lesser of:

- The amount of start-up expenses, or
- $5,000, reduced by the amount the start-up expenses exceed $50,000,
- The remainder of the expenses may be deducted ratably over the 180-month period beginning with the month the business begins.

Since direct sellers purchase and sell merchandise, inventories of products at the beginning and end of each taxable year are necessary to correctly reflect taxable income.

Products held in inventory include: merchandise with title vested in the seller; goods under contract for sale but not yet segregated and applied to the contract; and goods out on consignment.

Cost of Goods Sold

Generally, businesses that make or buy goods to sell may deduct the cost of goods sold from their gross receipts in computing business income. This information applies if the business is a manufacturer, wholesaler or retailer, or if engaged in any business that makes, buys or sells goods to produce income.

Businesses that must account for an inventory generally use an accrual method of accounting for income as well as expenses.

The following items need to be taken into consideration when computing COGS:

- Inventory at the beginning of the year
- Purchases less cost of items withdrawn for personal use
- Labor costs (generally applies to manufacturing and mining operations)
- Materials and supplies (generally a manufacturing cost)
- Other costs (generally applies to manufacturing and mining operations)
- Inventory at the end of the year

To gain a better understanding of COGS, each of these items is further clarified below.

Inventory at the Beginning of the Year

Beginning inventory is the cost of merchandise on hand at the beginning of the year that is available for sale to customers. A manufacturer or producer should include the total cost of raw materials, work in process, finished goods and materials and supplies used in manufacturing the goods as part of the beginning inventory amount.

Generally, the beginning inventory amount will be identical to the closing inventory of the prior year. If there is a difference between the ending inventory and beginning inventory, a statement explaining the difference must be included with the filed tax return.

Purchases Less Cost of Items Withdrawn for Personal Use

Businesses use the cost of all merchandise bought for sale to calculate purchases. For manufacturers or producers, this includes the cost of all raw materials or parts purchased for merchandise on hand at the beginning of the year manufactured into a finished product.

Trade discounts are the differences between the stated prices of articles and the actual prices paid. Businesses must use the prices paid (not the stated prices) in figuring cost of purchases. Do not show the discount amount separately as an item in gross income.

Cash discounts are amounts suppliers let businesses deduct from their purchase invoices for prompt payments. There are two methods of accounting for cash discounts. Businesses can either include them in a separate income account (added in as part of income) or deduct them from total purchases for the year. Whichever method is used, consistency is required.

Returns and allowances are amounts for items that are returned by customers to the business. These amounts should be deducted from total purchases during the year.

Merchandise withdrawn from sale for personal or family use should be deducted from the total amount of merchandise bought for sale. Deductions are not allowed for items used personally. Personal use items should be included under an account such as “withdrawal,” “drawing” or “personal.”

Labor Costs

Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold. Labor costs are usually an element of cost of goods sold only in a manufacturing or mining business. In a manufacturing business, labor costs properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, saleable product. Examples of indirect costs include:

- Rent on building used in manufacturing operation
- Depreciation of building/equipment
- Salaries for production supervisor and others indirectly involved
- Warehousing costs
- Bottling and packaging labor

Materials and Supplies

Include the cost of materials and supplies, such as hardware and chemicals, used directly or indirectly in manufacturing goods as part of cost of goods sold. Treat those materials and supplies not used in the manufacturing process as business expenses and deduct them as business expenses at the time of consumption.

Other Costs

Some examples of other costs incurred in a manufacturing or mining process charged to cost of goods sold are:

- Containers
- Freight-in
- Overhead expenses

Inventory at the End of the Year

Inventory at the end of the year is also known as closing or ending inventory. The ending inventory will usually become the beginning inventory for the next tax year.

Once ending inventory has been determined, cost of goods sold can be calculated as follows:

- Inventory at the beginning of the year
- Plus net purchases
- Plus cost of labor
- Plus materials and supplies
- Plus other costs
- Minus inventory at the end of the year
- Equals COGS

Cost of goods sold can be a complex calculation for any business. A formalized recordkeeping system, tax/accounting software programs and business use only bank accounts will assist in properly calculating cost of goods sold.

The IRS encourages businesses to establish reliable record keeping systems, accurately report all income, and properly compute cost of goods sold and other expenses. According to IRS research, the largest component of the tax gap comes from understated business income, including underreported receipts and overstated expenses. In addition to increasing outreach and education in these areas, the IRS will also be focusing enforcement efforts, including examinations, on these issues.