

 Fact Sheet

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Direct Sellers and the Tax Gap

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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.

This fact sheet, the seventeenth in the Tax Gap series, is designed to help direct sellers better understand the rules so they can get the most out of their deductions and pay their fair share of taxes.

The largest portion of the [tax gap](#), or the amount of tax that goes unpaid each year, results from taxpayers underreporting their taxable income. Most people want to pay their fair share of taxes, but many simply need a better understanding of their obligations.

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

Direct sellers report income on [Form 1040 Schedule C](#) or [C-EZ](#). 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.

(Start-up expense rules were amended in 2004. Expenses paid or incurred on or before Oct. 22, 2004, are treated differently.)

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.

Additional information on inventories and the cost of goods sold can be found in the second fact sheet of the series titled, [Cost of Goods Sold and the Tax Gap](#).

More information on reporting income and expenses can be found in [Publication 334, Tax Guide for Small Businesses](#).

