Audits of Direct Sellers

If you are a direct seller, the following industry specific audit procedures may be performed by the IRS in addition to the standard procedures performed during an audit of a retail business.

Direct Sellers

Introduction

Direct selling provides important benefits to individuals who desire an opportunity to earn an income and build a business of their own; to consumers who enjoy an alternative to shopping centers, department stores or the like; and to the consumer products market. It offers an alternative to traditional employment for those who desire a flexible income earning opportunity to supplement their household income, or whose responsibilities or circumstances do not allow for regular part-time or full-time employment.

The cost for an individual to start an independent direct selling business is typically very low (which is a major selling point for entering into this type of self-employment business). Usually, a modestly priced sales kit is all that is required for one to get started, and there is little or no required inventory or other cash commitments to begin. This stands in sharp contrast to franchise and other business investment opportunities that may require substantial expenditures and expose the investor to a significant risk of loss.

Types of Direct Selling Companies

There are two types of direct selling companies – single level marketing (SLM) or multilevel marketing (MLM). Single level marketing (SLM) companies reward direct sellers for their own personal sales activity. SLM direct sellers cannot take on other distributors or sales representatives. Income comes from commission or bonus on sales.

In a multi-level marketing company, sales representatives are able to sponsor other distributors or sales representatives and receive a commission or bonus on the sales made by their underlying resellers. This recruitment of down liners is necessary to increase a sales representative's sales force and thus generate a greater number of sales. MLM's are often referred to as network marketing companies.

Income Issues

Gross Receipts

In order to know how much commission a direct seller is earning the examiner must know when the direct seller is eligible for a commission. Each company has its own specific method of determining commissions. Some examples of when commissions are paid include:

- At the time the order is placed with the company for shipment,
- At a later specified date, even though the customer pays the full merchandise price upfront, and
- A portion of the commission is paid upfront and the remainder paid at a later specified date.

There are two ways that a direct seller can earn income/profits: They can sell the product and they can sponsor/recruit new representatives. Each company has its own set percentage of commission on direct sales, as well as additional percentages of additional income from their "down-line" sales. These percentages are generally smaller but are based on sales produced by that recruit.

All income that is received as a result of direct sales is taxable as gross receipts. Direct sellers may receive income in several different forms, including:

- Income from sales - these are payments received from their customers for product purchases.
- Commissions, bonuses, or percentages of income received as a result of sales from others who work under them (commonly referred to as their "down-line").
- Prizes and awards received from the selling business, taxable under IRC Section 74.
- Income also includes products received as a result of meeting certain sales quotas (for example, receiving all products displayed on the front page of the new catalogue in exchange for selling at a certain level for that month).
- Typically, the hostess, not the direct seller, receives gifts. However, gifts *received by the* direct seller are considered payments to help the direct seller make sales. The fair market value of these gifts must be reported as income under IRC Section 61.

Expense Issues

Start-Up Expenses

The costs of getting started in a business, before the direct seller is authorized to start selling products, are capital expenses. These start-up expenses include the cost of exploring different direct-selling opportunities, the cost of any training the direct seller must have before becoming a direct seller for their product line, any fees that must be paid to the company to become a direct seller, and similar costs. Examiners will consider whether these costs incurred are appropriate start-up costs or inventory costs. Furthermore, examiners will look at your records to ensure that you have not inappropriately expensed items.

Start-up expenditures typically include the following:

- paid or incurred in connection with –
  - investigating the creation or acquisition of an active trade or business, or
  - creating an active trade or business, or

- any activity engaged in for profit for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business.

Start-up expenditures generally may not be deducted. However, you may elect to deduct certain start-up expenditures. Examiners may request samples of certain expenses to verify whether you appropriately deducted such items for income tax purposes.

Employee v. Independent Contractor

Direct sellers are self-employed. This generally means that they have to pay self-employment tax. Selling consumer products as a company employee does not make you a direct sellers. Likewise, working under another direct seller does not make you an employee of that direct seller. Thus, no matter what your respective title is, examiners will look to see that you have paid your portion of self-employment tax. Additionally, the examiner may also use a series of nine factors to verify that you are actually in a business and not a hobby. These are evaluated under a totality of the circumstances approach and are as follows:

Factor 1 – Manner in which you carry on the activity; formal budgets, profit projects, etc. signals to the examiner your intent to run an actual business.

Factor 2 – Your expertise or the expertise of your advisors in the area of business indicates to the examiner the likelihood that you are serious about the activity as a business.

Factor 3– The time and effort you expend will tell the examiner whether you are engaged in the activity for fun or for a job.

Factor 4– Your expectation that company assets will appreciate in value indicates to the examiner that you consider the activity to be a business.

Factor 5– Your success in other activities indicates to the examiner that you are engaged in the activity for a business.

Factor 6– Your history of income or losses; the more losses with no income you have, the more likely the examiner will consider this a hobby.

Factor 7– The amount of any profits you have earned in the activity; the less you have earned in profits, the more the activity appears to be a hobby.

Factor 8– Your financial status; the more independently wealthy you are, the less legitimate the business appears.

Factor 9– The element of personal pleasure or recreation; signals to the examiner that the activity may be a hobby rather than a job.

Brown, PC represents direct sellers throughout Texas and across the United States. If you have questions regarding an IRS Audit, please call 888-870-0025 or contact us online for a confidential consultation.