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April 16, 1982

Honorable Fortney H. (Pete) Stark
Chairman, Subcommittee on
Select Revenue Measures
Committee on Ways and Means
Washington, DC 20515

Dear Mr. Chairman:

In announcing a public hearing (to be held April 19) on the deductibility of certain expenses incurred by self-employed individuals, the Subcommittee stated the concern that "certain individuals, particularly those engaged in certain kinds of selling activities, are being advised, and are actually attempting to convert nondeductible personal, living and family expenses into deductible business expenses***." Pursuant to your request in connection with this hearing, the staff of the Joint Committee has examined a number of Federal income tax returns filed by individuals engaged in direct-selling activities and has prepared the attached report.

The report includes examples reflecting income and deductions as shown on actual tax returns. The examples illustrate how some individuals engaged in direct-selling activities have reduced the amount of tax liability shown by them on their returns by using deductions claimed to arise from their selling activities to offset wages and other nonbusiness income. The report also includes a summary of present law on the deductibility of business and investment expenses.

In order to assure the confidentiality of taxpayer information, identification of the particular individuals who filed the returns from which the examples were prepared has been eliminated. In addition, the same general format has been used for all the examples.

Sincerely,

Mark McConaghy
Mark McConaghy

Enclosure

REPORT ON RETURNS OF INDIVIDUALS ENGAGED IN DIRECT-SELLING ACTIVITIES

The staff of the Joint Committee on Taxation has examined a number of 1979 and 1980 Federal income tax returns filed by individuals who are engaged in direct-selling activities. This report describes the returns which were examined and includes examples of income and deductions as shown on 20 such returns.

Confidentiality

Returns were provided to the Joint Committee staff by the Internal Revenue Service pursuant to section 6103(f) of the Internal Revenue Code. The required confidentiality has been assured by eliminating identification of the particular individuals who filed the returns from which the examples were prepared. In addition, the same general format has been used for all the examples. However, each example reflects income and deductions as shown on an actual tax return.

Returns studied

Neither the returns provided to the staff by the IRS nor the examples included with this report represent a valid statistical sampling of returns filed by individuals who are engaged in direct-selling activities. They do, however, illustrate actual situations in which individuals engaged in direct-selling activities have reduced the amount of tax liability shown by them on their returns by using deductions claimed to arise from their selling activities to offset wages and other nonbusiness income.

The examples included with this report are drawn from 81 tax returns selected from the work-in-progress inventories of three IRS districts. The majority of these returns came under examination through the IRS Return Preparers Program. No audit results are available with respect to the returns, because none of the individual examinations have been completed.

Profile of returns

In general, the returns furnished by the IRS reflect a married couple filing a joint return, three or four personal exemptions, gross wage and salary income in the range of \$10,000 to \$35,000, total business gross income (gross receipts from sales less cost of goods sold) of less than \$5,000, and net business losses of up to \$20,000. The categories of business deductions typically claimed on the returns include designations as automobile and transportation expenses, entertainment expenses, home meetings, lodging and meals expenses, commissions, demos and samples, awards and gifts, and home office and other office expenses. Other types of expenses claimed on one or more returns include designations as camera expenses, laundry and cleaning, suits, "outside services," household help, and "yard work."

The 20 examples drawn by the staff from the returns generally reflect this pattern.

Explanation of examples

Each example of a taxpayer return is divided into three parts: (1) summary of income and deductions as shown on the return, (2) composition of business loss claimed on the return, and (3) the tax savings resulting from claiming a net business loss on the return.

The first part of each example shows gross income (wages, total business gross income, and other income); adjusted gross income (gross income minus total business deductions); and taxable income (adjusted gross income minus itemized deductions and personal exemptions as shown on the return). The second part includes a detailed listing of categories of claimed deductions that comprise the total business deductions shown in the first part. The final part of each example shows the tax savings that resulted from offsetting the claimed net business losses against wage or other income. This tax savings computation assumes that the individual had sufficient valid business deductions to offset all gross income from the selling activity.

Because the examples are not drawn from a valid statistical sample of returns, any conclusions drawn from a review of them might not be valid generally for the total class of individuals engaged in direct-selling. However, the examples do illustrate how some individuals seek to reduce their tax liability by claiming losses from direct-selling activities to offset their wage and other nonbusiness income.

Taxpayer # 1

A. Summary of Income and Deductions as Shown on Return

Wages	\$52,905
Total business gross income	3,591
Other income	789
Gross income	\$57,285
Total business deductions	(\$14,651)
Adjusted gross income	\$42,634
Itemized deductions	(\$6,403)
Personal exemptions	(\$2,000)
Taxable income	\$34,231

B. Composition of Business Loss

Income:

Gross sales	\$3,591	
Cost of goods sold	0	
Total gross business income		\$ 3,591

Deductions

Automobile expense	\$4,126	
Parking fees	80	
Road tolls	0	
Commercial transportation fees	53	
Depreciation expense (Office equip.)	334	
Entertainment expense	1,103	
Convention expense	0	
Seminars	168	
Home meetings	211	
Hotel & motel expense	923	
Meals away from home	309	
Tax preparation fee	0	
Rent	112	
Printing expense	220	
Bank charges	36	
Telephone expense	702	
Postage	28	
Office supplies	783	
Freight charges	620	
Commissions paid	699	
Advertising expense	25	
Sales literature	0	
Demos & samples	1,469	
Awards & gifts	21	
Camera expense	149	
Contests	0	
Books & literature	496	
Dues & subscriptions	13	
Tapes & Recorders	1,371	
Home office	500	
Calculator	100	
Total deductions		(\$14,651)
Net business loss		(\$11,060)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$12,501
Tax shown on return	7,801
Tax savings	\$ 4,700

Taxpayer # 2

A. Summary of Income and Deductions as Shown on Return

Wages	\$23,338
Total business gross income	1,004
Other income	357
Gross income	\$24,699
Total business deductions	(12,703)
Adjusted gross income	\$11,996
Itemized deductions	0
Personal exemptions	(1,000)
Taxable income	\$10,996

B. Composition of Business Loss

Income:

Gross sales	\$1,457	
Cost of goods sold	(453)	
Total gross business income		\$ 1,004

Deductions

Automobile expense	\$ 3,221	
Parking fees	0	
Road tolls	64	
Commercial transportation fees	0	
Depreciation expense	50	
Entertainment expense	0	
Convention expense	0	
Seminars	180	
Home meetings	0	
Hotel & motel expense	324	
Meals away from home	596	
Tax preparation fee	0	
Rent	763	
Printing expense	0	
Bank charges	0	
Telephone expense	318	
Postage	10	
Office supplies	72	
Freight charges	9	
Commissions paid	0	
Advertising expense	0	
Sales literature	85	
Demos & samples	115	
Awards & gifts	0	
Camera expense	71	
Contests	0	
Books & literature	0	
Dues & subscriptions	0	
Tapes & Recorders	418	
Laundry & cleaning	75	
Business portion of new car price	5,864	
Business loss	130	
Misc.	338	
Total deductions	(\$12,703)	
Net business loss		(\$11,699)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 5,093
Tax shown on return	1,597
Tax savings	\$ 3,496

Taxpayer # 3

A. Summary of Income and Deductions as Shown on Return

Wages	\$33,781
Total business gross income	341
Other income	596
Gross income	\$34,718
Total business deductions	(8,395)
Adjusted gross income	\$26,323
Itemized deductions	(6,765)
Personal exemptions	(3,000)
Taxable income	\$16,558

B. Composition of Business Loss

Income:

Gross sales	\$ 341		
Cost of goods sold	0		
Total gross business income		\$	341

Deductions

Automobile expense	\$ 3,290
Parking fees	45
Road tolls	25
Commercial transportation fees	0
Depreciation expense	0
Entertainment expense	354
Convention expense	0
Seminars	1,084
Home meetings	158
Hotel & motel expense	100
Meals away from home	378
Tax preparation fee	80
Rent	273
Printing expense	39
Bank charges	0
Telephone expense	468
Postage	30
Office supplies	100
Freight charges	51
Commissions paid	0
Advertising expense	80
Sales literature	50
Demos & samples	400
Awards & gifts	196
Camera expense	200
Contests	0
Books & literature	160
Dues & subscriptions	10
Tapes & Recorders	644
Equipment	180

Total deductions	(8,395)
Net business loss	(\$ 8,054)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 4,513
Tax shown on return	2,403
Tax savings	\$ 2,110

Taxpayer #4

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 29,432
Total business gross income	471
Other income	428
Gross income	\$ 30,331
Total business deductions	(\$11,434)
Adjusted gross income	\$ 18,897
Itemized deductions	(\$ 9,082)
Personal exemptions	(\$ 2,000)
Taxable income	\$ 7,815

B. Composition of Business Loss

Income:

Gross sales	\$	471	
Cost of goods sold		0	
Total gross business income			\$ 471

Deductions

Automobile expense	\$ 3,025	
Parking fees	212	
Road tolls	0	
Commercial transportation fees	470	
Depreciation expense	82	
Entertainment expense	76	
Convention expense	0	
Seminars	671	
Home meetings	310	
Hotel & motel expense	160	
Meals away from home	24	
Tax preparation fee	0	
Rent	0	
Printing expense	28	
Bank charges	152	
Telephone expense	919	
Postage	16	
Office supplies	545	
Freight charges	172	
Commissions paid	103	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,547	
Awards & gifts	200	
Camera expense	90	
Contests	0	
Books & literature	933	
Dues & subscriptions	13	
Tapes & Recorders	880	
Storage	325	
Misc. expenses	481	

Total deductions	(\$11,434)
Net business loss	(\$10,963)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 3,487
Tax shown on return	869
Tax savings	\$ 2,618

Taxpayer #5

A. Summary of Income and Deductions as Shown on Return

Wages	\$20,095
Total business gross income	5,147
Other income	<u>1,105</u>
Gross income	\$26,347
Total business deductions	(\$21,146)
Adjusted gross income	<u>\$ 5,201</u>
Itemized deductions	(\$ 3,690)
Personal exemptions	(4,000)
Taxable income	<u><u>\$ 0</u></u>

B. Composition of Business Loss

Income:

Gross sales	\$ 5,147	
Cost of goods sold	<u>0</u>	
Total gross business income		\$ 5,147

Deductions

Automobile expense	\$ 6,586	
Parking fees	62	
Road tolls	31	
Commercial transportation fees	0	
Depreciation expense	186	
Entertainment expense	515	
Convention expense	0	
Seminars	682	
Home meetings	848	
Hotel & motel expense	381	
Meals away from home	366	
Tax preparation fee	78	
Rent	0	
Printing expense	5	
Bank charges	74	
Telephone expense	401	
Postage	38	
Office supplies	80	
Freight charges	375,	
Commissions paid	4,598	
Advertising expense	82	
Sales literature	526	
Demos & samples	1,836	
Awards & gifts	425	
Camera expense	246	
Contests	0	
Books & literature	67	
Dues & subscriptions	36	
Tapes & Recorders	856	
Home office	<u>1,766</u>	
Total deductions		(\$21,146)
Net business loss		<u><u>(\$15,999)</u></u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 1,745
Tax shown on return	<u>0</u>
Tax savings	<u><u>\$ 1,745</u></u>

Taxpayer # 6

A. Summary of Income and Deductions as Shown on Return

Wages	\$47,709
Total business gross income	851
Other income	1,571
Gross income	\$50,131
Total business deductions	(\$8,125)
Adjusted gross income	\$42,006
Itemized deductions	(\$8,854)
Personal exemptions	(\$3,000)
Taxable income	\$30,152

B. Composition of Business Loss

Income:

Gross sales	\$ 851	
Cost of goods sold	0	
Total gross business income		\$ 851

Deductions

Automobile expense	\$ 3,389
Parking fees	50
Road tolls	0
Commercial transportation fees	0
Depreciation expense	0
Entertainment expense	164
Convention expense	241
Seminars	350
Home meetings	330
Hotel & motel expense	431
Meals away from home	216
Tax preparation fee	100
Rent	0
Printing expense	0
Bank charges	230
Telephone expense	365
Postage	3
Office supplies	241
Freight charges	26
Commissions paid	350
Advertising expense	0
Sales literature	0
Demos & samples	390
Awards & gifts	75
Camera expense	32
Contests	0
Books & literature	85
Dues & subscriptions	10
Tapes & Recorders	221
Equipment	146
Storage	680

Total deductions	(8,125)
Net business loss	\$(7,274)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 9,119
Tax shown on return	6,303
Tax savings	\$ 2,816

Taxpayer # 7.

A. Summary of Income and Deductions as Shown on Return

Wages	\$19,954
Total business gross income	4,325
Other income	<u>2,285</u>
Gross income	\$26,564
Total business deductions	(\$17,310)
Adjusted gross income	<u>\$ 9,254</u>
Itemized deductions	(\$ 5,396)
Personal exemptions	<u>(1,000)</u>
Taxable income	<u><u>\$ 2,858</u></u>

B. Composition of Business Loss

Income:

Gross sales	\$45,660	
Cost of goods sold	<u>(\$41,335)</u>	
Total gross business income		\$ 4,325

Deductions

Automobile expense	\$ 4,199
Parking fees	0
Road tolls	0
Commercial transportation fees	0
Depreciation expense	0
Entertainment expense	0
Convention expense	0
Seminars	0
Home meetings	0
Hotel & motel expense	0
Meals away from home	0
Tax preparation fee	0
Rent	0
Printing expense	0
Bank charges	0
Telephone expense	678
Postage	0
Office supplies	1,648
Freight charges	0
Commissions paid	2,786
Advertising expense	0
Sales literature	0
Demos & samples	0
Awards & gifts	0
Camera expense	0
Contests	0
Books & literature	0
Dues & subscriptions	780
Tapes & Recorders	0
Utilities	249
Misc. expenses	<u>6,970</u>

Total deductions	(\$17,310)
Net business loss	<u><u>(\$12,985)</u></u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 2,853
Tax shown on return	<u>81</u>
Tax savings	<u><u>\$ 2,772</u></u>

Taxpayer #8

A. Summary of Income and Deductions as Shown on Return

Wages	\$32,585
Total business gross income	1,004
Other income	6,653
Gross income	\$40,242
Total business deductions	(\$10,378)
Adjusted gross income	\$29,864
Itemized deductions	(\$2,303)
Personal exemptions	(\$5,000)
Taxable income	\$22,561

B. Composition of Business Loss

Income:

Gross sales	\$ 1,004	
Cost of goods sold	0	
Total gross business income		\$ 1,004

Deductions

Automobile expense	\$ 1,528	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	1,453	
Convention expense	0	
Seminars	0	
Home meetings	237	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	69	
Telephone expense	296	
Postage	7	
Office supplies	11	
Freight charges	0	
Commissions paid	262	
Advertising expense	89	
Sales literature	0	
Demos & samples	1,012	
Awards & gifts	0	
Camera expense	98	
Contests	0	
Books & literature	0	
Dues & subscriptions	70	
Tapes & Recorders	0	
Motor office expenses	3,255	
Home office	937	
Misc. expenses	1,054	
Total deductions		(\$10,378)
Net business loss		(\$ 9,374)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 6,950
Tax shown on return	3,938
Tax savings	\$ 3,012

Taxpayer # 9

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 18,390
Total business gross income	1,443
Other income	490
Gross income	<u>\$ 20,323</u>
Total business deductions	(\$13,040)
Adjusted gross income	<u>\$ 7,283</u>
Itemized deductions	0
Personal exemptions	(\$ 2,000)
Taxable income	<u><u>\$ 5,283</u></u>

B. Composition of Business LossIncome:

Gross sales	\$ 1,443	
Cost of goods sold	<u>0</u>	
Total gross business income		\$ 1,443

Deductions

Automobile expense	\$ 3,932
Parking fees	165
Road tolls	0
Commercial transportation fees	300
Depreciation expense	0
Entertainment expense	43
Convention expense	261
Seminars	738
Home meetings	1,429
Hotel & motel expense	305
Meals away from home	636
Tax preparation fee	90
Rent	0
Printing expense	25
Bank charges	24
Telephone expense	672
Postage	56
Office supplies	103
Freight charges	255
Commissions paid	344
Advertising expense	0
Sales literature	0
Demos & samples	1,253
Awards & gifts	256
Camera expense	187
Contests	0
Books & literature	241
Dues & subscriptions	94
Tapes & Recorders	651
Home office	893
Equipment	<u>87</u>

Total deductions	(\$13,040)
Net business loss	<u><u>(\$11,597)</u></u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 2,475
Tax shown on return	<u>263</u>
Tax savings	<u><u>\$ 2,212</u></u>

A. Summary of Income and Deductions as Shown on Return

Wages		\$ 19,784
Total business gross income		1,919
Other income		<u>113</u>
Gross income		\$ 21,816
Total business deductions		(\$ 12,351)
Adjusted gross income		\$ 9,465
Itemized deductions		(\$ 3,923)
Personal exemptions		(\$ 3,000)
Taxable income		<u>\$ 2,542</u>

B. Composition of Business LossIncome:

Gross sales	\$ 1,919	
Cost of goods sold	<u>0</u>	
Total gross business income		\$ 1,919

Deductions

Automobile expense	\$ 5,888	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense)		
Convention expense)	1,176	
Seminars	0	
Home meetings	73	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	1,444	
Printing expense	0	
Bank charges	148	
Telephone expense	885	
Postage	46	
Office supplies	950	
Freight charges	192	
Commissions paid	365	
Advertising expense	122	
Sales literature	437	
Demos & samples	234	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	0	
Dues & subscriptions	75	
Tapes & Recorders	0	
Insurance	60	
Laundry & cleaning	55	
Legal fees	100	
Misc. expense	<u>101</u>	
Total deductions		(\$12,351)
Net business loss		<u>(\$10,432)</u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 1,630
Tax shown on return	<u>0</u>
Tax savings	<u>\$ 1,630</u>

Taxpayer #11

A. Summary of Income and Deductions as Shown on Return

Wages	\$30,441
Total business gross income	(\$2,810)
Other income	10
Gross income	\$27,641
Total business deductions	(9,716)
Adjusted gross income	\$17,925
Itemized deductions	(\$ 692)
Personal exemptions	(\$3,000)
Taxable income	\$14,233

B. Composition of Business Loss

Income:

Gross sales	\$2,507	
Cost of goods sold	5,317	
Total gross business income		(\$ 2,810)

Deductions

Automobile expense	\$2,084	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense)	2,124	
Convention expense)		
Seminars	0	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	0	
Rent	1,695	
Printing expense	0	
Bank charges	605	
Telephone expense	217	
Postage	50	
Office supplies	38	
Freight charges	227	
Commissions paid	0	
Advertising expense	0	
Sales literature	0	
Demos & samples	76	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	907	
Dues & subscriptions	238	
Tapes & Recorders	0	
Insurance	166	
Laundry & cleaning	66	
Taxes	347	
Utilities	364	
Suits	512	
Total deductions		(\$ 9,716)
Net business loss		(\$12,526)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 5,201
Tax shown on return	1,892
Tax savings	\$ 3,309

Taxpayer #12

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 32,702
Total business gross income	2,129
Other income	801
Gross income	\$ 35,632
Total business deductions	(\$16,858)
Adjusted gross income	\$ 18,774
Itemized deductions	(\$ 7,714)
Personal exemptions	(\$ 4,000)
Taxable income	\$ 7,060

B. Composition of Business Loss

Income:

Gross sales	\$ 2,129	
Cost of goods sold	0	
Total gross business income		\$ 2,129

Deductions

Automobile expense	\$ 6,010	
Parking fees	69	
Road tolls	36	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	0	
Convention expense	415	
Seminars	1,275	
Home meetings	403	
Hotel & motel expense	1,599	
Meals away from home	685	
Tax preparation fee	108	
Rent	0	
Printing expense	106	
Bank charges	19	
Telephone expense	882	
Postage	32	
Office supplies	136	
Freight charges	175	
Commissions paid	1,116	
Advertising expense	0	
Sales literature	0	
Demos & samples	487	
Awards & gifts	15	
Camera expense	596	
Contests	0	
Books & literature	98	
Dues & subscriptions	126	
Tapes & Recorders	1,773	
Storage	500	
Misc. expense	197	
Total deductions		(\$16,858)
Net business loss		(\$ 14,729)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 3,714
Tax shown on return	546
Tax savings	\$ 3,168

Taxpayer # 13

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 37,498
Total business gross income	2,711
Other income	711
Gross income	\$ 40,920
Total business deductions	(\$14,341)
Adjusted gross income	\$ 26,579
Itemized deductions	(\$ 2,417)
Personal exemptions	(\$ 4,000)
Taxable income	\$ 20,162

B. Composition of Business Loss

Income:

Gross sales	\$ 2,711	
Cost of goods sold	0	
Total gross business income		\$ 2,711

Deductions

Automobile expense	\$ 4,664
Parking fees	36
Road tolls	146
Commercial transportation fees	273
Depreciation expense	0
Entertainment expense	567
Convention expense	273
Seminars	914
Home meetings	508
Hotel & motel expense	303
Meals away from home	641
Tax preparation fee	0
Rent	0
Printing expense	26
Bank charges	8
Telephone expense	683
Postage	72
Office supplies	32
Freight charges	285
Commissions paid	1,738
Advertising expense	0
Sales literature	0
Demos & samples	1,348
Awards & gifts	326
Camera expense	58
Contests	0
Books & literature	42
Dues & subscriptions	34
Tapes & Recorders	228
Legal fees	110
Home office	1,026

Total deductions	(\$14,341)
Net business loss	(\$11,630)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 6,895
Tax shown on return	3,267
Tax savings	\$ 3,628

Taxpayer # 14

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 0
Total business gross income	2,797
Other income	<u>33,491</u>
Gross income	\$ 36,288
Total business deductions	(\$25,292)
Adjusted gross income	<u>\$10,996</u>
Itemized deductions	(\$ 4,908)
Personal exemptions	<u>(\$ 4,000)</u>
Taxable income	<u>\$ 2,088</u>

B. Composition of Business Loss

Income:

Gross sales	\$ 2,797	
Cost of goods sold	<u>0</u>	
Total gross business income		\$ 2,797

Deductions

Automobile expense	\$ 4,005	
Parking fees	5	
Road tolls	27	
Commercial transportation fees	414	
Depreciation expense (office furn.)	415	
Entertainment expense	1,056	
Convention expense	1,733	
Seminars	84	
Home meetings	820	
Hotel & motel expense	115	
Meals away from home	126	
Tax preparation fee	155	
Rent	0	
Printing expense	149	
Bank charges	124	
Telephone expense	432	
Postage	255	
Office supplies	817	
Freight charges	1,004	
Commissions paid	406	
Advertising expense	0	
Sales literature	606	
Demos & samples	7,559	
Awards & gifts	1,848	
Camera expense	86	
Contests	347	
Books & literature	0	
Dues & subscriptions	118	
Tapes & Recorders	31	
Home office	1,160	
Interpreting expense	296	
Outside services	<u>1,099</u>	
Total deductions		(\$25,292)
Net business loss		<u>(\$22,495)</u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 4,498
Tax shown on return	<u>0</u>
Tax savings	<u>\$ 4,498</u>

Taxpayer # 15

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 33,234
Total business gross income	718
Other income	0
Gross income	\$ 33,952
Total business deductions	(\$ 8,308)
Adjusted gross income	\$ 25,644
Itemized deductions	(\$ 4,591)
Personal exemptions	(2,000)
Taxable income	\$ 19,053

B. Composition of Business Loss

Income:

Gross sales	\$ 718	
Cost of goods sold	0	
Total gross business income		\$ 718

Deductions

Automobile expense	\$ 3,936	
Parking fees	46	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	74	
Convention expense	689	
Seminars	259	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	125	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	0	
Telephone expense	181	
Postage	22	
Office supplies	0	
Freight charges	270	
Commissions paid	23	
Advertising expense	79	
Sales literature	858	
Demos & samples	630	
Awards & gifts	225	
Camera expense	62	
Contests	0	
Books & literature	158	
Dues & subscriptions	7	
Tapes & Recorders	236	
Storage	428	

Total deductions	(\$ 8,308)
Net business loss	(\$ 7,590)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 5,153
Tax shown on return	3,003
Tax savings	\$ 2,150

Taxpayer # 16

A. Summary of Income and Deductions as Shown on Return

Wages		\$ 11,416
Total business gross income		718
Other income		<u>929</u>
Gross income		\$ 13,063
Total business deductions		(\$11,391)
Adjusted gross income		<u>\$ 1,672</u>
Itemized deductions		(\$ 2,506)
Personal exemptions		<u>(\$ 1,000)</u>
Taxable income		<u><u>0</u></u>

B. Composition of Business Loss

Income:

Gross sales	\$ 718	
Cost of goods sold	<u>0</u>	
Total gross business income		\$ 718

Deductions

Automobile expense	\$ 6,769	
Parking fees	10	
Road tolls	15	
Commercial transportation fees	606	
Depreciation expense	0	
Entertainment expense	0	
Convention expense	117	
Seminars	155	
Home meetings	702	
Hotel & motel expense	782	
Meals away from home	142	
Tax preparation fee	89	
Rent	0	
Printing expense	0	
Bank charges	18	
Telephone expense	175	
Postage	12	
Office supplies	281	
Freight charges	40	
Commissions paid	230	
Advertising expense	0	
Sales literature	0	
Demos & samples	340	
Awards & gifts	10	
Camera expense	32	
Contests	0	
Books & literature	232	
Dues & subscriptions	10	
Tapes & Recorders	0	
	<u>624</u>	

Total deductions	(\$11,391)
Net business loss	<u>(\$10,673)</u>

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 1,140
Tax shown on return	<u>0</u>
Tax savings	<u><u>\$ 1,140</u></u>

Taxpayer #17

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 30,160
Total business gross income	1,407
Other income	0
Gross income	\$ 31,567
Total business deductions	(\$14,110)
Adjusted gross income	\$ 17,457
Itemized deductions	(\$ 6,603)
Personal exemptions	(\$ 3,000)
Taxable income	\$ 7,854

B. Composition of Business Loss

Income:

Gross sales	\$ 1,407	
Cost of goods sold	0	
Total gross business income		\$ 1,407

Deductions

Automobile expense	\$ 5,472	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	24	
Depreciation expense	293	
Entertainment expense	0	
Convention expense	692	
Seminars	461	
Home meetings	0	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	30	
Rent	0	
Printing expense	0	
Bank charges	260	
Telephone expense	301	
Postage	85	
Office supplies	915	
Freight charges	0	
Commissions paid	0	
Advertising expense	0	
Sales literature	0	
Demos & samples	1,218	
Awards & gifts	43	
Camera expense	0	
Contests	79	
Books & literature	126	
Dues & subscriptions	97	
Tapes & Recorders	0	
Security system	425	
Insurance	83	
Household help	272	
Yard work	36	
Business debt interest	1,364	
Repairs	66	
Taxes	371	
Utilities	808	
Furniture	689	

Total deductions	(\$14,110)
Net business loss	\$ 12,703

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 3,378
Tax shown on return	680
Tax savings	\$ 2,698

Taxpayer # 18

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 33,177
Total business gross income	10,670
Other income	1,595
Gross income	\$ 45,442
Total business deductions	(\$30,576)
Adjusted gross income	\$ 14,866
Itemized deductions	(\$ 7,714)
Personal exemptions	(3,000)
Taxable income	\$ 4,152

B. Composition of Business Loss

Income:

Gross sales	\$ 10,670	
Cost of goods sold	0	
Total gross business income		\$ 10,670

Deductions

Automobile expense	\$ 6,665	
Parking fees	0	
Road tolls	0	
Commercial transportation fees	0	
Depreciation expense	0	
Entertainment expense	4,876	
Convention expense	0	
Seminars	0	
Home meetings	364	
Hotel & motel expense	0	
Meals away from home	0	
Tax preparation fee	42	
Rent	1,129	
Printing expense	0	
Bank charges	192	
Telephone expense	438	
Postage	122	
Office supplies	662	
Freight charges	404	
Commissions paid	2,954	
Advertising expense	1,075	
Sales literature	0	
Demos & samples	2,888	
Awards & gifts	0	
Camera expense	0	
Contests	0	
Books & literature	0	
Dues & subscriptions	155	
Tapes & Recorders	0	
Sales & promotion	5,159	
Misc. supplies	331	
Interest	2,498	
Insurance	522	
Legal services	100	
Total deductions		(\$30,576)
Net business loss		(\$19,906)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 4,358
Tax shown on return	186
Tax savings	\$ 4,172

Taxpayer # 19

A. Summary of Income and Deductions as Shown on Return

Wages	\$ 18,208
Total business gross income	2,053
Other income	0
Gross income	\$ 20,261
Total business deductions	(\$15,023)
Adjusted gross income	\$ 5,238
Itemized deductions	(\$ 1,267)
Personal exemptions	(\$ 4,000)
Taxable income	\$ 0

B. Composition of Business Loss

Income:

Gross sales	\$ 2,053	
Cost of goods sold	0	
Total gross business income		\$ 2,053

Deductions

Automobile expense	\$ 8,636	
Parking fees	100	
Road tolls	106	
Commercial transportation fees	356	
Depreciation expense	0	
Entertainment expense	58	
Convention expense	0	
Seminars	126	
Home meetings	104	
Hotel & motel expense	723	
Meals away from home	75	
Tax preparation fee	0	
Rent	0	
Printing expense	0	
Bank charges	52	
Telephone expense	1,456	
Postage	0	
Office supplies	218	
Freight charges	120	
Commissions paid	446	
Advertising expense	17	
Sales literature	49	
Demos & samples	454	
Awards & gifts	32	
Camera expense	72	
Contests	16	
Books & literature	0	
Dues & subscriptions	7	
Tapes & Recorders	488	
Home office	816	
Misc. expense	496	
Total deductions		(\$15,023)
Net business loss		(\$12,970)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 1,619
Tax shown on return	0
Tax savings	\$ 1,619

Taxpayer #20

A. Summary of Income and Deductions as Shown on Return

Wages	\$15,900
Total business gross income	1,155
Other income	0
Gross income	\$17,055
Total business deductions	(9,521)
Adjusted gross income	\$ 7,534
Itemized deductions	0
Personal exemptions	(2,000)
Taxable income	\$ 5,534

B. Composition of Business Loss

Income:

Gross sales	\$ 1,155	
Cost of goods sold	0	
Total gross business income		\$ 1,155

Deductions

Automobile expense	\$ 3,489
Parking fees	36
Road tolls	96
Commercial transportation fees	17
Depreciation expense	0
Entertainment expense	343
Convention expense	0
Seminars	468
Home meetings	760
Hotel & motel expense	293
Meals away from home	262
Tax preparation fee	15
Rent	500
Printing expense	0
Bank charges	273
Telephone expense	1,008
Postage	24
Office supplies	209
Freight charges	79
Commissions paid	0
Advertising expense	67
Sales literature	119
Demos & samples	219
Awards & gifts	367
Camera expense	71
Contests	63
Books & literature	197
Dues & subscriptions	153
Tapes & Recorders	393

Total deductions	(9,521)
Net business loss	(\$ 8,366)

C. Tax Savings Due to Business Deductions

Tax that would have been due without deductions for net business losses	\$ 2,206
Tax shown on return	474
Tax savings	\$ 1,732

PRESENT LAW ON DEDUCTIBILITY
OF
BUSINESS AND INVESTMENT EXPENSES

Overview

Subject to certain limitations and substantiation requirements, expenses incurred by an individual in carrying on a trade or business are deductible for income tax purposes (Code sec. 162), as are expenses incurred in an investment activity (sec. 212). If the expenses from a business or investment activity exceed the taxpayer's income from the business or investment activity for the year, the net business loss may be used to offset income from other sources, such as employee wages paid to the taxpayer.

Under present law, an activity in which the taxpayer incurs expenditures is presumed to be engaged in for profit (and hence is not subject to the "hobby loss" deduction limitations) if the activity produces net income for at least two years in a period of five consecutive years (sec. 183). Accordingly, as long as an activity shows a profit for any two years within the five-year period, the taxpayer generally may offset income from other sources with excess deductions from the activity in the loss years, unless the Internal Revenue Service can overcome the presumption by establishing that the taxpayer in fact did not engage in the activity for profit.

Except for certain expenses allowed as "above-the-line" deductions or as itemized deductions, an individual's personal or consumption expenditures are not deductible (see sec. 262, disallowing deductions for personal, living, or family expenses). Certain expenditures which otherwise would be treated as personal living expenses, such as expenditures for meals, lodging, travel, or entertainment, nonetheless may be deductible when incurred in a business or investment activity.

Expenses incurred in a trade or business

General rules

An individual may deduct all the ordinary and necessary expenses paid or incurred in carrying on a trade or business (sec. 162).

The determination of whether an activity in which expenditures are incurred constitutes a trade or business depends on the particular facts involved. In general, to constitute a trade or business there must be activities which are carried on for livelihood or profit and which occur on a regular basis. An employee is considered to be in the trade or business of being an employee, and may deduct certain expenses incurred as an employee.^{1/}

An individual may be engaged in more than one trade or business at a time. Thus, an individual who is an employee may incur deductible expenses from self-employment or investment activities. If the expenses from a business or investment activity exceed the taxpayer's income from that business or investment activity for the year, the net business or investment loss may be used to offset income from other sources, such as employee wages paid to the taxpayer or net income from another trade or business of the taxpayer.

To be deductible, expenses incurred in a trade or business must not be "capital expenditures" and must be "ordinary and necessary" to the operation of the business. In general, a capital expenditure is a cost, other than routine maintenance, incurred for assets or improvements to be used for an extended period. (Such expenditures for business assets, normally may be recovered through depreciation allowances.) As with the definition of trade or business, the determination of whether an expense is ordinary and necessary to the operation of the business is a factual question. The Supreme Court has ruled that expenses do not have to be "habitual or normal in the sense that the same taxpayer will have to make them often" to be ordinary.

Types of deductible expenses

Section 162 specifically lists three categories of trade or business expenditures which are deductible. However, this listing is not exclusive, and other types of trade or business expenses may qualify for deduction pursuant to section 162.

The first listed category of section 162 expenses consists of reasonable allowances for salaries and other compensation for personal services. The principal issue which arises concerning

^{1/} The employee business expenses which are deductible in determining adjusted gross income ("above-the-line deductions") are limited to the following expenses if paid or incurred by the taxpayer in connection with the performance of services as an employee: (1) expenses of travel, meals, and lodging while away from home; (2) other expenses covered by a reimbursement or other expense allowance arrangement with the employer; (3) transportation costs; and (4) expenses of "outside salesmen" (sec. 62(2)). In addition, an individual who itemizes deductions may deduct other employee business expenses (such as union dues or continuing professional education costs).

deductions claimed for compensation is whether the total of amounts paid is reasonable in light of the services performed. For example, a corporation may not deduct as compensation amounts paid to a shareholder-employee that are in substance dividends because they exceed reasonable compensation levels. Similarly, an individual operating a business as a sole proprietorship may also violate the reasonableness standard if the individual pays compensation to family members in excess of the value of services in an effort to "income-split" and thereby to maximize the amount of total family income taxable in lower brackets.

The second listed category consists of traveling expenses incurred while away from home in pursuit of business. Expenses of commuting to the taxpayer's place of business are nondeductible personal expenses. However, a taxpayer having more than one place of business may deduct the costs of traveling from one place of business to another. In addition, where the taxpayer is away from home in the pursuit of a trade or business, 2/ the taxpayer may deduct traveling expenses, 3/ including the costs of meals and lodging (other than amounts which are lavish or extravagant under the circumstances).

The third listed category of section 162 expenses consists of rentals paid for business property. A deduction may only be claimed for rent which does not exceed the fair market value of

2/ The travel must be primarily for business purposes. Thus, if a taxpayer makes a business trip (such as attending a convention) and engages in some personal activity such as sightseeing, that part of the total expenses of the trip which is directly attributable to the taxpayer's business is deductible, while expenses attributable to personal activities are nondeductible (Rev. Rul. 79-425, 1979-2 C.B. 81, and Rev. Rul. 56-168, 1956-1 C.B. 93).

3/ If an individual uses an automobile for business purposes (other than for commuting between home and the place of business), he or she may deduct expenses based on a standard mileage rate or based on actual costs incurred. The standard mileage rate is presently 20 cents a mile for the first 15,000 miles, and 11 cents a mile for each additional mile (or for all miles after the car is considered to be fully depreciated, i.e., after 60,000 miles of business use at the maximum rate). The standard rate includes all operating expenses and depreciation allowances.

Alternatively, the taxpayer may elect to deduct automobile expenses based on actual costs incurred and to claim an investment tax credit on the cost of a newly acquired automobile. Deductible expenses under the actual expense method include the cost of gasoline, oil, repairs, insurance, depreciation, licenses, and garage rent.

Parking fees and tolls are deductible separately under both the standard mileage and actual expense methods.

premises actually used for business purposes. In the case of business property purchased by the taxpayer, the cost of the property may be recovered through depreciation deductions.

Expenses incurred for the production of income

A taxpayer may deduct all the ordinary and necessary expenses paid or incurred for production or collection of income; for managing, conserving, or maintaining property held for the production of taxable income; or in connection with the determination of any tax (sec. 212). ^{4/} These expenses are deductible even though the income-producing activity does not constitute a trade or business under section 162.

Like business expenses, section 212 expenses are deductible only if they are not capital expenditures and are ordinary and necessary expenses to production of the income involved. Thus, the same types of expenses that may be deducted as costs of doing business generally may be deducted when incurred in an investment activity.

Substantiation requirements

Business or investment expenses are generally deductible only if the taxpayer substantiates that he or she actually incurred the expense. If the taxpayer establishes that a deductible expenditure has been incurred, but fails to substantiate the exact amount, the deduction generally may be allowed based on an approximated amount (Cohan v. Comm'r, 39 F.2d 540 (2d Cir. 1930)). However, section 274 requires substantiation of the amount of the expenditure in the case of traveling expenses, entertainment costs, or business gifts (see discussion below).

Limitations on deductible expenses

Present law provides three major limitations on the availability of deductions for expenses claimed to be incurred in business and income-producing activities.

Hobby losses

Hobbies and other activities may resemble business activities although they are not intended to produce a profit. To preclude the claiming of tax losses from such activities to shelter other income, present law restricts deductions in respect of "activities not engaged in for profit" (sec. 183). Under this rule, if an activity is not engaged in for profit, allowable deductions are limited to those amounts which could be deducted without regard

^{4/} Expenses incurred for production of tax-exempt income are not deductible (sec. 265).

to the nature of the activity in which incurred (such as certain interest or taxes), plus other expenses in an amount not exceeding the income produced by the activity.

Present law presumes an activity to be engaged in for profit if the activity produces net income for any two or more taxable years in a period of five consecutive taxable years. 5/ Accordingly, so long as an activity shows a profit for any two years within the five-year period, the taxpayer generally may offset income from other sources with excess deductions from the activity in the loss years, unless the Internal Revenue Service can overcome the presumption by establishing that the taxpayer in fact did not engage in the activity for profit. If a particular activity fails to meet the two-of-five-years test, net losses from the activity generally still may be used to offset other income unless the activity is considered not to be engaged in for profit. However, in that case the taxpayer does not get the benefit of the presumption.

If the taxpayer elects, the two-of-five-years determination will not be made before the end of the fourth taxable year, 6/ and the activity will be treated as a business or investment activity until the determination is made. During the period before this determination is made, all deductions otherwise allowable for business or investment expenses can be claimed, subject to later disallowance. Thus, while present law limits deductions when an activity does not have a true profit-making business or investment motive, it permits the taxpayer to defer for up to several years payment of tax on income from other sources to the extent of losses claimed from the activity.

Travel and entertainment expenses

Under section 274, no deduction generally is permitted for expenditures attributable to entertainment unless the entertainment is "directly related to" the active conduct of the taxpayer's business or investment activity; 7/ this requirement is in addition

5/ In the case of breeding and training race horses, the presumption test is two years of seven consecutive years.

6/ The sixth taxable year in the case of breeding and training race horses.

7/ Entertainment expenses incurred directly before or after a "substantial and bona fide" business discussion are deductible as "associated with" the business even though they are not "directly related to" its conduct. Costs of facilities (e.g., hunting lodges) are considered entertainment expenses.

to the rule limiting all deductible business or investment expenses to those that are ordinary and necessary. In general, entertainment expenses meet the "directly related" test only if (1) the taxpayer expects to derive income or some other specific business benefit (other than goodwill) from the activity; (2) the taxpayer engages in the active conduct of business during the entertainment with the person being entertained; and (3) the active conduct of business is the principal aspect of the combined business and entertainment (Reg. §1.274-2(c)(3)).

Section 274 provides special substantiation requirements for travel and entertainment expenses that are more stringent than the requirements for other types of business and investment expenses. No deduction is allowed for any traveling expense (including meals and lodging while away from home), any entertainment expense, or any business gift expense unless the taxpayer maintains records corroborating the item. ^{8/} These records must show (1) the amount of each such expense or other item; (2) the time and place of the travel, entertainment, amusement, recreation, or use of the facility, or the date and description of the gift; (3) the business purpose of the expense or other item; and (4) the business relationship to the taxpayer of persons entertained, using the facility, or receiving the gift.

Business use of home

The tax law imposes limitations on deductions for business use of the taxpayer's home (sec. 280A). A taxpayer may deduct expenses attributable to use of the home for business purposes only for that portion of the home that is used exclusively and on a regular basis as the principal place of business of a trade or business of the taxpayer, or as a place of business used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's business. Section 280A also contains special rules restricting deduction of expenses incurred in connection with "vacation homes."

Personal, living, and family expenses

In general, personal, living, or family expenses are not deductible in determining taxable income (sec. 262). Examples of such nondeductible expenses are the costs of maintaining a personal residence (e.g., rent, utilities, or depreciation), expenses incurred while traveling away from home (e.g., meals and lodging) to the extent the travel is not primarily for business

^{8/} Sec. 274 also contains special rules governing expenses of foreign travel and business gifts.

purposes, expenses of commuting from home to the taxpayer's place of business, and costs incurred for education which does not either maintain or improve skills required in the taxpayer's business or satisfy requirements imposed by the taxpayer's employer.

Present law includes several exceptions to the general rule denying deductions for personal expenses. These exceptions include certain "above-the-line" deductions (e.g., alimony and the deduction for two-earner married couples) and certain itemized deductions (e.g., interest, taxes, casualty losses, charitable contributions, and medical expenses).