

Update:

What records will you need when it's tax time *next* year?

by William P. Prescott, MBA, JD

This attorney — and former outside retail salesman — understands your situation if you are employed in outside sales, and offers information to bring you up-to-date on what records to keep for tax time next year.

IF you are in outside sales for a dental-supply house or a dental manufacturer, what kinds of records must you keep for income-tax purposes?

Reimbursed/Unreimbursed Expenses

When expenses paid by outside salespeople in connection with their employment are reimbursed, they are deductible from gross income. All other business expenses must be itemized and are deductible only to the extent that they cumulatively exceed 2% of adjusted gross income.

Deductions from gross income to determine adjusted gross income are referred to as "above the line" deductions. Deductions from adjusted gross income are referred to as "below the line" or "itemized" deductions.

Presently, employee business expenses that are reimbursed under an arrangement that does not require the salesperson to account for or substantiate the covered expenses to his employer must be itemized subject to 2% of adjusted gross income. An employee salesperson who adequately accounts to his employer is not required to report the expenses to the IRS if the reimbursements equal the expense. The excess of reimbursements above expenses must be reported as income.

Because unreimbursed business expenses are deductible only to the extent that they exceed 2% of adjusted gross income, it is important to distinguish between employees and independent contractors who can deduct all of their business expenses without consideration of the 2% rule.

Salespeople are employees if the employer retains the right to direct the manner of performance as well as the result to be accomplished. However, the status of a salesperson as an employee or independent contractor determines whether the employer must withhold taxes on wages or whether the salesperson must pay self-employment taxes.

Business Expenses

For business expenses to be deductible, they must be "ordinary and necessary." "Ordinary" refers to an expense that is a common and accepted practice in a particular business, while a "necessary" expense is one that is appropriate and helpful in carrying on a trade or business. Except for meals, all "ordinary and necessary" expenses incurred by outside salespeople in connection with their sales activities are deductible. The cost of meals is deductible only if the salesperson is away from home overnight or if the meals qualify as an entertainment expense.

Entertainment. Costs of entertaining customers, prospective customers and suppliers at parties, restaurants, sporting events, etc., can be deductible as "ordinary and necessary." However, starting in 1987, only 80% of the cost of business entertainment

is deductible, and the expenses are also required to be "associated with" and "directly related" to the active conduct of the taxpayer's trade or business.

"Associated with" means that a meal or entertainment is deductible if it directly precedes or follows a business discussion. The discussion must be substantial in relation to the meal or entertainment. The meal or entertainment can take place a day before or after the business discussion if the business guest is from out-of-town.

"Directly related" entertainment involves a business discussion that looks forward to a business benefit at a specific future time and business must be actually conducted during the entertainment. Entertainment at a night club, show or sports event must directly precede or follow a substantial business discussion and the salesperson must show that he had a clear business purpose in making the expenditure. Neither lavish, extravagant or reciprocal entertainment is deductible.

Not only is the deduction for business meals and entertainment limited to 80% of the cost, but also subject to the 80% rule are the related parking charges, taxes and tips. Transportation to and from the business meal or entertainment is not subject to the 80% rule.

Cost of a business gift can be a deductible expense. However, the taxpayer may only deduct up to \$25 in gifts made to any individual in a single tax year.

Educational expenses incurred to maintain or improve skills are deductible. However, salespeople may not deduct expenses for education that will qualify them for a new trade or business. A change of responsibilities is not considered a new trade or business if the individual continues to do the same general type of work. When educational expenses are deductible, the costs of typing, research, travel and transportation are also deductible.

Home office deduction. Salespeople can take deductions for the business use of the home if it is used "exclusively and regularly" as the principal place of business. A taxpayer must use a specific part of the home to carry on a trade or business. If the salesperson uses an area for both personal and business purposes, he cannot allocate the expenses as deductions.

Under the present rules, deductions for home office expenses are restricted to outside salespeople who do not maintain a permanent place of business elsewhere. For example, if an outside salesperson has no other office, except at home, and spends a substantial amount of time there doing paperwork, the office in the home may qualify as the salesperson's principal place of business and may be a deductible business expense.

Home telephones no longer qualify as a deductible business expense. For the home telephone to qualify as a deductible expense, a separate line must be installed for business use. In

addition, cellular telephones have now become "listed" property subject to depreciation rules, similar to the depreciation of a computer used by an outside salesperson for business purposes.

Club dues and costs of entertaining facilities. Club dues and fees are deductible if the taxpayer proves that the facility is used primarily to further his trade or business. This includes country, sporting, social and athletic clubs. If the taxpayer uses the club more than 50% for business purposes, he can deduct that portion of the dues that are directly related to the business use of the club.

By contrast, expenses relating to facilities used in connection with entertainment are nondeductible. An entertainment facility is property owned, rented or used by the taxpayer for entertainment and can include yachts, hunting lodges, and apartments.

Travel expenses can be deducted by an outside salesperson while "away from home." The cost of meals and lodging can be deducted as part of the travel expense only if the travel is long enough to require "rest or sleep." This requirement has been interpreted to mean an overnight trip.

Starting in 1987, only 80% of the cost of meals while away from home is deductible.

A standard meal deduction is allowed on a business trip without having to record the amount of the expense for meals. This deduction is \$14 per day for fewer than 30 days in one general area, and \$9 per day for 30 days or longer in one general area. Where a standard-meal deduction is taken, the taxpayer must prove time, place and business purpose of travel.

Deductions of business expenses are allowed for travel and related purposes of attending conventions and business meetings for the purpose of furthering the business interest of the taxpayer. When a taxpayer is accompanied by his spouse at a convention, the expenses of the spouse are not deductible, unless it can be established that the spouse's presence has a bona fide business purpose.

Business relationships in regard to foreign travel, foreign conventions and cruise ships are subject to special rules.

Recordkeeping Requirements

Taxpayers are required to substantiate four elements of each business expense taken as a deduction. The requirements are: (1) amount, (2) time and place, (3) business purpose, and (4) business relationship. According to the IRS, a taxpayer must substantiate every element of each expenditure by adequate records supported by appropriate documentation, or by sufficient corroboration of the taxpayer's oral statement. For IRS purposes, the value of written documentation holds greater weight than does an oral statement by the taxpayer. Also, the value of written documentation recorded "at" or "near" the time of the expenditure is given greater weight than is documentation made later.

An adequate record is an account book, diary, statement of expense or similar record in which the taxpayer records each of the required elements for the expenditure "at" or "near" the time of the expenditure. Adequate records must be supported by documentation evidence, such as a receipt, for any expenditure that is \$25 or more.

Where a taxpayer's records are lost due to circumstances beyond his control, such as in a fire, flood, earthquake, or some other casualty, the taxpayer may substantiate his expenses by making a "reasonable construction" of them.

Transportation/automobile expenses. Automobile expenses are deductible to the extent that the taxpayer uses the automobile in a trade or business.

Automobile expenses incurred in traveling between the residence and place of business are nondeductible personal expenses. Also nondeductible is the trip from home to the first customer and the return trip home from the last customer. Automobile operating costs can include the cost of gas, oil, repairs, tires, as well as insurance, storage, depreciation, taxes, registration, interest, automobile club, parking fees and tolls. Some costs are required to be capitalized, such as the purchase

price of a new car, and must be recovered through depreciation tables supplied by the IRS. If a salesperson leases an automobile for his business, leasing costs are deductible, in addition to other operating expenses paid by the lessee. Deductible rental costs are in lieu of depreciation paid by the lessor.

Where an individual uses his car for business and personal purposes, an apportionment of the total expense must be made, usually on a mileage basis, to determine the part of the expense that can be deducted. As with other business expenses, the IRS requires the taxpayer to substantiate automobile deductions by records. In addition, for automobiles, the records must show the business miles as well as the total miles driven during the tax year. Outside salespeople are required to keep a diary that shows the amount of the expenditure, the time and place, the business purpose, and a description of the expense. To avoid the need for the computation and substantiation of actual automobile expenses, the taxpayer can elect to use the standard mileage rate supplied by the IRS, but must still maintain mileage records.

For the year 1990, the IRS has increased the standard mileage rate to 26¢ per mile for business use from 25½¢ per mile for 1989. The 11¢ per mile rate that previously had been applied after the first 15,000 miles of business use, is no longer applicable. The 11¢ per mile rate had applied also to cars that were fully depreciated after 60,000 miles of business use, but not any longer. The IRS will adjust the business standard mileage rate each year.

Where a taxpayer uses the standard mileage rate, parking fees, tolls, interest expenses, plus state and local taxes are still deductible business expenses.

Purchasing an automobile. There are now dollar limits on depreciation write-offs, and first-year expensing for passenger automobiles, even if the car is used 100% for business. For automobiles placed in service after 1986, the dollar limits will generally reduce depreciation deductions if the cost of the automobile exceeds \$12,800.

Leasing an automobile. For outside salespeople leasing mid-priced and luxury automobiles, there is an annual income inclusion that reduces the deduction for lease payments. This inclusion is leasing's equivalent to the depreciation limits that apply when an automobile is purchased. However, the rental expenses are otherwise fully deductible.

The inclusion amount is calculated from tables supplied by the IRS. Different tables are provided whenever depreciation limits change. There are four separate tables, depending on what year the automobile was leased. Tables also have been provided for additional inclusion amounts where business use of the automobile is less than 50%.

When determining whether to purchase or lease an automobile, the outside salesperson should compare the costs and potential tax savings of each method after the net cost of the automobile is determined. It is important to know whether the dealer is basing the loan or lease payments on the retail price or for what the dealer could actually sell the car.

Conclusion.

Tax considerations are always time consuming and complicated. However, the time and effort needed to properly compute deductions can be minimized by proper recordkeeping throughout the year. This article is not meant to provide specific legal advice. Every taxpayer's needs are different and each outside salesperson should consult his attorney, accountant, or financial advisor prior to making decisions in regard to tax matters. □

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