

Income Taxes for Artists: Presented by the Arts Council of Indianapolis ©
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I. General Income Tax Structure

- A. Tax law is written by congress. It changes all the time. It is used to influence social and economic behavior.
- B. All **income** is subject to taxation, unless specifically exempt by the IRS.
- C. All **expenses** are nondeductible unless specifically allowed by the IRS.
- D. **Trade or Business.** You must hold yourself out as being in business and engage in the activity for **profit**. You must be soliciting work, applying for shows, auditioning, writing, etc. "The activity will be presumed to have been for profit if it results in a profit in at least 3 out of 5 consecutive years." But this is not a requirement for proving you are a for profit business. If it were, there would be no airline industry in America. You do not have to pursue your art full-time, but you must be able to document a serious effort towards making a profit.
- E. **Hobby.** This is what you have if you don't have a trade or business. Income is taxable. Losses are not deductible. Expenses related to a hobby may be deducted, but only on Schedule A as a Miscellaneous Itemized Deduction and only to the extent of income from the hobby.
- F. **Employee versus Independent Contractor.** If you are an employee, your employer controls where, when and how you perform your work. If you are an independent contractor, you control where, when and how the work will be performed. An independent contractor is allowed to hire other people to do the work. You should agree upon your status before you begin a project or job. If you are going to be an independent contractor, you should have a contract prepared and invoice your client.
 - 1. Employees have taxes deducted from their paychecks and receive W-2's at yearend. Independent contractors pay their own taxes, deduct their business expenses against their income and may receive a Form 1099.
 - 2. If you have employees, you must withhold and pay taxes to federal and state taxing authorities. If you plan to hire employees, **get an accountant** first. The penalties are huge if you don't follow the rules and they can come after your personal assets to satisfy these debts. If you hire independent contractors, get a signed contract and have them complete a Form W-9. Hold them responsible for their own tools, training, etc. You must issue them a Form 1099 at yearend if you pay them more than \$600. If the IRS or the state determines that they are your employees, you will be required to pay all the payroll taxes, including the employees' portion.
 - 3. Whether you are being treated as an employee or an independent contractor affects where you get to deduct the related out of pocket expenses. Expenses related to your employee work are deducted as a miscellaneous itemized deduction subject to the 2% AGI limitation. Expenses related to your independent contractor work are deducted against the income and you pay taxes on the net.

II. Record Keeping

- 1. In General, the IRS does not require a business to keep records in any special way.

2. Your records must be able to support your income and especially your deductions. The more complete and accurate records you maintain, the more likely you are to win if your accounting is questioned by the IRS.
3. Cancelled checks or credit card statements are not enough; you must have receipts or paid bills, especially for expenses over \$75.
4. Certain expenses, such as business use of your car, meals, and travel, have special documentation requirements.
5. **Bookkeeping systems.**
 - a. Computerized systems: Quicken (checkbook), Quickbooks (full accounting)
 - b. Manual ledger system: Chicago Artists' Coalition's Bookkeeping Book.
 - c. Shoe box method: Keep receipts in envelopes or file folders.
6. Keep a Business Diary. Use to document small expenses, business meetings, meals, travel, auto miles, and any other activity that you perform to support the fact that you are actively trying to make a profit from your business.
7. You should **keep all records** for at least 3 years from the date you file your tax return. Seven years is safer. Keep documents relating to the purchase of property until three years after you file the final return reporting the sale of the property. Keep records relating to depreciable assets for three years after the last tax return showing their depreciation. Keep copies of all tax returns.

III. **Income** Most artists will file a Schedule C to report income and expenses.

- A. All amounts you receive for you work are income. This includes cash, checks, credit cards and barter. Both parties to the barter must include the fair market value of the goods or services they receive in their income.
- B. Income is taxable when you receive the payment, not when you deposit the payment into the bank.
- C. Grants are income. (**Publication 970**) If you are required to perform specific duties or produce specific work, the income goes on your Schedule C. If there are no specific requirements, it goes on the front of the Form 1040, on the wages line, line 7. Write "grant" to the left.
- D. Scholarships (**Publication 970**) are not taxable if received by a degree seeking student and used for tuition, fees, books and supplies required by the student's courses. Amounts received for room and board are taxable. Put on wages line, line 7, and put "SCH" to the left.
- E. Prizes are taxable income.
- F. The disposition of fixed assets can produce income. Generally, the disposition of assets used in a trade or business generates ordinary income, not capital gains.

IV. **Expenses** – These are business expenses, not Itemized Deductions such as mortgage interest or charitable donations. (**Publication 535**)

- A. You are allowed to deduct all **ordinary and necessary business expenses** and nothing else. This includes your costs of supplies, studio rent, studio utilities, slides or digital images of your work, web domain names, accounting and legal fees, etc. If you attend a show or performance, document how the show relates to your work. Do it when you see the show. This is especially important for those of you in film, sound and acting. Remember, anything that can be deemed a personal expense needs stronger documentation.
- B. Assets with a useful life of more than one year are called fixed assets and must be capitalized. This means they must be expensed over their useful life, as prescribed by the IRS. This expensing is called

depreciation. Computers have a useful life of 5 years, equipment is 7 years, and furniture is 5 years. Software is amortized over 3 years. Although you can deduct fixed assets using straight line (a ratable method), there are more advantageous methods provided by the IRS. The IRS has special tables that will assist you in calculating depreciation. There is a way to get a deduction for the equipment you purchased before you declare your art business a business if the equipment still has a fair market value.

- C. **Section 179 expense.** Currently, the IRS will allow you to elect to deduct, the entire cost of some assets. Furniture, equipment and vehicles generally qualify as Section 179 expense. Buildings and improvements do not qualify. For 2007 the maximum deduction is \$125,000. It will be \$128,000 for 2008. This deduction is only allowed to the extent that you have income from your art business. Purchased computer software is eligible for this deduction.
- D. **Inventory (Publication 538).** In general, businesses are required to capitalize all expenses incurred in creating goods. These amounts will be deducted as cost of goods sold in the year the product is sold. Writers, photographers and artists are exempt from most of these rules. "However, this exemption does not apply to any expense that is (1) paid or incurred by an employee or (2) related to printing, photographic plates, motion pictures films, video tapes, or similar items." The originality and uniqueness of the item created will be taken into account in determining if the expense is incurred in the business of being an artist. "...any expense paid or incurred in producing jewelry, silverware, pottery, furniture, and other similar household items" are generally not considered to be paid or incurred in the business of being an artist. Showing in juried art fairs or in galleries will help elevate your work to the status of art. If you keep the rights to the item you produced and only allow the property to be used for a fee, you must capitalize the costs and deduct them as depreciation over the useful life of the asset. Printed items, such as reproductions of your work or greeting cards must be inventoried.

If your work is subject to inventory rules, you must perform a physical inventory count and valuation at the end of your tax year (December 31 for most taxpayers.) If you believe you may be subject to these rules, it is recommended that you consult with an accountant immediately.

- E. **Business use of your home (Publication 587).** Form 8829. You are entitled to a deduction for the costs associated with the portion of your home that you use regularly and exclusively as your principle place of business. A separate room is satisfactory, but a separate structure is better. Part of a room is okay, but must be exclusive to your business. You are also entitled to a deduction for the costs associated with storage of your artwork, inventory or supplies. You may deduct a proportionate share of rent, insurance, mortgage expenses, real estate taxes, utilities (except telephone), maid service, and repairs. The deductible portion is determined by square footage. The deduction for the business use of your home is limited to your income from the art related business. You can deduct 100% of direct expenses, such as painting the room, repairing a storage unit, etc. It is recommended that you document your home office with a sketch of your floor plan, room measurements and photographs. This is critical if you move, since this will be your only proof of your home office.
- F. **Business use of a car (Publication 463).** Form 2106. You are allowed a deduction for the business use of your vehicle. There are essentially two methods of calculating your deductible expense. Both methods require you to keep a log of the miles you drive for business. The easiest method is the standard mileage rate. The rate is \$.485 for 2007 and \$.505 for 2008. The standard mileage rate includes all costs except parking, tolls and car loan interest. The second method is the actual cost method. You must use the vehicle more than 50% for business to qualify to use this method. Under this method you still need to keep a log of your miles. You will also need to record your odometer reading at the beginning and the end of the year. Under this method, you may deduct all costs associated with your vehicle, including gas, repairs, cleaning, parking, insurance, tolls and licenses. You can also depreciate a portion of the cost of your vehicle. If you elect this method in the first year, you must continue to use this method throughout the life of the vehicle. If you elect the standard mileage rate, you can switch back and forth between the two methods in future years. If you own a newer vehicle, the actual cost method will generally provide a higher deduction but it requires more accounting.
- G. **Telephones.** You are not allowed to deduct the cost of the first telephone line to your home, even if you use it for business. You may deduct the cost of a second line used exclusively for business. Cell phones are a problem, because they are used for personal and business use. You must be able to support the business use percentage. The IRS has announced they plan to review cell phone expenses

more closely, focusing on allocations of personal use. Business related long distance is 100% deductible.

- H. **Computers, digital cameras, video equipment.** Again, you must be able to support the business usage. If you are a free lance graphic artist or a filmmaker, it will be easier, but still difficult. If you can, set up two computers. Never throw away an old computer.
- I. **Travel.** Business travel is an area of higher scrutiny by the IRS due to a long history of abuse. Travel away from your tax home, entirely or primarily for a valid business purpose, for longer than an ordinary business day, where the person will need sleep to complete the trip, is considered business travel. You must maintain a travel log documenting the business purpose and the amount of time spent pursuing the business purpose. You may deduct meals and lodging for days off while traveling, but be very careful that you can document that the purpose of the trip is primarily business. If you are on a temporary assignment (realistically expected to last less than one year) you can deduct either your meals and lodging for your days off or your travel costs to return to your tax home for your days off (generally the weekend). If you travel outside the United States for business the trip must be entirely for business purposes in order to deduct all travel costs. If the trip is primarily for business purposes but contains a personal portion, then you must allocate travel costs based on the number of days that were entirely devoted to business. If the purpose of the trip is primarily personal, you are not allowed to deduct any of the costs of travel, such as airfare and lodging, but you may deduct any expenses directly related to business. For example, if you are in New York visiting family for a week and you spend a day visiting galleries where you may be interested in showing your work or if you have lunch with a gallery owner, then you can deduct the costs associated with visiting the galleries or the cost of your meal.

Instead of maintaining actual receipts for travel, you may use the IRS per diem rates for lodging, and/or meals & incidental expenses. These rates vary based on the location. For example, the Indianapolis/Carmel area has a lodging per diem rate of \$97 and meals and incidentals of \$44. You can obtain those rates on the website www.GSA.gov. For international travel, you can obtain those rates on the website www.aoprals.state.gov.

Travel costs of spouses, friends, children, etc. are never deductible unless there is a valid business purpose for them attending the trip. Beautiful arm piece is not a valid business purpose. If traveling with another person, you can only deduct the cost of a single room and your personal meal and travel expenses. Travel for education is not deductible.

- J. **Meals & Entertainment.** In order for meals or entertainment to be considered a business expense the activity must take place before, during or after a substantial business discussion. Just asking your best friend, "So, how's business?" does not count. You must document the business purpose of your meals and entertainment, including the names and relationships of the people you took out to eat. I recommend you do this before leaving the restaurant or other entertainment venue. Business meals and entertainment are only 50% deductible.
- K. **Gifts.** The deduction for business gifts is limited to \$25 per a recipient per a year. This included flowers, holiday gift baskets, etc. This does not include inexpensive items with your company logo imprinted upon the item, such as pens, calendars, etc.
- L. **Charitable contributions.** You are only allowed a deduction for the cost of your materials when you donate a piece of art to a charity. Additionally, the costs associated with the donated work are reported on Schedule A, (Itemized Deductions), not Schedule C. Please note that you may have already deducted the supply costs as a business expense in the current or a prior year.
- M. **Medical insurance premiums.** Self-employed individuals are now allowed to deduct 100% of their medical insurance premiums. This deduction is only for plans secured in the name of the self employed individual or their business. If the taxpayer is eligible to participate in a subsidized plan provided by an employer they may not take this deduction. This deduction does not go on the Schedule C, so it will not reduce your self-employment tax. Self employed taxpayers with a High Deductible Health Plan (this is specifically defined by the IRS) can benefit from a Health Savings Account Deduction if they establish a Health Savings Account (HSA). The taxpayer gets a deduction for the amounts deposited into the HAS, up to certain annual limits. The funds must be used to pay qualified medical expenses.

Withdrawals for other purposes will be subject to taxation and a 10% penalty. Unused amounts in the account at yearend can be rolled over to subsequent years.

- N. **Retirement.** Self-employed individuals have several retirement options. Your main options are a SEP IRA and a SIMPLE IRA. A taxpayer may contribute to a SEP IRA up to 20% of net self employment income up to the maximum of \$45,000 for 2007 \$46,000 for 2008. A taxpayer may contribute to a SIMPLE IRA up to \$10,500 (\$13,000 if they are over age 50 by the end of the year) for both 2007 & 2008. This amount is not calculated using a percentage of income but the taxpayer may not contribute more than their annual self-employed income to a SIMPLE IRA. Taxpayers have until their tax return due date, including extensions, to establish and fund a SEP IRA. A SIMPLE IRA plan must be established by October 1 of the tax year but can be funded until the tax return due date, including extensions. If you have a business with employees there are more retirement options available to you and your employees, such as 401(k) plans.
- O. **Musicians & Entertainers.** There are some special rules for performing artists and some of their expenses. Most people can only deduct the cost and upkeep of their work clothing and uniforms if it must be worn as a condition of employment and the clothes are not suitable for everyday wear. However, musicians and entertainers can deduct the cost of theatrical clothing and accessories that are not suitable for everyday wear.
- P. **Qualifying Performing Artist.** If you meet the requirement to be considered a "qualifying performing artist" you may deduct your out of pocket expenses related to wages directly on the front page of the Form 1040 rather than as a miscellaneous itemized deduction. You are a qualifying performing artist if you meet all of the following requirements: 1) You perform services in the performing arts for at least two employers during your tax year, 2) you received from at least two of those employers wages of \$200 or more per employer, 3) your allowable business expenses related to the performing arts are more than 10% of your gross income from the performing arts, and 4) your adjusted gross income is \$16,000 or less before deducting these business expenses. The IRS should rename it the "starving artist" deduction.

Pigs get fat, hogs get slaughtered. Don't be a hog!

V. Taxes

- A. **Regular tax** is a percentage of your taxable income. We currently have a graduated tax rate system. As we have discussed, taxable income is not necessarily cash income. Taxable income is calculated taking into account all the rules we just discussed, along with many other laws that allow for such deductions as home mortgage interest and real estate taxes. Your tax has nothing to do with the amount you have paid in, via withholding or other payments.
- B. **Self Employment tax.** You must pay Social Security (12.4%) and Medicare (2.9%) taxes on your Schedule C net income. You will pay the flat rate of 15.3% on net self employment income up to \$97,500 for 2007. Income in excess of \$97,500 will pay only Medicare tax or 2.9%. When you are employed, your employer pays half of this amount. Therefore, you get a deduction on your tax return for 50% of the SE Tax you pay. Hobby income is not subject to Self Employment Tax.
- C. **Estimated taxes.** You are required by law to pay your taxes to the IRS on a quarterly basis. The payments are due April 15, June 15, Sept 15 and Jan 15 of the following year. You will be penalized and subject to interest if you have not paid the necessary amounts by the due date of your tax return. There are several permitted methods for estimating your tax including paying in your prior year tax, that will allow you to avoid penalties and interest if any balance due is paid by the original due date of the tax return (generally April 15 of the following year). Additionally, in certain cases, such as natural disasters or major illness, the IRS may waive penalties but they do not have the authority to waive interest.
- D. **Sales Taxes.** You are required by most states to collect and pay over sales taxes on retail sales. You may also be required by certain cities to collect sales tax. In Indiana, you register using the Form BT-1, and remit your sales tax using the Form ST-103 either monthly, quarterly, or annually depending on your annual sales. The rate of sales tax depends on the location of the sale. If you sell work at art fairs, often the state taxing authorities will come to your booth and collect sales tax. It is best to contact the local taxing authority before selling your work, to determine your obligations.

- E. **State taxes.** Each state has its own tax system. Some follow the IRS, some don't. In general, Illinois taxes individuals based on Federal income at a flat rate of 3%. New York has both a city and state tax. They even manage to tax you when you move in or out of New York City or Yonkers. If you sell work through a gallery or art fair in another state, you may be required to file an additional income tax return in those states. You should consult a tax advisor before selling your work in other states. If you go on tour or get a job which requires you to work in another state, be sure to look into the non-resident tax obligations imposed by the other state(s). Keep records of what you earn and what dates you were in each location. These will be greatly helpful to you and your tax preparer when you file your tax return.

VI. **Help**

- A. **IRS** Their website, www.irs.gov, gives you access to most forms, including many that you can fill in using Adobe Acrobat. Additionally, they have most IRS Publications and lots of other resources.

To order forms or publication by telephone, 1-800-TAXFORM (829-3676)

For general assistance, 1-800-829-1040

Prerecorded topics, 1-800-829-4477

- B. IRS Publications that will be helpful to you in setting up your art business.

Publication 17 Your Federal Income Tax

Publication 334 Tax Guide for Small Business

Publication 583 Starting a Business and Keeping Records

Publication 538 Accounting Periods and Methods (Includes Inventory)

Publication 535 Business Expenses

Publication 587 Business Use of Your Home

Publication 463 Travel, Entertainment, Gifts and Car Expenses

Publication 590 Individual Retirement Arrangements

Publication 560 Retirement Plans for Small Businesses

Publication 553 Highlights of Tax Changes (not out for 2007 as of this printing)

- C. **Indiana Dept. of Revenue.** Their website is www.in.gov/dor and links you to Indiana forms and tax information along with links to other states' dept. of revenue websites.

- D. There are many books available this time of year. Try to pick up a reputable one, such as "The Ernst & Young Tax Guide 2008" or "Wall Street Journal Guide to Understanding Your Taxes: An Easy-to-Understand, Easy-to-Use Primer That Takes the Mystery Out of Income Tax" by Kenneth Morris. Some other good ones are "The New Tax Guide for Performers, Writers, Directors, Designers and Other Show Biz Folk" by R. Brendan Hanlon, Fourth Edition, 1996 (out of print, but you can find used copies and still get some good information) and "Small Business Taxes Made Easy" by Eva Rosenberg.

- E. Commercial tax preparation software. TurboTax and Taxcut are two.

- F. Accountants and CPAs.