TAXES FOR ARTISTS

Professional Practices
American University
October 11, 2012

Benjamin Takis
Tax-Exempt Solutions, PLLC

Overview

- Stage 1: Occasional Income from Your Creative Endeavors
  - Different kinds of taxes
  - Reporting income and taking deductions
- Stage 2: When Your Art Becomes a Business
  - Types of Business Entities & Common Deductions
  - Business vs. Hobby
  - Self-employment Taxes & Estimated Taxes
  - Sales & Use Taxes
- Stage 3: When Your Business Grows Beyond Just You
  - Hiring employees and independent contractors
- Final Thoughts

Stage 1

Occasional Income From Your Creative Endeavors

What taxes do you pay?

- Income Tax
  - State <u>and</u> Federal
  - Personal/Corporate
- Sales Tax (state law)
- Business Tax (state law)
- Employment Tax (state and federal)

Income Tax

- What is income?
  - All income from whatever source derived, including
    - In-kind compensation;
    - Nearly all prizes and awards;
    - Grants; and
    - Unemployment benefits
  - Certain items of income are "excluded" from the definition of income, e.g. gifts, certain employee benefits.
- Personal Exemptions
  - Tax is reduced by the number "personal exemptions" you are allowed to take – you get one for yourself, one for your spouse, one for each dependent ($3,800 per exemption in 2012)

Deductions

- Standard deduction v. itemized deductions
  - Standard deduction amount depends on "filing status," e.g. single, married filing jointly, married filing separately, head of household.
  - Standard deduction for single person is $5,950 for 2012.
- "Above the line" deductions (e.g. expenses of operating a trade or business, IRA contributions), vs. "below the line" deductions (e.g. charitable deductions, mortgage interest deductions).
  - "Below the line" deductions are only available if you itemize – you would choose to itemize if your below the line deductions exceed the standard deduction.
  - Beware of "alternative minimum tax," which reduces certain deductions.

Credits

- Earned Income Tax Credit
  - For low income earners, particularly those with children
  - Paid as refund if it exceeds taxes owed
  - Phases out at certain income levels (credit generally maxes out when you have about $16,000 in income if you have children, or about $7,000 if you don't have children)
  - *See* IRS Pub. 596 or http://www.eitc.irs.gov

Credits (cont'd)

- American Opportunity Credit (formerly known as Hope Credit)
  - Maximum of $2,500 per student for tuition, books and related fees (does not include lodging expenses)
  - For the first 4 years of undergraduate studies
  - 40% of the credit is refundable, which is up to $1,000.00
  - Set to expire at the end of 2012
- Lifetime Learning Credit
  - Maximum of $2,000 per taxpayer for tuition, books, and related fees
  - For graduate or undergraduate (not subject to 4 year limit)
  - Not refundable
- *Must choose either American Opportunity Credit or Lifetime Learning Credit for each tax year—cannot combine them*
- Both credits are subject to income limits

How and When to File

- Due April 15th – Don't worry…
  - An automatic 6-month extension is available for filing (still have to pay taxes by 4/15)
- Generally File using Form 1040
  - Use 1040A if your income is less than $100,000 and you don't itemize
  - Use 1040-EZ if you have no dependents, your income is below $100,000, and you don't itemize
- Keep records (for at least 3 years)
  - Keep receipts for deductions and charitable donations!

Stage 2

When Your Art Becomes a Business

Hobby v. Trade or Business

- Why it matters –
  - "Business" income is reported net of expenses, and business losses reduce your taxable income
  - Deductions for "hobbies" are limited
    - Cannot take a deduction that exceeds the income you generate from your hobby
    - Cannot take this deduction at all unless you itemize
  - If you have income from a "business," you may be subject to significant "self-employment" taxes
- What is a Hobby?
  - Hobbies are carried on without an expectation of making a profit.

Hobby v. Trade or Business

- You might have a business if…
  - The time and effort put into the activity indicates an intention to make a profit
  - You depend on income from the activity
  - Any losses occurred in the start-up phase of the business
  - You have changed methods of operation to improve profitability
  - You have the knowledge needed to carry on the activity as a successful business
  - You made a profit in similar activities
  - You make a profit in some years
  - You expect to make a profit in the future from the appreciation of the assets used
- Presumed to be "for profit" if it produced a profit in at least 3 of the last 5 years.
  - *See* IRS Pub. 535 for more info

Types of Business Entities

- When starting a business, factors to consider when choosing the form of your business include:
  - Tax advantages or disadvantages
  - Length of business operation
  - Type of business operation
  - Legal restrictions
  - Potential liabilities
  - Earnings distribution
  - Capital needs
  - Number of employees

Forming a Business Entity

Basic steps for starting a business:

- Choose the type of entity (discussed later)
- File necessary forms with the state
- Find out what state and local taxes apply
- Register a trade name with the state (if applicable)
- Find out what licensing requirements apply
- Find out if any zoning requirements apply

The IRS is a good source of information for small businesses: http://www.irs.gov/businesses/small/index.html

Sole Proprietorship

- A sole proprietorship is an unincorporated business with one owner. The owner is personally liable for the debts of the business.
- This is the simplest form of business to start and maintain -- the business has no existence apart from the owner (although state licensing requirements may apply).
- Pass-through taxation: the owner simply includes the income and expenses of the business on his/her own tax returns (Schedule C, Form 1040)
- Conclusion: sole proprietorship can make sense when liability is not a concern and the business does not generate large amounts of money.

Partnership

- A partnership is an association of two or more persons to carry on a business for profit as co-owners.
- Similar to a sole proprietorship – a partnership is an unincorporated business, for which the owners are generally personally liable.
- Partnerships in D.C. must be registered.
- Pass-through taxation: as with a sole proprietorship, the business is not taxed. The partnership files Form 1065 to figure out each partner’s share of the income, and each partner reports the taxable income on Schedule C, Form 1040.

Benefits of Incorporating

- Limited liability (protecting your personal assets or the assets of your other businesses)
- Helps to prove to the IRS that you have a “business” and not a “hobby.”
- Possible tax benefits (e.g. S Corporation status, tax deduction issues)
- Looks more professional and permanent to customers, lenders, insurers, and business partners

C Corporation

- The term “C Corporation” refers to its tax status under federal law. The earnings of a C Corporation are double taxed, i.e. taxed to the corporation when earned and then taxed to the shareholders when distributed as dividends.
- C Corporation files Form1120-C (very complicated and expensive to prepare). Not to be confused with “Schedule C” on the Form 1040.
- C Corporation not recommended unless you have a very large company with many shareholders.

Limited Liability Company

- The LLC is a very popular form of business for three reasons: (1) ease of administration; (2) flexible tax status; and (3) limited liability.
  - Fewer formalities than a corporation.
  - Can elect to be treated as C Corporation, disregarded for tax purposes (i.e. sole proprietorship or partnership), or S Corporation.
  - Generally, limited liability (with caveat about single-member LLCs)

S Corporation

- A corporation or LLC that meets certain requirements can elect to be treated as a “S Corporation” under federal law (Form 2553)
- Requirements: (1) formed in United States; (2) no more than 100 shareholders; (3) shareholders are not partnerships, corporations, or non-resident aliens; (4) only one class of stock; and (5) your type of company is not ineligible, i.e. certain financial institutions, insurance companies and others.
- Benefits: pass-through income taxation AND potential to lower employment tax liability.

Non-Profit and Tax-Exempt Status

- Many arts organizations are non-profit tax-exempt entities. “Non-profit” refers to the type of business entity under state law, while “tax-exempt” refers to its tax status under federal and/or state law.
- The typical business form for a tax-exempt non-profit is the “non-profit corporation.”
- To be exempt from federal taxation, a non-profit must be tax-exempt under 501(c) of the Internal Revenue Code (e.g. a “501(c)(3)” organization). *See* IRS Pub. 557 for more info. Often, states will require a nonprofit to have 501(c)(3) status before granting an exemption from state taxation.

Benefits of 501(c)(3) Status

- Earnings generally tax-exempt under federal and state law
- Donations are tax deductible
- Eligible for grants

Burdens of 501(c)(3) Status

- Should have a variety of funding sources to avoid being classified as a “private foundation”
- Complicated to administer: generally requires articles, bylaws, board of directors, corporate policies, plan for distribution of assets upon dissolution
- Must take steps to show that any payment to yourself is “reasonable”
- Finances open to public inspection

Obtaining 501(c)(3) Status

- To be recognized as a 501(c)(3) organization:
  - The non-profit must be organized and operated exclusively for an exempt purpose such as a charitable, educational, or literary purpose.
    - “Promotion of the Arts” is recognized as a legitimate 501(c)(3) purpose, but a nonprofit created mainly to promote the work of its founders or members will not be recognized as tax-exempt.
  - The earnings of the non-profit cannot inure to the benefit of a private shareholder or individual.
  - The non-profit can only conduct very limited lobbying activities.
  - The non-profit must submit an application for recognition of 501(c)(3) status to the IRS (IRS Form 1023).
  - The non-profit must file annual returns (IRS Form 990).

Tax Deductions for Businesses

- Generally, you can deduct the costs of running the business from business taxes. To be deductible, the expense must be ordinary (common and accepted in your field of business) and necessary (helpful and appropriate for your business).
- For small businesses, common deductions are for:
  - Equipment or other property used in the business
  - Car or truck expenses (*e.g.*, delivery vehicle)
  - Insurance
  - Rent for property used in the business
  - Taxes
  - Use of your home (see next slide)

Home Office Deduction

- To deduct expenses related to the part of your home used for business, you must meet specific requirements. Even then, your deduction may be limited.
- To qualify to claim expenses for business use of your home:
  - Your use of the business part of your home must be: (1) exclusive, (2) regular, (3) for your business, and

Home Office Deduction

- The business part of your home must be one of the following:
  - (1) your principal place of business,
  - (2) a place where you deal with clients or customers in the normal course of your business, <u>OR</u>
  - (3) a separate structure (not attached to your home) you use in connection with your business.

Self-Employment Taxes

- What are self-employment taxes?
  - Employers and employees each required to pay taxes in addition to income taxes to cover Social Security and Medicare for the employee (also known as "FICA").
  - A self-employed person, or partially self-employed person, must pay both the employer and employee's share.
  - Total self-employment tax is 2.9% of net earnings from self-employment for Medicare and 12.4% of the first $106,800 of net earnings from self-employment for Social Security (i.e. generally 15.3% if net earnings from self-employment equal $106,800 or less)
  - Paying self-employment taxes ensures that you are credited for purposes of receiving Social Security and Medicare benefits.

Self-Employment Taxes

- Who must pay self-employment taxes?
  - Any individual who receives $400 or more from a "trade or business" carried on as a sole-proprietor, independent contractor, or sometimes, as a partner in a partnership or LLC (see the Instructions for the Form 1040 Schedule SE for more info)
  - You are <u>not</u> subject to self-employment tax if your activity is not a trade or business (e.g. if it is considered a "hobby" for tax purposes).

Self-Employment Taxes

- Who must pay self-employment taxes? (cont'd)
  - You are <u>not</u> subject to self-employment tax on amounts earned as an employee rather than an independent contractor.

    General rule: you are an employee if the person paying for your services has the right to control the manner and means of your performance.
  - If you want a definitive determination as to whether an individual constitutes an "employee," you can submit a Form SS-8 to the IRS.

    See IRS Pub. 15-A for more info on the employee vs. independent contractor issue

Self-Employment Taxes

- Determining net earnings from self-employment
  - Basic Method: (1) calculate the combined income and deductions from all of your businesses and (2) multiply this number by .9235.
    - Example: You have a total net income of $50,000 from all your businesses (after deductions).Your net earnings from self-employment equals $46,175 ($50,000 x .9235 = $46,175)
    - Total self-employment tax in this situation would be approximately $7,065 (15.3% of $46,175 = $7,065).
  - There are optional more complicated methods that result in a larger number and higher self-employment tax. Useful if you want to increase your Earned Income Tax Credit, or if you need more credit for Social Security purposes.

Self-Employment Taxes

- How to report self-employment taxes
  - File Schedule SE along with your Form 1040.
  - Note: spouses must file separate Schedules SE, even if they otherwise file jointly.

See IRS Pub. 334 and the instructions to Schedule SE for more info

Estimated Tax Payments

- What are estimated tax payments?
  - Employees are subject to “withholding” to ensure that the government receives tax payments throughout the year.
  - Individuals who are not subject to withholding, or too little withholding, must send tax payments four times per year—cannot wait until April 15 to make payment.
  - Failure to pay estimated tax on time results in an annual charge of 5-6% interest based on the number of days you are late.
  - Note: if you are required to make estimated tax payments for federal purposes, it is very likely that you must do so for state income tax purposes as well.

Estimated Tax Payments

- Who must make estimated tax payments?
  - Individuals expected to owe at least $1,000 in taxes for the year, after subtracting withholding and credits.
  - Individuals whose withholding and credits are less than 90% of the tax owed for the current year, or less than 100% for the prior year.
  - Tip: if you work as an employee, you may be able to avoid paying estimated taxes by submitting a Form W-4 to your employer to withhold additional amounts.

Note: you may be required to make estimated tax payments even if you do not have a trade or business.

Estimated Tax Payments

- Determining the minimum required estimated tax payments
  - Basic method: (1) estimated personal income tax and self-employment tax liability; (2) multiply this amount by 90%; and (3) divide by four.
    - Example: estimated personal income tax and self-employment tax liability for the year equals $20,000. Estimated tax payment is $4,500 per quarter (90% of $20,000, divided by 4 = $4,500).
  - Annualized Income Installment Method: more complicated, but useful if you do not receive income evenly throughout the year. This lets you pay estimated tax based on income received in each quarterly period. To use this method, complete Worksheet 2-10 in IRS Pub. 505, and file Form 2210 with your annual return.

Estimated Tax Payments

- When are estimated tax payments due?
  - April 15 (for the period Jan. 1 – Mar. 31)
  - June 15 (for the period Apr. 1 – May 31)
  - Sept. 15 (for the period June 1 – Aug. 31)
  - Jan. 15, or Feb. 1 if you file your annual return and pay in full by then (for the period Sept. 1 – Dec. 31)
- How are estimated tax payments submitted?
  - Send payment along with Schedule ES, or
  - Pay online at www.eftps.gov.

See IRS Pub. 505 for more info

Sales and Use Tax

- Who is responsible for collecting sales tax?
  - Sales Tax applies very broadly in most states, including DC, MD, and VA, to almost any sale of "tangible personal property," regardless of whether you have a trade or business.
  - Very few exceptions, but some possible exceptions in DC, MD, and VA include wholesale sales, and "casual and isolated" or "occasional" sales. MD limits the "casual and isolated sale" exception to $1,000 per sale.
  - *However*, if you are shipping an item to an individual who lives in another state, you may not be responsible for collecting and paying sales tax in your state. However, states sometime disagree, and this area of the law is rapidly evolving.

Sales and Use Tax

- Determining the amount of sales tax
  - The tax generally applies to the sale price of the item, not including postage if that charge is stated separately.
  - Tax rates for most items: 5.75% in DC, 6% in MD, and 5% in VA.
- How to pay sales tax?
  - You must be registered in your state before making any sales subject to sales tax (even if you do not have a "trade or business" for federal income tax purposes)
    - In DC: file Form FR-500, or register online at https://www.taxpayerservicecenter.com
    - In MD: file "Combined Registration Application" online at www.marylandtaxes.com
    - In VA: file Form R-1, or register online at https://www.business.tax.virginia.gov/VTOL/Login.seam
  - Once registered, you are generally required to file and pay sales tax for each month by the 20th of the next month. DC, MD, and VA all offer online filing and payment at the URLs noted above.

Stage 3

When Your Business Grows
Beyond Just You

Hiring Employees and Independent Contractors

- Hiring an employee
  - Generally: you have hired an employee when you pay someone for services in connection with your trade or business and have the right to control the manner and means of that person's performance.
    - *Distinguish from independent contractors and individuals who can be considered business partners.*
  - If you have employees, you are responsible for tax withholding, the employer's share of Social Security and Medicare taxes, federal and state unemployment taxes, etc.
    - If you hire an employee, you must obtain an "Employer Identification Number" for your business. File Form SS-4 or apply online at https://sa2.www4.irs.gov/modiein/individual/index.jsp.
    - If you hire an employee, you must also obtain a social security number from the employee and have them fill out Form W-4 and Form I-9.

Hiring Employees and Independent Contractors

- Hiring an independent contractor
  - Generally: you have hired an independent contractor when you pay someone for services and that person is not a business partner or employee.
  - If you pay an independent contractor $600 or more during the year in connection with your trade or business, you must obtain the person's social security or tax I.D. number and submit a Form 1099-MISC to the independent contractor and the IRS.
    - Form 1099-MISC is due to the independent contractor by Feb. 15 and due to the IRS by March 1.
  - Note: if your independent contractor is a corporation, you are generally not required to submit a Form 1099-MISC.

Final Thoughts…

- The IRS will get its money
- Failure to file or pay may result in
  - an audit
  - a tax lien or
  - worse
- If you are in tax trouble, seek help.

Questions?