

Life on the Ledger

How to Make Your Art Add Up

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1. What Can Artists Deduct?

- a. Are you employed by others or self-employed?
 - i. If you are employed by others then your ability to deduct out of pocket expenses is limited.
 - ii. If you are self-employed then you may deduct whatever expenses are considered “reasonable and necessary” to conduct your business.

- b. Types of expenses
 - i. Direct expenses would not be incurred if you were not in business. Such as:
 - Paying subcontractors
 - Studio rent
 - Accountants
 - Supplies

 - ii. Indirect/shared expenses are for items you may pay for anyway but they nevertheless have a legitimate business purpose as well. For instance:
 - A cell phone may be personal and business
 - So might your home internet

- c. What is a business meal? Not your daily cup o' joe! Must be with a client, employee, prospect, etc., unless out of town. Must include a "bonafide business discussion".

- d. Automobile travel: There are two ways to deduct auto travel costs – but either way you must track your business mileage.
 - i. Based on mileage and the IRS "Mileage rate" for that year.
 - ii. Based on actual expenses of purchasing and maintaining a specific vehicle.
 - iii. If you do not keep a log, watch out if you are audited.

- e. Home office complexities
 - i. You must have an exclusive space for business.
 - ii. It does not apply if you are "running a loss".
 - iii. Computing it is not always worth the time and expense.

2. Minimizing Audit Risk

- a. The “Rule of thumb” is that showing profit in 3 out of any 5 years precludes an IRS challenge that you are doing this as a hobby.
 - i. This is not a rule per se; artists especially may incur more than 3 years of losses before showing real income , or may never show a profit.
- b. Other ways to show you are in business to make a profit:
 - i. Keep a log of galleries you have visited to represent you and record other activities not evident from tax return.
 - ii. Hire an artists’ representative.
 - iii. Establish a separate bank account for your activities.
 - iv. Keep good records!
 - v. Register as a DBA “doing business as” or fictitious name with your state or...
 - vi. Establish a one-person LLC (“Limited Liability Company”).
 - vii. Report any income, no matter how small.
 - viii. Track inventory and work in progress rather than deducting it all right away – the “matching principle”.
- c. Consider incorporation if you have sufficient income to make it worthwhile.

3. Keeping records

- a. I do not need to see every receipt!
- b. Time frames
 - i. Generally, the IRS has three years to audit your returns
 - ii. IRS has six years if it suspects substantial underreporting of income
 - iii. No time limit for fraudulent or non-filed returns!
- c. Which records to keep, given the above:
 - i. Anything related to taxable deductions – keep records a minimum of three years.
 - ii. If you are self-employed, keep records for six years.
 - iii. A lot of stuff can be trashed!
- d. Financial record-keeping basics
 - i. You need to have a system that you, or someone you hire, maintains.
 - ii. “Reconcile” bank statements if you want to catch mistakes – yours **or** theirs.
 - iii. Separate personal and business, no co-mingling!

4. Financial Statements – Quick Overview

- a. Balance sheet – What you've got and what you owe
- b. Income – What you're making or not
- c. Compare multiple years – learn your patterns

5. Sales Taxes

- a. No, Martha, it is NOT your money.
- b. States can be especially annoying, and each state has different rules.
- c. Internet sales rules: most sales made on-line are currently exempt
- d. Separate billing for services may limit your exposure

e. **Should I be a Sole Proprietor, form an LLC, or Incorporate?**

- f. Sole Proprietorship: You are self-employed and have no separate business organization structure. While it is wise to separate your business and personal accounts, from a legal standpoint you, personally, have unlimited liability for business debts and claims. You are taxed through your individual tax return (Schedule C).

PROS

- i. Cheap!
- ii. No structure to maintain
- iii. Easy, especially if minimal income and activity

CONS

- iv. No legal protection of personal assets
- v. Self-employment tax can be onerous
- vi. Tendency to forget to pay estimated taxes
- vii. Most likely to be audited

- g. Limited Liability Company (LLC) – This is a sole proprietor or partnership with legal protection. The proprietor or members' liability for company debts generally only extends to their investment in the company. The income or loss “passes through” the LLC and is reported on the individuals' personal tax return.

PROS

- i. Easy and cheaper formation than S-Corp
- ii. More flexibility than a c corporation regarding partners and changes in ownership
- iii. One-person LLC – no separate tax return needed

CONS

- iv. No difference in deductions or taxability from sole proprietor
- v. No salary and withholding for owner so estimated payments needed
- vi. Multiperson LLC needs more forethought and written agreements, and these are often neglected.

- h. S-Corporation – This is also a “pass-through entity” except that it has a corporate structure. Again, your personal assets are generally not at risk. There are some differences from a “multi-member LLC” in terms of operations and taxation.

PROS

- i. It is a set and established structure
- ii. Ability to take distributions and limit reach of the “nasty” self-employment tax
- iii. Profits are not immediately subject to self-employment tax
- iv. Less likely to be audited
- v. Can be a one-person owner

CONS

- vi. May be more expensive to incorporate and maintain
- vii. Some owners do not like being on payroll
- viii. More rigidity regarding who can be an owner and changes in ownership percentages

i. Other Entity Choices

- i. C-Corp: if you have venture capital or can afford additional and substantial owner benefits this may be an option. However you may be exposed to “double taxation”
- ii. Partnership: “Multi-member LLC’s” are essentially partnerships with more extensive legal protection. While they have fallen a bit out of favor with the ascent of LLC’s, there are some instances where they are still favored.
- iii. Non-profit: If you qualify, have the time and money to invest in setting up, expect substantial contributions and grants AND are willing to “share” control with a board of directors – then this may be a good option.
- iv. L3C : New. Hybrid for-profit and non-profit. Only available in a few states.

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