

TAXATION OF THE VISUAL AND PERFORMING ARTIST

2009

PREPARED FOR TALA
Texas Accountants and Lawyers for the Arts

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INTRODUCTION

This handbook provides an overview of federal income tax matters frequently encountered by artists. It contains a summary of the tax laws applicable to calendar year 2009 and includes an explanation of income tax details an artist should know. **IT IS NOT INTENDED TO SUBSTITUTE FOR PROFESSIONAL TAX, ACCOUNTING, OR LEGAL ADVICE**

The information in this booklet is not intended as legal advice but to provide a general understanding of the law. Readers with legal problems, including those whose questions are addressed here, should consult attorneys for advice on their particular circumstances.

Disclosure Pursuant to Treasury Regulations in Circular 230: To ensure compliance with requirements imposed by the Internal Revenue Service, we are required to inform you that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any tax-related matter(s) addressed herein.

Included in this handbook are sections on a variety of subjects including record keeping, preparing an individual income tax return, determining business deductions, estimated tax payments, and self-employment taxes. It also includes a practical list of publications available from the Internal Revenue Service (IRS).

Texas Accountants and Lawyers for the Arts extends its appreciation to the following for their contributions in producing the 2006 edition of this handbook:

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WHICH FORMS TO USE

Most individual taxpayers file Form 1040. Although the IRS also allows certain individuals to use one of the “short forms” (Form 1040A or Form 1040EZ) this handbook focuses on Form 1040. This is the form an artist in business generally uses.

In addition to filing pages 1 and 2 of Form 1040, an artist in business must file a Schedule C, *Profit or Loss from Business*, unless that artist has set up a partnership or corporation. In those cases, the artist may file another form for the business and should consult a tax accountant or attorney to determine the appropriate form to file for their business. If the artist has set up an LLC (Limited Liability Company) with only a single member, that entity can be ignored for tax purposes, and the artist files a Schedule C as if he had not established an entity.

In addition to Form 1040, an artist may file any or all of the following additional forms:

- Schedule A - Itemized Deductions
- Schedule B - Interest and Dividend Income
- Schedule SE - Self-Employment Tax
- Form 4562 - Depreciation and Amortization
- Form 8829 - Expenses for Business Use of Your Home

Other forms may be required. Therefore, an artist should carefully review the instructions to Form 1040 or consult a tax accountant or attorney.

FILING STATUS

Filing status plays an important role in determining an artist's income tax liability. There are five categories for filing an individual income tax return. Filing status is determined as of the last day of the tax year. Each taxpayer must file under one of the following categories:

- Single (unmarried)
- Married filing jointly
- Married filing separately
- Head of household (unmarried with a qualifying dependent)
- Qualifying widow(er) with dependent child

Those who file under "Married filing jointly" and "Qualifying widow(er) with dependent child" use the same income tax rates. If "Married filing separately" is used or if the taxpayer is divorced during the year, special income and deduction rules apply in accordance with the tax laws and with Texas community property laws.

Artists should carefully read the instructions accompanying their tax returns to determine which filing status is applicable. Most individual artists will file as Single or Head of household (if they have a dependent) or Married filing jointly.

FINANCIAL RECORDS

Taxpayers must keep records to substantiate income and expenses reported on their federal income tax returns. While no particular method is required, records must be complete and accurate and must be maintained with a system of accounting that will enable the IRS to determine tax liability. According to regulations, every person is required to maintain their records for at least three years after the due date of the return or the date of payment of the tax, whichever is later.

Business and personal transactions should always be segregated. Separate bank accounts (personal and business) should be maintained. Separate records of business income and expenses make it easier to prepare tax returns and to identify those business expenses that are valid deductions. If the IRS ever questions the artist's tax return, separate expenses make it easier to prove the taxpayer is not underreporting income or claiming excessive deductions. Separate records also show that the taxpayer is serious about the business and making a profit and not merely engaged in a hobby. The burden of proof lies with the taxpayer and adequate, accurate records can sustain the burden of proof.

Primary and Secondary Records

There are two basic types of records: primary and secondary. Primary records are the actual receipts, invoices, and bills the artist receives in the course of art related business or personal life. Canceled checks, bank statements, and deposit slips are also included. It is essential that such records be well organized and complete in order to substantiate the figures entered on the tax return.

Secondary records are those records that summarize and classify the primary records into categories. One simple method of keeping track of income and expenses involves a system of files, one for each category of expenses. All supporting records are placed in an appropriate file. The artist may also use several software packages to accumulate and summarize records such as Quicken, QuickBooks, and MYOB.

A more complex system of record keeping may be necessary depending on the level of business activity. Some artists may seek professional assistance and have a bookkeeper or accountant maintain the books and records.

Practical Advice

Pay all business expenses by check or credit card and have a separate credit card for your business expenses. When an expense is paid by check, the dates paid and check number should be written on the invoice or bill. Do not make a check out to "Cash" to pay a business expense. The IRS will not consider that substantiation of a business payment. For minor expenses, such as parking, which are usually paid with cash, the information can be recorded in a journal, dairy, calendar, or PDA.

Methods of Accounting

There are two basic methods of accounting: cash and accrual. The cash method requires that all forms of income be included in gross income in the year in which you receive it. A cash basis taxpayer generally deducts expenses in the in the year in which they are paid. However, expenditures for items with a useful of more than one year must be capitalized and deducted (depreciated) over time.

The accrual method of accounting is different than cash. It requires that revenues be included in gross income in the year “earned or the taxpayer has the right to receive them,” whether or not payment has actually been received. For example, income would be recorded on the date a musician performed a recital in 2009 even though the payment was received in 2010. Similarly, expenses are deducted in the year in which they are incurred or when the artist becomes liable for payment whether or not the expenses are actually paid during that year.

The accrual method is more complicated than cash. The cash method is generally more favorable to the taxpayer because you do not want to pay tax on income you have not yet received. If you must maintain inventory for your business, you should consult a tax accountant to determine the appropriate method for you.

PREPARING THE RETURN

Preparing the individual income tax return involves a number of important steps to determine the correct tax due. If preparing the tax return manually, these steps include determining what constitutes gross income, subtracting adjustments and deductions, applying the correct tax rate schedule or table to taxable income, and figuring tax credits. If you are using tax software, you generally answer questions posed by the software. However, it is important to know if the results given by the tax software are appropriate. Therefore, even if you use tax software, you may want to read through the following information to make sure that the software produces a result that is appropriate. In addition, you may want to see if you qualify to use the free software on the IRS website at www.irs.gov.

What is Gross Income

The first step in preparing an individual income tax return is to determine “gross income.” The IRS defines gross income as “all income from whatever source derived,” subject to a few exceptions. Typically, visual artists receive gross income in the form of salaries, outright sales of artwork, copyright royalties, and payments for commissioned work. Literary artists’ gross income may include salaries, advances, copyright royalties, and sales of copyrights. Performing artists’ gross income typically includes salaries, performance fees, and copyright royalties. Net profit or loss from a business (Schedule C) is also included in gross income.

Noncash items may be included in gross income. For example, “Swapping” artwork for goods or services or rent should be included in gross income in the amount of the fair market value of the goods or services or rent received in the exchange.

Interest income, dividends, gain from the sale or exchange of a capital asset and alimony received must also be included in gross income. See the “Income” section of Form 1040 and its instructions for more information. Child support, gifts, inheritances, and some scholarships (see below) are excluded from gross income.

Scholarships and Fellowships

Qualified scholarships received by a candidate in pursuit of a degree are not included in gross income if the amounts are used for tuition, fees, books, supplies, and equipment required for courses of instruction. Scholarships for vocational training at federally or state authorized and accredited institutions to prepare a student for recognized occupations are also excluded from gross income.

If the scholarship or fellowship is actually a disguised salary, it might be included in income. For example, amounts received for teaching, research, or any other activity in the nature of part-time employment must be included in gross income. On the other hand, if teaching, research or other such services are degree requirements for all candidates for the same degree, the IRS does not consider this “employment,” and the entire scholarship or fellowship may be excluded. Additional amounts received for travel, research, clerical help or equipment expenses may also

be excluded.

What is Taxable Income

The next step in preparing an individual income tax return is to determine the allowable adjustments to income. These include payments to an Individual Retirement Account, Single 401(k), SEP, or other retirement plans. You may also deduct one-half of the self-employment tax that you owe an allowable adjustment. Other adjustments include educator expenses, student loan interest, self-employed health insurance, alimony paid, and certain moving expenses. Your gross income less allowable adjustments is called “Adjusted Gross Income” or AGI.

Next, deductions from AGI are determined. Artists are allowed to deduct at least the standard deduction. The 2009 standard deduction amounts are:

Single	\$ 5,700
Married filing jointly	\$11,400
Married filing separately	\$ 5,700
Head of household	\$ 8,350
Qualifying widow(er) with dependent child	\$11,400

If total itemized deductions (Schedule A) are greater than the standard deduction, the artist is allowed to deduct total itemized deductions in lieu of the standard deduction. Schedule A should be used as a worksheet to calculate itemized deductions such as interest, taxes, charitable contributions, and medical expenses. If total itemized deductions exceed the standard deduction amount, Schedule A should be completed and attached to Form 1040. Because Schedule A deductions are generally understood by all taxpayers, this handbook will omit a detailed discussion of itemized deductions.

All taxpayers are also allowed a \$3,650 exemption amount for each dependent including themselves and their spouse (if filing jointly). This amount is reduced for those taxpayers with adjusted gross income over \$125,100. See the definition of dependent in the Glossary.

Therefore, based on the above, taxable income consists of:

Gross Income
Less - Adjustments
Equals = Adjusted Gross Income
Less - Itemized Deductions/Standard Deduction
Less - Exemptions
Equals = Taxable Income

After taxable income is determined and the appropriate tax rate is applied, certain credits may be used to reduce the amount of tax to be paid. See the discussion of tax credits below.

Taxpayers also need to consider the alternative minimum tax. The greater of the regular tax or the alternative minimum tax must be paid. Alternative minimum tax calculations are complex and beyond the scope of this handbook. Therefore, if you think you may be, or have been, in an alternative minimum tax situation, you should consult your CPA or tax attorney.

PROFIT OR LOSS FROM BUSINESS SCHEDULE C

General

A sculptor selling artwork from a studio, through a gallery, or on commission is conducting a business, as is a dancer who teaches students at home, or a singer who gives voice lessons. Visual and performing artists who operate an unincorporated trade or business (or a single member LLC) should complete Schedule C to report the net income or loss from the trade or business. This amount is included in the “income section” on line 12 of the first page of Form 1040.

The tax law allows a deduction for all “ordinary and necessary” and reasonable expenses paid or incurred during the taxable year in carrying on a trade or business. Allowance of these business expenses is based on actual payment of the expenses and the existence of a bona fide business.

Actual Payment

In one court case, an artist was not permitted to deduct his donation of three paintings to charitable organizations as advertising and public relations expense. According to the court, there had been no actual payment of the expense claimed. The court stated that the artist could not deduct the value of his own labor as a business expense [see *Maniscalco v. Commissioner*, 632 F. 2nd 6 (6th Cir. 1980)].

Hobby Losses

In some cases, the IRS may consider the artist’s business as a recreational outlet (hobby), particularly when the business fails to show any profit for long periods of time. As discussed above, the allowance of business deductions is only available to a bona fide business engaged in “for profit.”

The artist who relies on other sources of income for support while pursuing his or her art business at a loss may discover that the IRS categorizes the artist’s work as “an activity not engaged in for profit.” If so, deductions will be allowed only to the extent of income received from this activity. This is to prevent the artist from offsetting other income with the losses from the “hobby.”

To avoid the appearance of engaging in a hobby, the artist should take advantage of the “for profit” presumption. This is the concept under current tax law that if gross income from the activity for three or more of the last five years exceeds the deductions attributable to the activity in those years (i.e., years in which the business shows a net profit), then it will be presumed that the activity is carried on “for profit.” The artist is the one who picks the start of the five-year period when the art is declared as a business on Schedule C. Only at this time does the five-year period start running. Nothing prior to this tax year has an effect on the hobby loss rule. Even without the “for profit” presumption, it is still possible to prove the activity is a bona fide business engaged in for profit. The following is a list of some factors the IRS may take into

consideration in making this determination:

- Businesslike manner in which the activity is operated.
- Professionalism of the artist in both artistic and business matters, showing both artistic and business training or that professional business advice has been solicited and followed.
- Time and effort expended by the artist. However, the activity should not have substantial personal or recreational aspects (e.g., hang gliding as an art form will run into serious difficulties).
- Expectation that the assets used will appreciate in value (i.e., based on past records, a visual artist's painting or sculpture will sell for more or that a performing artist will command higher performance fees).
- Past successes of similar activities by the artist/taxpayer (i.e., whether a previous business was successful).
- Income history of the activity (i.e., whether the artist shows a steady increase in gross income, regardless of net profit).
- Profit earned versus losses incurred over the years.
- Financial assets of the artist/taxpayer, particularly if the art activity generates substantial tax benefits (e.g., an independently wealthy artist may have a hard time proving "for profit" status for an art endeavor that continually loses money).
- Absence of elements of personal pleasure or recreation that show a motive other than profit for the activity.

Business Deductions

There are several categories of business expenses:

- Expenses deductible in the year incurred. See Schedule C, Part II.
- Expenditures that are deductible over the life of the assets (i.e., depreciation on expensive cameras, kilns, buildings, and other major items used in the business). See Form 4562.
- Direct costs of the products produced which are deducted when the product is sold (i.e., paint, canvas, clay, silver). See Schedule C., Part III. These items are called Cost of Goods Sold.

All expenses must be ordinary, necessary, and reasonable to be deductible.

Ordinary	Incurred in the normal course of business.
Necessary	Incurred to be able to conduct business.
Reasonable	A subjective test applied to compare the income generated to the expense of generating that income.
<u>Expense</u>	<u>Criteria for Allowance</u>
Advertising	Ordinary and necessary to the business (e.g., printing of flyers for dance classes, magazine advertisement, and business cards).
Bad Debts (accrual basis taxpayers only)	Debt must be worthless. Worthless accounts receivable are not deductible unless the corresponding revenue was previously included in income. A cash basis taxpayer may not deduct business bad debts. A “business debt” is one which is created or acquired in connection with a trade or business or a loss from the worthlessness of a debt which is incurred in a trade or business. Business bad debts are given more favorable tax treatment than personal bad debts.
Bank Charges	Business accounts only.
Car and Truck	Must be used in the business.
Clothing	Purchase price of clothing required for profession, such as leotards, costumes, smocks, welder’s masks, and gloves, etc. Deductions are not allowed for clothes that may be worn outside the business, such as business suits or coveralls.
Commissions (to agents or dealers)	Deduction is permitted if gross sales or receipts prior to Payment of agent’s commission are deposited and included in the gross income of the artist.
Depreciation	The expense allowed to recover a capitalized asset’s cost over a useful life of many years, when it is used in a trade or business.
Dues and Publications	Necessary to keep up to date on professional developments

(e.g., dues to professional societies or unions, subscriptions to professional journals and art books).

Education	Cost of courses taken to improve present business or professional skills but not education costs which qualify the artist for a new trade or business. Voice lessons for a singer or actor and sculpture classes for a painter would be deductible because they improve present skills.
Entertainment	Cost of entertaining business associates or clients is 50% deductible if there is a bona fide business purpose. These deductions must be supported by good records showing business purpose, date, business reason, and the name of the person or persons entertained.
Independent Contractors	Amounts paid to anyone in their business, not under the artist's substantial control. Independent contractors (contract labor) work for the general public.
Insurance	For business assets only; not allowed for personal life insurance. If you have a net profit from self-employment and you or your spouse were not eligible for any employer-subsidized health plan, you can deduct 100% of health insurance costs for you and your dependents as an adjustment to income on Form 1040. The deduction is limited to your net profit from self-employment and any other earned income, minus retirement plan deductions (SEP, IRAs).
Office Supplies	Include those materials and supplies used in the business (e.g. stationery, toner, diskettes, etc.).
Postage	For business correspondence only. This includes the cost of mailing portfolios, resumes, or entries in juried shows.
Professional Fees	For services received in connection with the business (e.g. legal, accounting, consulting, etc.) but not personal matters (e.g., divorce).
Rent	For the primary place of business only. Office at home costs may be deducted only if a portion of the home is used exclusively and regularly for business. Also, hourly rent for darkroom, dance studio, etc., is deductible.

Repairs	Necessary for maintenance of business equipment and studio only; not allowed for personal items.
Salaries	Amounts paid to employees for any work performed, but not “draws” taken by the owner of an unincorporated business.
Supplies	Included in this category are the cost of film, paintbrushes, sheet music, tapes, makeup for performances, etc.
Telephone	Only the cost of long distance calls made for business on a personal telephone. To simplify record keeping and to provide proof to the IRS, artists should consider a separate business telephone line in the workplace that would be fully deductible.
Travel	Actual costs of overnight business travel, but not commuting (i.e., transportation for business trips, plus 50% of meals, plus lodging, plus any incidental expenses).
Utilities	Cost of heat, air-conditioning, light, and power used in the place of business. This also includes the percentage of utilities allocable to the office at home studio, deductible on Form 8829.

It is apparent from the preceding list, artists are allowed a number of business expense deductions that decrease their taxable income. The following sections examine some of these deductions in more depth.

Car and Truck

Artists may deduct the business use of an automobile or truck (except commuting) in one of two ways:

- Standard Mileage Rate

The standard mileage rate is multiplied by the number of business miles driven during the year. In addition, actual tolls, parking fees, and the business percentage of auto loan interest are deductible. For 2009, the standard mileage rate is 50 cents per mile for all business miles.

- Actual Expenses

Actual expenses include depreciation, gas, oil, repairs, insurance, interest, etc. Actual expenses are deductible based on the percentage of business used miles over total miles driven during the year. In addition, actual tolls, parking fees, and the business percentage of auto loan

interest are deductible.

GOOD RECORDS ARE REQUIRED IN THIS AREA! Receipts should be kept for all expenses. Either method requires the total miles driven during the year and the total business miles for the year (including the date of each trip and its business purpose). An auto log completed on a daily basis is highly recommended. If claimed deductions are not supported by such records, the taxpayer could be subject to negligence penalties, and the deduction may be disallowed. The forms used to claim a deduction for business use of a car specifically ask whether the claimed business use is supported by evidence and whether the evidence is written.

Office or Studio in the Home

Artists are allowed to deduct rent or other expenses attributable to business property. Problems may occur when the artist both works and lives at the same location. In this situation, the IRS requires that the portion of the artist's home be used "exclusively" and "regularly" for the business purpose.

There are a few exceptions. The "exclusive" rule does not apply to space used for storage of inventory when an artist's business is selling products at retail or wholesale and the home is the principal place of business. For example, if a sculptor sells pieces solely from his home and keeps finished works awaiting sale in her basement or garage, the proportionate cost of the basement or garage may be deducted even if the family uses the room for recreation or other personal purposes.

The overall limit on deductions for the use of an artist's home as a regular place of business is the amount of gross income derived from the business. A proportion of otherwise deductible expenses, such as mortgage interest, real estate taxes, and casualty losses, are deducted first to reduce the amount of art business gross income from which business related expenses may be deducted. If not deductible in the current year because of limitations, those expenses may be carried forward to future years.

In order to deduct expenses from the business use of your home, you must complete and attach Form 8829 to your tax return. The form is used to compute the allowable expenses for business use of a home, including depreciation of the home.

Remember, taxes, interest, or casualty losses on your personal residence not claimed as a business deduction may be claimed as itemized personal deduction on Schedule A Form 1040.

Travel and Transportation

Domestic travel (within the U.S.) expenses are deductible if they are reasonable and necessary to the conduct of the business. They include transportation, meals, and lodging while "away from home" (see Glossary). Artists who make one-day business trips are allowed to deduct the cost of transportation, but meals may be deducted only if they are entertainment expenses for the artist's business (see Entertainment Expenses). An artist who works at two or more places may deduct the transportation costs of getting from one business to another but not the transportation cost of

getting from home to the first business stop and from the last business stop to home.

Foreign (outside the U.S.) travel expenses, including transportation, meals, and lodging, are deductible if substantially all the time is spent on business matters or if the trip does not exceed one week. If more than 25% of the time is spent on personal matters and the trip lasts over a week, then a proportionate amount of the travel expenses may be deducted.

Adequate records of travel and transportation costs must be kept showing:

- Amount of the Expense
And
- Time and place of the travel expense
And
- Business purpose of the travel expense

A spouse's deductible business travel has been severely limited. Please consult with your tax advisor for additional information.

Per Diem Allowances

Depending on the employer's reimbursement plan, a dancer, musician, or actor may receive per diem allowances to cover travel, meals, and incidental expenses related to a performance or tour that are not included in the artist's gross income. However, if the actual travel expenses exceed the per diem reimbursement, then the excess, if reasonable, is deductible.

Artists should keep good records of receipt of per diem and travel expenses. This will prevent loss of any deductions if the expenses exceed the allotted amount or if the artist's employer fails to comply with the necessary record keeping requirements.

Entertainment Expenses

Entertainment expenses must be substantiated in the same manner as travel expenses with the added requirement of showing the business relationship of the taxpayer to the person(s) entertained. To be able to deduct entertainment expenses, the taxpayer must show:

- Who was entertained.
- There was more than a general expectation of receiving income or some other business benefit at a future time.
- Substantial and bona fide business discussions were conducted with the person(s) being entertained at that time, immediately before, during, or immediately after.

- The main purpose of the meeting was the business transaction.

The cost of entertainment for the artist's or client's spouse may not be deducted unless his/her presence had a clear business purpose.

Expenditures Deductible Over a Period of Time

An artist is permitted to deduct the cost of purchasing business equipment through depreciation. For most equipment and real estate placed in service after 1986, depreciation expense is calculated using the Modified Accelerated Cost Recover System (MACRS). Under MACRS, property is categorized under the following class years: 5, 7, 27.5, and 39.5-year property. Cars and light duty trucks are in the 5-year class. Almost all other types of equipment and office furniture and fixtures are in the 7-year class. Residential real property is in the 27.5-year class. Nonresidential real property is in the 39.5-year class. There are other classes of property in the MACRS system, but are specialized for heavy industries and municipalities.

The question of whether a given item is MACRS property usually arises when an artist uses expensive long lasting items such as cameras, darkroom equipment, kilns, welding equipment, recording equipment, etc. Artists may elect to deduct the entire cost of such equipment up to \$250,000 per year in the first year of purchase for 2009. However, this amount cannot exceed their net income from the business activity.

Professional tax advice should be sought if you have problems determining the best way to recover the cost of equipment.

Expenditures Deducted When a Product is Sold

Normally, an artist deducts the cost of materials purchased to produce an artwork in the year materials are purchased. The IRS will allow this "deduction" if the cost of the materials is a part of the total selling price of the artwork, the artist makes less than \$10 million per year, and the artist uses the cash basis. See your tax advisor for details.

CHARITABLE CONTRIBUTIONS

Taxpayers who itemize deductions are allowed to deduct cash contributions to public charities. If these contributions exceed 50% of the taxpayer's adjusted gross income, the excess over 50% is not deductible in the current year, but may be "carried forward" up to five years. Contributions of real and personal property (not created by the artist) and contributions to private foundations are also deductible at fair market value but are subject to more stringent limitations. An independent appraisal is required for property contributions valued at more than \$5,000. Taxpayers who do not itemize may not deduct charitable donations. Therefore, add the value of your donations to your other itemized deductions to see if you may itemize. Otherwise, you may want to delay a donation until the following year to bunch your total itemized deductions and exceed the standard deduction.

The artist has a special problem obtaining a charitable deduction for a donation of his or her own work. Generally, an artist may only deduct the direct cost of producing the artwork, not its fair market value (see Glossary) at the time of the donation. If the artist had deducted the materials as a business expense, no charitable deduction is allowed. Therefore, obtaining a charitable deduction for an artist's own work will take careful planning.

For example, an artist may keep a piece of work for life, then bequeath the piece to his or her surviving spouse under federal estate tax laws. The spouse may then donate the artwork to a museum or other charitable organization and thereby obtain a deduction in the amount of the fair market value of the piece at the time of donation. Remember: the copyright may be retained by the donor, even though the piece has been given away, thereby allowing the donor to continue to collect royalties on any reproduction of the work. Artists may also elect to retain a piece for life, then bequeath it to a charitable organization and obtain a charitable deduction from their estate taxes. Note: no income tax deduction is allowed for this contribution. The amount of any deduction under this plan will be the fair market value of the piece at the time of the artist's death, thus offsetting the value of the piece included in the artist's gross estate for estate tax purposes. Again, the copyright may be retained by the artist's estate and bequeathed to heirs. These are very complex issues and your tax advisor should be consulted.

TAX CREDITS

After taxable income is determined and the appropriate tax rate is applied, certain credits may be used to reduce the amount of tax paid. Remember: a deduction reduces the taxable income. A tax credit reduces the amount of tax owed. Tax credits are more valuable to a taxpayer.

Child and Dependent Care Credit

If you as a single person work, or if both spouses work or attend school, you may be eligible for credit for the amount spent during the year to care for a child or dependent to allow you to work or go to school full time. Form 2441 should be filed with your 1040 to calculate this tax credit. Note: you and your spouse both must have earned income or one spouse must be a full time student to qualify.

Earned Income Credit

Earned Income Credit (EIC) is a refundable tax credit just like the income tax withholding or estimated taxes paid in during the year. This credit is added to the income tax withholding and estimated tax payments to calculate the total amount of money credited to you. If you owe less than this amount, the excess will be refunded to you if you owe no other taxes (See Schedule EIC).

To qualify for EIC:

- You must have earned income, AND
- You are single or married with no qualifying child and your adjusted gross income is less than \$13,440 (\$18,440 for married filing separately). OR
- You have one qualifying child and your adjusted gross income is less than \$35,463 (\$40,463 for married filing jointly). OR
- You have more than one qualifying child and your adjusted gross income is less than \$40,295 (\$45,296 for married filing jointly).

A qualifying child is your natural child, stepchild, foster child, adopted child, or grandchild under 19 years of age, or under 24 years of age and a full time student. A child also qualifies if the child is totally and permanently disabled.

If you are eligible, you can choose to get the credit in advance through your paycheck by filling out Form W-5 (Earned Income Credit Advance Payment Certificate). For more information on the earned income credit, see Publication 596, which is available at most IRS offices or at www.irs.gov. The rules for EIC can be very complex and you should consult with a tax professional for additional information if you think you may qualify.

Retirement Savings Contributions Credits

If you were born before January 1, 1986, and your adjusted gross income is not more than \$27,750 (\$55,600 if married filing jointly) you may take a credit equal to 50% of contributions to an employer retirement plan or to an IRA, up to a maximum credit of \$2,000. You must complete Form 8880 to claim the credit. Other rules also apply. Consult your tax professional for additional information if you think you may qualify for this credit.

Education Credits

You also may be eligible for education credits (formerly Hope and Lifetime Learning Credits) of up to \$2,500 if you paid qualified education expenses in 2009. These credits are phased at higher adjusted gross incomes and the amount changes every year. You should complete Form 8863 to claim either of these credits. There are both refundable and nonrefundable credits and the calculations can be complicated. Most tax software packages or your tax consultant can make these calculations to determine the most beneficial use of these expenditures.

Homebuyers Credit

For those who purchased a home in 2009, you may take a credit of 10% of the purchase price of the home up to \$8,000 if you were a first time homebuyer and up to \$6,500 if you previously owned a home. You will need to complete Form 5405 and attached the HUD statement (first page of closing documents) to your return.

ESTIMATED TAXES

Regardless of whether an artist is partially or wholly self-employed, he or she is required to pay federal income tax, social security tax, and Medicare tax as income is earned. Generally, an artist's employer withholds these taxes from the artist's paycheck. However, the partially or wholly self-employed artist may face a more complex situation. Depending on the amount of tax paid in the prior year, the artist may be required to make quarterly estimated tax payments to the IRS.

Quarterly Payments of Estimated Tax

For 2009 the tax laws require that the lesser of 90% of current year taxes (including self-employment tax and alternative minimum tax) or 100% of the prior year's taxes be deposited with the IRS to avoid a penalty for underpayment of estimated taxes if you expect to owe at least \$1,000 in taxes including self-employment taxes. High income individuals (a person with a prior year's AGI of \$150,000 or more) are required to pay at least 110% of prior year's total tax due to avoid penalties. This test is made on a quarterly basis. If an artist has not had adequate income tax withheld by his or her employer, he or she is required to make an estimated tax payment. Form 1040-ES is used to calculate and file estimated tax payments. The artist is subject to self-assessed penalties for failure to make adequate quarterly payments. If an artist determines that underpayment of the total tax bill appears likely, the artist may request his or her employer to withhold larger amounts of federal income taxes from his paycheck, or the artist may decide to make estimated tax payments in addition to the payroll tax withholding.

**SELF-EMPLOYMENT TAX
SCHEDULE SE**

Self employed artists are subject to self-employment tax if:

Net income from self-employment is more than \$400.

All wages earned are subject to Medicare tax.

The self-employment tax rate for 2009 is 15.3% which includes 12.4% for Social Security and 2.9% for Medicare. The 12.4% rate applies to the first \$106,800 of self-employment income. The 2.9% rate applies to all self-employment income earned with no limit.

The maximum income subject to social security self-employment tax is reduced by wages from non-self employment sources (i.e., wages subject to withholding).

Additionally, a deduction of one-half the self-employment tax is an adjustment before adjusted gross income before calculating income tax. Self-employment tax is due even if no income tax is due.

REDUCING TAX LIABILITY

The following sections describe some common techniques used to reduce an individual's tax liability.

Retirement Plans

Individual retirement plans provide four major tax breaks:

1. Contributions are currently deductible (subject to limitations).
2. The income from retirement plan funds can accumulate tax free in the plan.
3. The individual is not taxed until the funds are distributed (which is hopefully when the individual is in a lower tax bracket).
4. Roth IRAs are not deductible currently for tax purposes, but the withdrawals later, including earnings will be tax free.

There are numerous retirement plans for individuals including Individual Retirement Accounts (IRAs), Self Employed Plans (SEPs), Roth IRAs, SIMPLE plans, and 401(k)s for individuals. These plans can be complex and you should consult your tax advisor or financial planner to select the appropriate retirement plan for you.

Incorporation

There are very few tax reasons to incorporate an art business. Corporations are entitled to certain business deductions, such as certain fringe benefits. These deductions have been unavailable to the unincorporated sole proprietor (see Glossary). However, the tax laws have changed over the last several years and incorporation does not include the tax benefits it once did. And, in addition, you may be subject to Texas Franchise or Gross Margin tax if your business is successful. The variance in tax treatment between the two types of entities is also shrinking due to the reduction in the individual income tax rates. However, nontax reasons, such as limiting personal liability, may make it desirable for an art business to incorporate. If you believe your business could benefit from incorporation, consult a lawyer and a tax advisor for further details.

Bunching Deductions

In recent years, the standard deduction amount has been increased to the point where itemized deductions, for many people, do not exceed the standard deduction, particularly in Texas, a state without a state income tax. A strategy that may prove useful for some taxpayers involves "bunching" itemized deductions in every other year. The idea is to bunch deductions in a particular year to exceed the standard deduction. For example, a bunching strategy for 2009 would include deferring December 2009 payments such as property taxes to January 2010.

FILING THE RETURN

Reasons for Filing a Return

After plowing through this material, it may be tempting for an artist to consider joining a so-called “tax protest” movement whose members claim that filing returns is not necessary or that income taxation itself is unconstitutional. Joining those taxpayers who fail to report some of the income received, whether in cash, trade or services, may also appear attractive. However, the willful failure to file correct returns or report income is both a federal criminal and civil offense.

In answer to those arguments, there are many sound reasons for filing a federal income tax return and disclosing all income.

- The IRS has several effective ways of determining if a taxpayer did not report all income. These techniques include: comparing the taxpayer’s return with informational returns filed by employers and financial institutions, reviewing bank checking account deposit records and net worth (for individuals) and examining internal controls over gross receipts for the possibility of the diversion of funds to owners (for businesses).
- If the IRS determines that an artist owes tax, whether or not a return was filed, the artist’s property and wages may be taken by the IRS without going to court for a formal judgment – even in states where this is prohibited for private creditors.
- Income tax returns establish a financial report with which to obtain grants, loans, credit, and other personal or business financing.
- Even if your income is below the minimum filing requirement, you must file to get a refund of tax withheld from any payments made to you. Also file if you can claim the earned income credit.
- The time in which the IRS must assess tax penalties is generally three years from the later of the date the return is filed. If no return is filed or if fraud is involved, there is no time limit.
- You could go to jail.

It makes sense to avoid problems and file an income tax return by April 15. If you know you cannot file by then, you should use Form 4868 to request an extension of time to October 15 to file. Form 4868 does not extend the time to pay your income tax. If you owe tax, it should be estimated and paid with the extension to avoid penalties.

Filing Reminders

1. Mail your completed return using the preaddressed IRS envelope, but be sure the IRS address on the envelope is the correct service center for your return to be mailed. If you have moved during the year, notify the IRS service center and the post office serving your old address. To notify the IRS of an address change, use the IRS change of address Form 8822.
2. Form 1040 is not considered a return unless you sign it. Your spouse must also sign if it is a joint return.
3. Be sure to include your social security number in any correspondence with the IRS.
4. If you file your return and later become aware of changes, you can file Form 1040X, Amended U.S. Individual Income Tax Return, to change the previously filed return.
5. If you have a tax problem you have been unable to resolve through normal channels, call your local IRS office and ask for a Taxpayer Advocate.

FREQUENTLY ASKED QUESTIONS

1. How do I keep my personal and business expenses separate?

Using separate bank accounts is essential. Never pay personal expenses with a business check. Instead, make a “draw” against the business account and deposit in the personal account.

2. What records must I keep to deduct the cost of using my car for business?

A record of total mileage for the year and the number of business miles must be kept. Entries should be made in a diary describing the business reason for the use of the car, the mileage, the date, and the amount of tolls and parking. Entries to the diary should be made at or near the time of the business trip. If the “actual expenses” method (versus standard mileage rate method) of deducting costs is used, receipts should be kept for any deducted expenses.

3. Must I declare as income a grant from the National Endowment for the Arts?

Yes. As of 1986 all grant money received is taxable.

4. My dealer gave me advances of \$500 per month against future sales of my sculpture. When must I declare this as income?

If you do not have to repay and even though the advance is against future sales, a cash basis artist must declare the income in the year received. To avoid this outcome, the advance may be structured as a loan.

5. My wife is a doctor. Can we deduct the losses generated by my free-lance photography business from her income?

As long as the “hobby loss” problem is overcome by showing that the business is engaged in “for profit.” You will still need to complete a Schedule C.

6. As a dancer, I frequently attend performances of the New York City Ballet. May I deduct the cost of these tickets as a business expense?

If the primary purpose of attending the performance is educational and records are kept substantiating the purpose and expense, the cost of the ticket is deductible.

7. Although I am a painter, I would like to deduct the tuition cost of my dance class at the university. May I?

The costs of course work taken to improve skills in a present trade or business are

deductible. If you can reasonably improve your skills as a visual artist by taking dance classes, the cost of the course work is deductible.

8. I sing in an exclusive club on weekends. Can I deduct the cost of evening gowns that I buy solely for that purpose?

As you can wear the evening gowns for other purposes, it is unlikely the IRS will allow this deduction. It may be done with additional documentation proving only business use and that the costumes are stored at the place of business.

9. I am a paralegal during the day and perform in a resident theater at night. What costs of using my car may I deduct?

Commuting costs (e.g. home to work) are not deductible. However, mileage between one job and another is deductible as a transportation expense.

10. On a recent trip to Chicago with my ballet company, the per diem I received did not cover all of my expenses. What can I do?

If the dancer accounts to his or her employer for expenses and provides the required information to the IRS on his or her return as to the amount received from the employer and the expenses incurred, the excess expenses (unreimbursed) are deductible.

11. I just had to replace the enlarger in my darkroom. Can I depreciate it?

Yes. Capital expenditures may be depreciated using the MACRS method. However, capital expenditures up to \$250,000 in 2009 can be deducted in the year purchased as a Sec. 179 deduction. You still must complete Form 4562.

12. As a jewelry maker, I stock a large amount of silver. May I deduct the purchase price in the year I buy the silver?

If you are a cash basis taxpayer with gross revenues (sales) of less than \$10,000,000, you may deduct the silver as materials and supplies in the year in which you purchase it.

13. Where can I get help for other legal and accounting problems I encounter in my art business?

Texas Accountants and Lawyers for the Arts (TALA) in Texas and similar organizations around the country provide free assistance to visual and performing artists with art related problems who are unable to pay for those services. They can help.

TALA Houston, 1540 Sul Ross, Houston, TX 77006 713.526.4876

APPENDIX I

LISTING OF COMMON IRS FORMS AND PUBLICATIONS

You can download or print all IRS forms from the website at www.irs.gov. You can also get many forms and publications at many Post Offices and IRS offices. Here is a listing of the most common forms and publications artists may use in preparing their returns.

FORM OR PUB. NO.	TITLE OR DESCRIPTION
1	Your Rights as a Taxpayer
17	Your Federal Income Tax (Individuals)
334	Tax Guide for Small Businesses
463	Travel, Entertainment, and Gift Expenses
501	Exemptions, Standard Deductions, and Filing Information
503	Child and Dependent Care Expenses
505	Tax Withholding and Estimated Tax
525	Taxable and Nontaxable Income
526	Charitable Contributions
529	Miscellaneous Deductions
535	Business Expenses
552	Record Keeping for Individuals
560	Retirement Plans for Small Businesses
561	Determining the Value of Donated Property
583	Starting a Business and Keeping Records
587	Business Use of Your Home
596	Earned Income Credit

946	How to Depreciate Your Property
1040	Individual Tax Return
1040 ES	Estimated Taxes
2106	Employee Business Expenses
2106 EX	Employee Business Expenses
4797	Sales of Business Property
4868	Automatic Extension of Time to File
6251	Alternative Minimum Tax- Individuals
8606	Nondeductible IRA Contributions
8822	Change of Address
Schedule A	Itemized Deductions
Schedule B	Interest and Dividend Income
Schedule C	Profit or Loss from Business
Schedule C-EZ	Net Profit from Business
Schedule D	Capital Gains and Losses
Schedule SE	Self Employment Tax
Form 4562	Depreciation and Amortization
Form 8829	Expenses for Business Use of Your Home

APPENDIX II

GLOSSARY

Adjusted Gross Income	Gross income minus trade or business deductions, employee business, and adjustments.
Away From Home	Travel outside the general area of the taxpayer's principal place of business for a period substantially longer than an ordinary workday (generally overnight). But if less than 24 hours, it must be reasonable for the taxpayer to need sleep or rest during nonbusiness hours.
Bona Fide	Carried out in good faith.
Capital Expenditure	Cost of acquisition or construction of buildings, machinery, equipment, furniture, fixtures, and similar property with a useful life greater than one year. Also, amounts incurred to add to the value of or prolong the useful life of such long-lived property.
Capitalize	Treat as a capital expenditure - do not deduct as a current expense in the year of purchase.
Corporation	A separate legal entity with rights, privileges, and liabilities distinct from its owners/shareholders. For federal income tax purposes, "corporation" includes associations, business trusts, joint stock companies and insurance companies.
Cost of Goods Sold	The direct costs of making a product that are deducted when the product is sold. The price of inventory at the beginning of the year plus direct costs minus price of inventory at end of year equals costs of goods sold.
Credit	A dollar-for-dollar reduction in the amount of tax owed.
Deduction	A dollar-for-dollar reduction in the amount of taxable income.

Dependent

A person who bears one of the following relationships to the taxpayer and who received over one-half of his or her support from the taxpayer:

- * Son, daughter, or their children
- * Adopted child, stepson, or stepdaughter
- * Brother, sister, stepbrother, or stepsister
- * Mother, father, or grandparents
- * Stepmother or stepfather
- * Niece or nephew by blood
- * Uncle or aunt by blood
- * Son-in-law, daughter-in-law, father-in-law, mother-in-law, sister-in-law, brother-in-law
- * Any individual who has a principal place of residence at the home of the taxpayer and is a member of the taxpayer's household.

Generally, a dependent must have gross income of less than \$3,650, unless the individual is the taxpayer's child and is less than 19 years of age (or is a full time student for at least five months of the year and less than 24 years of age at the close of the calendar year).

Depreciation

Gradual loss of usefulness resulting from exhaustion, wear and tear, and obsolescence of tangible property used in a trade or business or for the production of income. A deduction is allowed using the Modified Accelerated Cost Recovery System (MACRS) for capitalized property placed in service after 1986.

Donor

A person who gives, contributes, or bestows a gift.

Draw

Withdrawal of funds from a business bank account or transfer of funds to a personal bank account to pay personal expenses.

Employee

Person rendering services for another who is under the substantial control and direction of that person, both as to the methods used and results achieved. Factors considered include: method of payment, furnishing of tools and equipment, ability to realize a profit or loss, payment of expenses, and

requirement of reports.

Employee Business Expense

Performance of services for an employer is considered a trade or business. Therefore, certain unreimbursed expenses may be deductible:

- * Travel, meals and lodging while on business for the employer
- * Transportation costs, other than commuting
- * Other expenses covered by reimbursement or expense account arrangements by employer.

Fair Market Value

Price at which the property would change hands between a willing seller and a willing buyer neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts of the transaction.

Grantor

Individual or institution that confers a benefit on an individual or organization without expectation of return.

Gross Income

Total income from whatever source, except for specific items listed in the Internal Revenue Code. Income includes all wealth flowing to a taxpayer in the form of compensation for services in cash or property, income from a business, interest, rent, royalties and dividends, alimony, annuities and pensions, to name a few. It does not include gains in the value of property (appreciation) until the property is sold.

Head of Household

Unmarried or legally separated person and who pays at least one-half the cost of keeping up a home (not necessarily the taxpayer's house) which is the principal residence of the person who could be claimed as dependants of the taxpayer, or who pays at least one-half of keeping up a home in which taxpayer and a dependent reside for at least six months.

Independent Contractor

One who contracts to do or perform certain work for another person without being subject to the control of the other person (compare with

“employee”). This person is in business for himself by working for many other people

Inventory Method

Method used to match costs against revenue by deducting expenses when items are sold. If the trade or business requires inventories greater than an insubstantial amount of supplies or works in process, and if the failure to use this method will distort income, the inventory method should be used.

Married

Marital status is determined as of the last day of the taxable year. If a spouse dies during the year, marital status is determined as of the date of death.

Joint Return

All income, exemptions, deductions, and credits reported for both spouses. Both must sign return even if one one had income. Each is responsible for any tax due.

Separate Return

May be filed if either one or both spouses have income. Both taxpayers must figure tax in the same way and report their own income. Each spouse is only responsible his/her own tax due. Since Texas is a community property state, most items of income and expense would be split evenly between husband and wife under community property laws.

Net Income

Income remaining after deduction of business expenses.

Ordinary and Necessary Expense

Reasonable expenses that are normally incurred in a particular business and are appropriate and helpful in carrying out the business.

Principal Place of Business

Primary location where taxpayer conducts business. Factors considered are:

- * Total time spent in performing duties in this area
- * Degree of business activity
- * Relative amount of income generated

A taxpayer may have only one principal place of usiness for each business.

Single Person	<p>A person who is:</p> <ul style="list-style-type: none"> * Unmarried * Legally separated or divorced * Who does not qualify for another filing status
Sole Proprietor	<p>A person who owns and runs his or her own business. The owner is personally liable for debts incurred by the business.</p>
Taxable Income	<p>Amount to which tax rates are applied, determined subtracting itemized personal deductions and personal exemptions from adjusted gross income.</p>
Trade or Business	<p>An activity carried on with a profit motive or expectation of profit resulting from some type of economic activity or transaction. Simply because a business does not make a profit does not mean it is not a business.</p> <p>A taxpayer may have more than one business.</p>
Trade or Business Expenses	<p>Ordinary and necessary costs paid or incurred which are directly connected to the carrying on of a trade or business. To be deductible, the expense must:</p> <ul style="list-style-type: none"> * Be incurred in a trade or business * Be ordinary and necessary * Not be a capital expenditure