

## Taxation & tax deductions for the self-employed visual artist

By Peter Jason Riley, CPA

Artists and taxes don't seem to mix very well. Taxes and administrating the business of art are often last on the list of concerns for the visual artist. The artistic temperament simply does not interface well with the exacting rule-filled world of federal and state taxation. Artists tend to avoid the whole matter and consequently leave themselves vulnerable to bad advice. The secret to overcoming this phobia is to develop an understanding of the mechanisms of the tax code and some simple, effective ways of complying with this onerous task. I often use the analogy that you may not need to know how to fix your car but it is helpful to know how it basically works. In so doing you will pay less in taxes and you will be less likely to fall prey to erroneous tax information and disreputable or ill-informed advisors.

A majority of visual artists are considered "self-employed" in regards to filing their taxes. In a legal and taxpaying sense this means that your "business" as an artist and you as an individual taxpayer are one and the same. There is no legal separation, such as one would have in a corporation, partnership, LLC or other legal entity. The artist usually files a "Schedule C" as part of their regular 1040 income tax form, which is where you report your art income and expenses. The artist may file a form 8829 for the home office (studio) deduction and will also be required to pay self-employment tax (Schedule SE) on your net income (profit) as well as federal income tax. All these forms are part of the year-end 1040 income tax filing. As a self-employed artist, you will usually be required to pay estimated quarterly taxes using Form 1040-ES if your Federal tax liability is over \$1,000 for the year.

The goal is first and foremost to lower your taxes! The artist has a number of tax deductions that are unique. In the balance of this article I will try to break them down to their component parts to make the issues understandable. For the IRS all deductible business expenses are those that are:

1. Incurred in connection with your trade, business, or profession
2. Must be "ordinary" and "necessary"
3. Must **NOT** be lavish or extravagant under the circumstances"

It does not take much analysis to see that these guidelines are not an exacting science. The artist has a large group of basic expenses that easily fit the above criteria: travel (hotel, meals, etc.), vehicle and transportation costs, equipment, art supplies, home studio expenses, legal and professional fees, gallery costs & commissions, etc (see our attached list). Let's review some of the more complex and contentious deduction areas.

### Is Being an Artist a Business?

The first hurdle visual artists often have is the question regarding whether their "art" is indeed a business for tax purposes. The heart of this matter is whether the I. R. S. sees the

endeavor as a real "business" or as a "hobby." Because the artist's ventures often (sadly) yield losses, the question then becomes when the tax code determines an enterprise to be a true business as opposed to a hobby. Here's how you may be affected by these so-called "hobby" rules.

Although you must claim the full amount of income you earn from your hobby, hobby-related expenses are generally deductible only to the extent of income produced by the activity. So if you don't generate any income from your hobby, you can't claim any deductions. What's more, even those hobby expenses which can be deducted are subject to an additional limitation: they are considered miscellaneous itemized deductions on Schedule A, which are deductible only to the extent that they exceed two percent of your adjusted gross income. In contrast, if your activity can be classified as a bona fide business, you may be able to deduct the full amount of all your expenses by filing a Schedule C. In short, a hobby loss won't cut your overall tax bill because the tax law stipulates that you can't use a hobby loss to offset other income.

Converting your hobby into a bona fide business means you can deduct a net loss from other income you earn, such as wages and salaries. How does the IRS determine whether your activity is a hobby or a for-profit business? The Internal Revenue Service publications discuss these nine criteria:

1. Whether you carry on the activity in a businesslike manner.
2. Whether the time and effort you put into the activity indicate you intend to make it profitable.
3. Whether you are depending on income from the activity for your livelihood.
4. Whether your losses from the activity are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).
5. Whether you change your methods of operation in an attempt to improve the profitability.
6. Whether you have the knowledge needed to carry on the activity as a successful business.
7. Whether you were successful in making a profit in similar activities in the past.
8. Whether the activity makes a profit in some years, and how much profit it makes.
9. Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

The primary determinant is your ability to make a profit at what you are doing. If your efforts result in a profit in three out of five consecutive years, your activity is presumed not to be a hobby by the IRS. If you don't meet the three-out-of-five years profit rule, is all lost? Not necessarily, if you can prove to the IRS's satisfaction that you have made a genuine effort to earn a profit and that the reason you are not successful is related to special circumstances, the IRS might agree that your art is, in fact, a business. This is often true for individuals engaged in the arts, where profits and successes are difficult to achieve. To increase your chance of gaining the IRS's recognition of your business, I recommend that you run your activity in a professional, businesslike manner. Doing

such things as having business cards and stationery printed, maintaining a separate business checking account and telephone number, keeping accurate records of the time you put in, and carefully documenting all business-related expenses. The Internal Revenue Service places great credence on computerized accounting records as evidence of the artist's "businesslike" intent. Keep records of all show entries (even including ones that you don't get into) and all gallery activity. In short anything related to attempts to sell your artwork.

## Income

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Income for the artist includes amounts paid to the artist for their artwork. Income for the artist also includes prizes, awards, fellowships, and endowments received. There is also the concept of "taxable income other than cash." This includes trades of art between artist and other individuals. For example: an artist agrees to "sell" a painting to another artist by exchanging artwork. The painting that the first artist gives up "costs" \$75 (the cost of paint, canvas, and framing). The artwork received has a market value or price of \$1,000. The first artist will have a taxable income from this transaction of \$925 (\$1,000 less \$75). In other words the artist received something worth \$1,000 but only paid \$75.

## Inventory

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Inventory is often problematic for many artists; I often get blank stares when I ask the question at tax time. The inquiry concerns the artists cost at year end of the artwork that has not yet been sold, this is the artist's inventory.

Not to get too technical, but the calculation of inventory is primary in arriving at "cost of goods sold." In other words, my direct materials deduction for tax purposes is **(1)** the direct *cost* of all material used in the production of finished art work; materials, framing, printing, etc *LESS* **(2)** the finished artwork held at the end of the year (ending inventory).

Some artists (being cash based taxpayers) can ignore this process altogether because the direct product costs are relatively minor (a potter comes to mind), but for most fine artists, photographers, etc. the cost of framing alone can be sizable enough to require addressing ending inventory.

On the tax return the calculation looks something like this:

Beginning Inventory (beginning of year – from all prior years)	\$5,000
Materials purchased during the current year	\$3,000
Printing done during the current year	\$2,000
Framing done during the current year	<u>\$6,000</u>
Total inventory available for sale in the current year	\$16,000
Ending Inventory (end of year)	<u>-\$5,500</u>
Cost of Goods Sold	\$10,500

In this example the artist started the year with \$5K of value (stretchers, printing, materials costs, framing, prints, etc) in “unsold” art work from prior years. During the year she purchased \$3K of materials, had \$2K of printing costs and spent \$6K in framing so that during the year she spent \$11K producing new finished art work. The \$11K added to the \$5K beginning number to yield \$16K of direct costs in finished art for the year. Finally at year end she had \$5,500 (in cost) of unsold art work, this was her ending inventory. According to this example her deductible direct cost of art work sold during the year is \$10,500.

Since you don't *really* want to be an accountant (!), the key thing the artist has to be aware of is that they need to take an inventory at year-end. This means coming up with a (usually) estimated cost of art work unsold at year end (keep in mind that this may include work from earlier years). This is art work held everywhere; in galleries, the home as well as in the studio. The artist should first make an inventory list of titles and then estimate to the best of his or her abilities the direct costs represented by each work. Keep in mind that the selling price is NOT relevant, just the actual cost of materials, framing, etc.

## Travel & Meals

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The artist is allowed to deduct all expenses associated with overnight business travel. These include meals (only 50% deductible), hotel & lodging, reasonable tips, dry-cleaning, phone calls home, etc. Overnight travel is roughly defined by the IRS as travel that is far enough away from home so as to make it inconvenient to return home at night. Travel could include expenses related to gallery visits, openings of shows, delivering artwork, art fairs, etc. and will include many of the expenditures made on such trips. The other question often asked is the travel deduction for mixed vacation/business travel. As long as the trip is **primarily** business then deductibility will be maintained. For example, what if the artist has a five-day trip to NYC for a gallery opening and outdoor art fair that includes a two-day stopover in Philadelphia on the way home to visit a friend. In this case the entire NYC trip would be deductible but the expenses related to the Philadelphia stopover, which was personal would not be. Since maintaining individual meal receipts is inconvenient, consider using the IRS “meal allowance” for deducting meals when traveling. This “meal allowance” (adjusted annually by the IRS) ranges from \$39 for “low cost” localities and up to \$64 per day for “high cost” localities depending on the city or town. In practice this means that receipts for meals are not required as long as the travel itself can be substantiated. This “allowance” includes all three meals and incidental expenses for the day. Travel for spouses or dependents are not allowed unless they are employees of the art business.

Meals are deductible (remember, only 50%) as part of the overnight travel and they are also allowed as a separate (non-travel) deduction when they meet the criteria of “ordinary,” “necessary” and business related. This means that the meal must include

direct business discussions. This can mean lunch or dinner meetings with agents, fellow artists, gallery owners, etc. If a direct business purpose is clearly documented then the deduction is allowed. These meals could include talks on potential gallery showings, museum exhibits, future sales, Website design or setup, and meetings with lawyers or accountants. The best place to keep records for these expenses is in an appointment book. Log into your book who was present, and briefly the nature and substance of the discussion. I often suggest that you keep a copy of the person's business card as further substantiation.

## Automobile & Vehicle Expenses

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The use of an automobile can be one of the most common and largest deductions for the artist. The automobile use expense can be taken in two ways. The first method is by using the IRS "standard mileage allowance." In 2008 this annually defined allowance is 50.5 cents a mile thru 6/30 and 58.5 cents thereafter. To take this deduction you do not need receipts, only records that show the distances driven and the business purpose of the trips. These would include travel to galleries and museums; trips to the art supply store, classes, etc. The best tool for tracking and calculating this expense is your appointment book or calendar. If your calendar has a record of business travel it can be used as a tool to estimate your mileage deduction (odometer readings are appreciated by IRS but NOT required).

The second method is to write off direct expenses. In this method you actually depreciate the cost of the vehicle (over 5 years) and then tally up gas slips, repairs, insurance, etc and use that amount as a basis for your expense. This method requires more work and organization. If you were writing off a cube van or other larger vehicle, the second method would be preferred. In my practice I often find the mileage allowance method generally yields the highest deduction for straight automobile use. In any case, the IRS allows the taxpayer to calculate the best method year by year and take the one that yields the highest deduction (within limits).

## Equipment

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Equipment purchased is generally "depreciated" and written off over 5 or 7 years on Form 4562. Depreciation is a technique for expensing or writing off purchases that have a useful life of greater than one (1) year. In other words, a kiln or printing press is intrinsically different in nature than clay, a tube of paint, brushes or photographic chemicals. Supplies such as inks, film, canvas, welding material, etc. will be written off (or deducted) in the year of purchase. Most art equipment including computers is written off in 5 to 7 years; these "depreciable lives" are defined in the IRS code. The main tax strategy when it comes to depreciation is the use of what is often called "the section 179 election." In 2008 the IRS allows taxpayers to "expense" up to \$250K of equipment in any one year. In this case the potter is allowed to write-off his/her \$5,000 kiln in one year rather than wait seven years to do it, or a photographer could write-off digital cameras on other technology in the year purchased. Remember this "section 179

expensing election” only accelerates the deduction into one year. Either way, the artist is able to write-off (depreciate) the full cost of the purchase.

## The Home Studio

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The home studio (office) has been a contentious subject in my profession for a number of years. With recent legislation, the home office has clearly returned to its rightful place as an allowable deduction for most artists. If you use a room (or rooms) in your home exclusively as your studio, you will probably qualify for the home office deduction. The use of the room can be as a studio, storage area for equipment and art, record keeping for the business, marketing, etc. The home office is a fairly straightforward deduction to calculate on form 8829. It simply utilizes a formula based on the square footage of the business portion (the home studio) of your home vs. the total square footage of the house or apartment and then applies that percentage to all associated costs. The costs could include rent, mortgage interest, real estate taxes, condo fees, utilities, insurance, repairs, etc. Other rules that come into play here include the “exclusive use” requirement. This rule states that the home office must be used only for the business – no “mixed use” allowed. In other words the studio cannot be a part of a larger room such as the living room unless the business part is partitioned off in some way. The home office can be a powerful write-off in that it allows the artist to deduct a part of what were non-deductible personal expenses.

## Finally...

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Remember that this outline is not intended to be the whole story. The Federal Tax Code is very complicated and your specific applications should be reviewed with a tax professional before filing your taxes. The visual artist is unique in the world of taxes. When you are shopping for a tax preparer please make sure they have some experience in taxation for artists. Organizing your numbers using our on-line worksheets (and this article) will make the process easier, cheaper and will help you maximize your deductions. Ask your preparer about other tax saving strategies for self-employed individuals such as retirement plans, health insurance and the timing of deductions.

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## The Basics of the Home Studio/Office Tax Deduction

By Peter Jason Riley, CPA

The home studio/office has been a contentious subject in my profession for a number of years. With recent legislation, the home studio/office has clearly returned to its rightful place as an allowable deduction for many folks with home based businesses. If you use a room (or rooms) in your home exclusively as your office, you will most likely qualify for the home office deduction. To qualify as a deductible studio/office the space must generally be:

1. The principal place of business
2. The place where the taxpayer meets with clients, customers or patients

The use of the room can be as an office, storage area for equipment and supplies, record keeping for the business, marketing, practice room, etc. The home office is a fairly straightforward deduction to calculate on Federal form 8829. It simply utilizes a formula based on the square footage of the business portion (the home office) of your home vs. the total square footage of the house or apartment and then applies that percentage to all associated costs. The costs can include rent, mortgage interest, real estate taxes, condo fees, utilities, insurance, repairs, etc. If you own your own home you can even depreciate that portion of your house for an additional write-off.

For example:

Business use (square footage)	250
Total square footage of home	1250
Business use % (250/1250)	20%

Mortgage Interest	\$7,500
Real Estate Tax	\$2,500
Utilities	\$1,820
Water & Sewer	\$820
Insurance	\$400
Repairs	<u>\$225</u>
Total home expenses	<u>\$13,265</u>

Potential home office deduction:  
( $\$13,265 \times 20\%$ ) **\$2,653**

Other rules that come into play here include the "exclusive use" requirement. This rule states that the home office must be used only for the business – no "mixed use" allowed. In other words the studio cannot be a part of a larger room such as the living room unless the business part is partitioned off in some way.

Recent legislation has established that the home office does NOT affect the subsequent sale of the home. This means that the use of the home studio does not "taint" the home as a principle residence.

# Painters, Photographers, & Other Visual Artist

<b>Continuing Education</b>		<b>Auto Travel (In miles)</b>	
Private Lessons		Museum & Gallery Visits	
Master Classes & Apprenticeships		Client & Business Meetings	
Schools & Conferences		Continuing Education	
Tickets to Special Exhibits		Gallery Interviews (Potential Shows)	
Gallery Visits & Talks		Out-Of-Town Business Trips	
Museum Memberships		Purchasing Art Supplies & Materials	
Other: _____		Professional Society Meetings	
<b>Promotional Expenses</b>		Parking Fees & Tolls (\$)	
Portfolio Costs		Other: _____	
Business Cards & Resume'		<b>Travel - Out of Town</b>	
Film & Slide Processing		Airfare & Auto Rental	
Postage & Shipping		Van Rental for Moving of Artwork	
Slide and Photographer Fees		Parking	
Printing of Show Announcement Cards		Taxi, Train, Bus & Subway	
Shows & Exhibits		Lodging (do not combine with meals)	
Printing Costs		Meals (enter 100% of expense)	
Other: _____		Laundry, Maid, & Porter	
<b>Supplies &amp; Expenses</b>		Tolls	
Gallery Memberships and Dues		Telephone Calls (including home)	
Brushes and Cleaning Supplies		Other: _____	
Paints, Film, Papers, etc.		<b>Telephone Costs</b>	
Gifts - Business (\$25 per person limit)		Paging Service	
Chemicals for Film Processing		Internet and on-line Services	
Museum Dues and Memberships		Pay & Toll Calls	
Canvas and Stretchers		Cellular Phone	
Framing Costs		Other: _____	
Meals - Business (enter 100% of cost)		<b>Equipment Purchases</b>	
Slide & Film Processing		Phone & Answering Machine	
Stationary & Office Supplies		Computer & Computer Software	
Rent - Studio & Gallery Space		Press, Easel, and Paint Box	
Art Magazines and Books		Darkroom Equipment	
Legal & Accounting Fees		Camera (Digital & Traditional) & Lens	
Rents & Repairs of Equipment		Enlarger & Camera Bag	
Sculpture Supplies & Hardware		Modems and computer peripherals	
Food & Wine - Gallery Openings		Framing Apparatus	
Modeling Fees & Props		Power & Hand Tools	
Commissions - Agent/Gallery		Sculpting Tools	
Other: _____		Other: _____	





