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# Tax Strategies for Creative Entrepreneurs

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## Overview

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- Gross Income
- Exemptions
- Deductions
- Credits

Part 2: Business Tax Issues

- Business vs. Hobby
- Types of Business Entities
- Business Deduction Issues
- New pass-through deduction
- Self-Employment Taxes & Estimated Taxes
- Reporting Compensation Paid




## Gross Income

Start by showing your "Gross Income."

Defined very broadly: any accession to wealth, clearly realized, over which the taxpayer has complete dominion.
*Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (involving taxpayer who won punitive damages in an antitrust lawsuit).

- Income can be received as money, property, or even services (e.g., bartering).
- Certain specified items of income are "excluded" from the definition of income, e.g. gifts, certain employee benefits.
- See IRS Pub. 525 for more information.

## Personal Exemptions

Gross income 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 ($4,050 per exemption in 2016 and 2017).

- These exemptions can phase-out for higher income taxpayers.
- *Suspended by the TCJA from 2018 forward.*

"Dependents" generally include your children who live with you, or other relatives or adults whom you support financially. Check IRS definition because there are numerous special rules. See IRS Pub. 501 for more information.




## Deductions

"Above the Line" deductions

- Reductions applied to calculate "adjusted gross income," e.g. expenses of operating a trade or business, IRA contributions, self-employment health insurance deduction. Available whether or not you itemize.

"Below the Line" deductions

- These are applied after "adjusted gross income" is computed.
- Two types: the "standard deduction" and "itemized deductions."
- Beware of the "alternative minimum tax," which reduces certain itemized deductions, and note that there is a potential phase-out of itemized deductions that can affect higher-income taxpayers in 2017. *(The phase-out has been repealed from 2018 forward.)*




## Deductions

The "standard deduction" vs. "itemized deductions"

- The standard deduction is a flat amount, which depends on your "filing status," e.g. single, married filing jointly, married filing separately, head of household.
  - Standard deduction for a single person is $6,350 for 2017, and $12,000 for 2018.
- Itemized deductions are for specific qualifying expenses, e.g. mortgage interest, charitable deductions, certain medical and dental expenses.
- Potential tax planning strategy: cluster your expenses that could be itemized deductions in one tax year.

*This is an either/or choice: take whichever gives you the bigger deduction.*

## Credits

Credits are dollar-for-dollar reductions of your tax liability.

- Can be "refundable" or "non-refundable"
- Generally subject to limits based on income level
- Examples:
  - Earned Income Tax Credit
  - Education Credits (American Opportunity Credit and Lifetime Learning Credit)
  - Child and Dependent Care Credit
  - The Retirement Savings Contributions Credit (Saver's Credit)
  - Adoption Credit




## Part 2: Business Tax Issues

Business Tax Issues

- Business vs. Hobby
- Types of Business Entities
- Business Deduction Issues
- Pass-through income deduction *(New in 2018)*
- Self-Employment Taxes & Estimated Taxes




## Hobby vs. Trade or Business

What is a "Hobby"?

- Hobbies are carried on without an expectation of making a profit.
- IRS looks at facts and circumstances, such as:
  - Whether you carry on the activity in a businesslike manner;
  - The time and effort you put into the activity indicate you intend to make it profitable;
  - Whether you depend on the income for your livelihood.
- Presumed to be a trade or business if it produced a profit in at least 3 of the last 5 years.
- See IRS Pub. 535 for more info.

## Hobby vs. Trade or Business

### Why It Matters

- "Business" income is reported net of expenses, and business losses reduce your taxable income.
- Deductions for "hobby expenses" are limited for 2017 (and earlier) – you cannot take a deduction that exceeds the income you generate from the hobby, and hobby expenses can only be deducted to the extent these expenses exceed 2% of adjusted gross income. *You cannot deduct hobby expenses at all unless you itemize.*
  - *Deductions for "hobby expenses" no longer allowed beginning in 2018.*
- If you have income from a "business," you may be subject to significant "self-employment" taxes.




## Choosing a Business Entity

There are a variety of different entity options, with different tax and liability characteristics.

Unincorporated Entities
- Sole proprietorship
- Partnership

Registered/Incorporated Entities
- C Corporation
- Limited Liability Company (LLC)
- S Corporation
- Nonprofit Corporation
- Hybrid Entities, e.g. Benefit Corporations




## Sole Proprietorship

A sole proprietorship is an unincorporated business with one owner. The business and owner are one and the same.

- This is the simplest form of business to start and maintain.
- Good tax consequences: the owner simply includes the income and expenses of the business on his/her own tax returns (Form 1040, Schedule C). This is called "pass-through taxation."
- The owner is personally liable for the debts of the business. However, some of these risks can be mitigated through insurance.
- 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.
- Different types of partnerships (e.g., general partnership, limited partnership). Some states require partnerships to be registered.
- Pass-through taxation, but more complicated: the partnership is not taxed. The partnership files Form 1065 to figure out each partner's share of the income and expenses, and each partner reports the taxable income on Form 1040, Schedule C.
- Conclusion: if you own a business with anyone else, it's generally recommended to form an LLC or corporation for liability reasons.





## Why Incorporate or Form an LLC?

Benefits of incorporating or forming an LLC:

- Limited liability (protecting your personal assets or the assets of your other businesses);
- Possible tax benefits (e.g. S Corporation status); and
- May look more professional and permanent to customers, lenders, insurers, and business partners.

Note: If you want a separate bank account for your business, you don't need to incorporate or form an LLC to do that. Banks will generally let you open an account in the name of the business as long as you register the trade name.





## C Corporation

A "C Corporation" is a corporation that is taxed as an entity separate from its owners.

- Limited Liability
- Double Taxation: earnings are taxed to the corporation when earned and then taxed to the shareholders when distributed as dividends.
- C Corporation files Form 1120 (very complicated and expensive to prepare).
- C Corporation has some advantages when it comes to deductions for health insurance.
- C Corporation generally not recommended unless you are (or want to be) a very large company.

## Limited Liability Company

The LLC is the most popular choice of entity for small businesses (and many large ones):

- Easy to administer: fewer formalities than a corporation.
- Flexible tax status: Can elect to be treated as C Corporation, disregarded for tax purposes (like a sole proprietorship or partnership), or S Corporation.
- Generally, limited liability (with caveat about single-member LLCs).

Recommendation: to bolster liability protection, have an "operating agreement" and maintain formalities around distributions (even if you're the sole owner).




## S Corporation

A corporation or LLC that meets certain requirements can elect to be treated as an "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.
- However: S Corporations are sometimes not recognized (and thereby double taxed) at the state level.




## Nonprofit, 501(c)(3) Organizations

Many arts organizations are nonprofit 501(c)(3) organizations.

- "Nonprofit" refers to the type of business entity under state law (i.e. a non-profit corporation, or non-stock corporation).
- "501(c)(3)" refers to its tax status under federal and/or state law.
- To be a 501(c)(3), you must submit an application to the IRS. Two possible options:
  - Form 1023-EZ (very quick and simple – generally for small organizations)
  - Form 1023 (very difficult and burdensome)

## Nonprofit, 501(c)(3) Organizations

Benefits of 501(c)(3) Status:

- Net earnings generally tax-exempt under federal and state law;
- Donations are eligible for charitable deduction; and
- Eligible for grants from private foundations and governments.




## Nonprofit, 501(c)(3) Organizations

Burdens of 501(c)(3) Status:

- Very complicated to administer: must be run by board of directors, pursuant to articles of incorporation, bylaws, and corporate policies;
- Activities must be consistent with 501(c)(3) exempt purpose;
- Director or officer compensation must be "reasonable" and approved by an independent board;
- Need to have a variety of funding sources to avoid being classified as a "private foundation" (private foundations are a special type of 501(c)(3) organization subject to much more burdensome restrictions); and
- Numerous reporting requirements (Form 990, corporate reports, charitable solicitation registrations).




## Nonprofit, 501(c)(3) Organizations

"Promotion of the Arts" is recognized as a valid 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.

A 501(c)(3) arts organization should:

- (1) have at least some educational activities;
- (2) be involved with the public or local community;
- (3) focus on art that lacks commercial recognition; and
- (4) focus on a variety of artists, not just the founders or members.

## Benefit Corporations

Varies by state, but "benefit corporations" generally pursue a business purpose and are required to have a material positive impact on society and the environment, as measured by a third-party standard (a "general public benefit").

- Also, may choose to pursue "specific public benefit" purpose written into the Articles or Bylaws (similar to 501(c)(3) purpose).
- The Board of Directors is required to consider certain other stakeholder interests in addition to the interests of shareholders.
- Required to issue annual report detailing public benefit (sometimes public, sometimes just to shareholders).
- Taxed as a C Corporation or, if elected, S Corporation. *No special tax benefits.*
- Maryland also has "Benefit LLCs."
- Not to be confused with "B Corps."




## Tax Deductions for Businesses

You can deduct the costs of running the business, so long as the expense is *ordinary* (common and accepted in your field of business) and *necessary* (helpful and appropriate for your business).

- Deductible expenses for artists may include studio rent, art supplies, promotion, copying, printing, equipment and software, etc.

*You must keep good records*. Be prepared with documents showing that:

- (1) You incurred the expense; and
- (2) The expense is related to your business.




## Home Office Deduction

To deduct expenses related to the part of your home used for your business, you must meet specific requirements. Even then, your deduction may be limited.

To deduct expenses for the business use of your home, your business use of this part of your home must be:

- (1) <u>Exclusive</u> (i.e., used *only* for business purposes);
- (2) <u>Regular</u> (i.e., not just occasional); <u>and</u> …

The business part of your home must be one of the following:

- (1) your principal place of business,
- (2) a place where you meet or deal with clients or customers in the normal course of your business (case law holds that phone calls don't count), *OR*
- (3) a separate structure (not attached to your home) you use in connection with your business.

## Home Office Deduction

New optional simplified method for computing home office deduction:

- Previously, you had to calculate the percentage of actual expenses allocated to the office, based on square footage.
- Simplified method: standard $5 per square foot allowed as a business deduction (up to a max of 300 square feet).

See IRS Pub. 587 for more info.




## Pass-through Income Deduction

The TCJA introduced a 20% deduction for certain pass-through income (starting in 2018). It applies for certain income from sole proprietorships and partnerships (including LLCs taxed as sole proprietorships or partnerships), as well as S corporations. It is an above-the-line deduction, so a taxpayer does not need to itemize to take advantage of it.

Does not apply to income from:

- Services provided as an employee;
- Reasonable compensation paid from an S corporation; and
- Capital gain, among other categories.

Certain restrictions on the deduction phase in over $157,500 in taxable income for a single filer and $315,000 for a joint filer.

- Income can't be from the performing arts, a business where the reputation or skill of an employee is its principal asset, or certain other professional services.
- Deduction-eligible income restricted based on W-2 wages paid and/or tangible assets used in the business.




## Self-Employment Taxes

What are Self-Employment Taxes?

- Employers and employees each required to pay payroll taxes in addition to income taxes to cover Social Security and Medicare for the employee (also known as "FICA").
- A self-employed person must pay both the employer and employee's share.
- Total self-employment tax is generally 2.9% of net earnings from self-employment for Medicare and 12.4% of the first $127,200 of net earnings ($128,400 for 2018) from self-employment for Social Security (i.e. generally 15.3% if net earnings from self-employment equal $127,200 or less).
- Paying self-employment taxes ensures that you are credited for purposes of receiving Social Security or 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 not 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.)
- You are not subject to self-employment tax on amounts earned as an employee rather than an independent contractor.
  - General rule: You are generally an employee if the person paying you has the right to control the method and means of your performance of service. See IRS Pub. 15-A for more info.




## 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: If both spouses have self-employment income, then two Schedules SE must be filed, one for each spouse (even if they 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 income tax "withholding" to ensure that the government receives income tax payments as income is earned throughout the year.
- Individuals who are not subject to withholding, or from whom too little is withheld, must send tax payments four times per year. *This requirement applies to any income regardless of whether you have a trade or business.*
- 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.
- 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.




## Estimated Tax Payments

Basically, three different methods of figuring estimated tax payments:

- Basic method: Estimate your personal income tax and self-employment tax liability for the year, and pay at least 90% of this amount evenly throughout the year. See Form 1040-ES.
- Safe Harbor method: Pay 100% of last year's tax liability evenly throughout the year (110% if you have more than $150,000 in gross income).
- If you receive income unevenly throughout the year, you may use the "Annualized Income Installment Method," which allows you to pay in higher or lower amounts each quarter based on your income. See IRS Pub. 505. If you use this method, you must file Form 2210 with your annual return.
- Tip: When in doubt, paying 30% of your gross income each quarter is generally sufficient to avoid penalties.




## 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 Form 1040 ES, or
- Pay online at www.eftps.gov.

See IRS Pub. 505 for more info.

## Reporting Compensation Paid

If you have employees, you are generally responsible for:

- (1) withholding payroll and income taxes from your employees, and remitting them to the government;
- (2) paying the employer's share of FICA taxes, unemployment taxes (FUTA and state), workers compensation insurance premiums, etc.; and
- (3) various periodic tax reporting requirements, such as Form W-2, Form 940, and Form 941/944.




## Reporting Compensation Paid

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 (use Form W-9) 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




## Q & A

## Ivins, Phillips & Barker

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