

The Art of Bookkeeping & Tax Saving for Artists

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Introduction

Artists and income taxes don't always seem to mix well. Accounting for your business and taxes are often last on the list of concerns for an artist. Your artistic temperament sometimes doesn't blend well with the exacting, rule-filled world of federal and provincial taxation. Some artists tend to avoid the whole matter, consequently leaving themselves vulnerable to expensive predicaments.

The secret to overcoming this phobia is to develop a basic understanding of the mechanisms of the tax system 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 basically how it works. By understanding the tax system and how it affects your business, you'll pay less tax and be less likely to fall prey to erroneous tax information.

Most artists are considered "self-employed" when filing their taxes. In a legal 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, or other legal entity. A self-employed artist reports art income and expenses on a "T2125 Statement of Business Activities" as part of the regular T1 personal income tax return. A self-employed artist will also be required to pay CPP on net income (profit), as well as federal and provincial income tax. All these items are part of the year-end T1 income tax preparation, which must be filed by April 30 to avoid non-deductible penalties and interest.

Your goal is first and foremost to lower your taxes! As an artist, there are a number of tax deductions that are unique to you. In this guide, I will try to illustrate them to make them understandable and to help you to record and deduct all eligible expenses.

According to the Canada Revenue Agency (CRA), deductible business expenses are those that:

1. Are 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 doesn't take much to see that these guidelines are not an exacting science. An artist has a large group of basic expenses that easily fit the above criteria: travel (hotel, meals, etc.), vehicle and transportation costs, equipment, supplies, home studio expenses, legal and professional fees, rehearsal costs, etc (see the attached list).

Is Being an Artist a Business?

The first hurdle artists often have is the question regarding whether you operate a business for tax purposes. The heart of this matter is whether CRA sees the endeavor as a real "business" or as a "hobby." Because an artist's venture often (sadly) yields losses, the question then becomes when does the tax act determine an enterprise to be a true business as opposed to a hobby?

Here's how you may be affected by the so-called "hobby" rules. Although all taxpayers must claim the full amount of income earned from a 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. In short, a hobby loss won't cut your overall tax bill because the Income Tax Act stipulates that you can't use a hobby loss to offset other income.

However, converting a hobby into a bona fide business means you can deduct a business loss from other income you earn, such as wages and salaries. How does the CRA determine whether your activity is a hobby or a for-profit business? They consider these 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 three out of five consecutive years, your activity is presumed not to be a hobby. If you don't meet the three-out-of-five years profit rule, is all lost? Not necessarily. If you can demonstrate to the CRA'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 CRA might agree that your art is, in fact, a business.

This is often true for individuals engaged in the arts, where profits and successes may be difficult to achieve. To increase your chance of gaining the CRA'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 bank account and telephone number, keeping accurate records of the time you put in, and carefully documenting all business-related expenses. CRA places great credence on computerized accounting records as evidence of the artist's "businesslike" intent. Keep records of all shows (even including ones that you don't get into) and all gallery activity. In short anything related to attempts to sell your artwork.

Income

Income for an artist includes all amounts paid to the artist for their artwork. It also includes commissions, 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.

In addition, if an artist donates an original piece of artwork with a market value of \$1,000 then they have taxable income from this transaction of \$1,000. Of course, you would also have a donation receipt for \$1,000. The resulting net tax impact is therefore zero.

GST

The GST is a tax that applies to the supply of most property and services in Canada. Almost everyone has to pay the GST on purchases of goods and services (other than zero-rated supplies).

Although the consumer pays the tax, businesses are generally responsible for collecting and remitting it to the government. Businesses that are required to have a GST registration number are called registrants. When your business exceeds \$30,000 in sales in any 12 month period, you are required to register.

Registrants collect the GST on most of their sales and pay the GST on most purchases they make to operate their business. They claim an "input tax credit" to recover the GST paid on the purchases they use in their commercial activities.

GST registrants must also meet certain responsibilities. Generally, they must collect the tax on taxable supplies they make in Canada, file GST returns on a regular basis, and remit any resulting net tax owing.

Out of Town Travel Expenses

An artist is allowed to deduct all expenses associated with overnight business travel. These include meals, hotel & lodging, reasonable tips, dry-cleaning, phone calls home, etc. Overnight travel is roughly defined by the CRA 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 Victoria for a gallery opening and art fair that includes a two-day stopover in Vancouver on the way home to visit a friend. In this case the entire Victoria trip would be deductible but the expenses related to the Vancouver stopover, which was personal, would not be. Travel costs for spouses or dependents are not allowed unless they are employees of the art business.

Meals and Entertainment Expenses

Meals for meetings and promotion are deductible (but only 50%) 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 your favorite accountant. The best place to keep records for these expenses is in an appointment book. Record who was present and the nature and substance of the discussion. I also suggest that you keep a copy of the person's business card as further substantiation.

Automobile & Vehicle Expenses

The use of your automobile can be one of the most common and largest deductions for an artist. The automobile expense can be calculated in two ways. The first method is by using the CRA "standard mileage allowance." In 2011, this allowable amount is 52¢ per kilometre for the first 5,000 kilometres driven, and 46¢ for each additional kilometre driven (it's 0.53¢ & 47¢ a kilometre for 2012).

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, bank, etc.

The best tool for tracking kilometres 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 determine your mileage deduction. CRA suggests that the best method is to record each business trip, the destination, the reason for the trip, and the distance covered.

The second method is to write off actual expenses. In this method you actually depreciate the cost of the vehicle (30% per year) 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, this 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 CRA allows the taxpayer to calculate the best method year by year and take the one that yields the highest deduction (within limits).

Equipment

Equipment purchased is generally "depreciated" and written off over 3 to 5 years on Form T2125. Depreciation is a technique for expensing or writing off purchases when they have an expected useful life of greater than one (1) year. In other words, a camera or printing press is intrinsically different in nature than 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 office furniture and computers, is written off in 3 to 5 years as specified in the Income Tax Regulations. Either way, an artist is ultimately able to write-off (depreciate) the full cost of the purchase.

Your Home Office

The home office has been a contentious subject for a number of years, but is an allowable deduction for most artists. If you use a room (or rooms) in your home exclusively as your office or rehearsal or meeting space, you will qualify for the home office deduction. The use of the room can be as a studio, rehearsal space, storage area for equipment, record keeping for the business, marketing, etc. The home office is a fairly straightforward deduction to calculate on form T2125. It's simply based on the square footage of the work space vs. the total square footage of your house or apartment. You then apply that percentage to all associated costs.

For a business, the deductible home office expenses include:

Rent, mortgage interest, property tax, supplies, heat and water, house insurance, cleaning and repair costs.

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 space 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 you to deduct a part of what were previously non-deductible personal expenses. One final note, the home office deduction cannot exceed your income from the business. In other words, the deduction cannot create a loss in the year. However, any excess expenses can be carried forward and deducted in the next year.

Avoid the Red Flag

One thing that you will want to avoid is being red flagged by the tax department (requiring special attention or bringing special attention to yourself). The reasons are obvious. Here are some important points.

1. Always, always, **always** file on time. A late Income Tax Return will get special attention, which you don't want, and it may trigger an audit or bring potentially outrageous penalties. If you owe any money, do everything you can to pay it with the return, but if you just can't pay, send in the return on time anyway with a letter informing them how you are going to look after the taxes due. Never, never avoid filing because you don't have the money to pay the tax.
2. If at all possible, try to fill out your own tax return. I strongly recommend a good computer tax program. These programs will also help you to avoid the most common mistakes. It's worth the effort and time investment to learn how to use it. But if you just don't have the patience for it, find yourself a great accountant. You won't find one at a booth in the local mall. Pay a little extra for a qualified accountant and avoid the "tax preparation services" that are all over the place at tax time. Ask the person who is going to do your taxes for his or her qualifications. Many of those who do this for the tax service companies are not accountants, but have been trained to just fill in the spots on the return. Good tax accountants must be sought out. Ask your colleagues for a recommendation and visit with a few to see if they subscribe to the same philosophy that you do. The best accountants will save you more than they'll cost you.
3. Pay your taxes on time. If you are required to pay installments on self employed earnings, pay those on time too. Even if you have to borrow to do so, do your best to follow this rule, but as noted above, if you just can't pay, file on time anyway.

4. Double-check your return for any errors or omissions.

Paying CPP and Income Tax Instalments

As a self-employed businessperson, you are required to pay your own Canada Pension Plan premiums. The amount you must pay is calculated as a percentage of your net income each year, minus a \$3,500 basic exemption. For 2018, the rate is 4.95% and, because you are deemed to be the employer as well as the employee, you have to pay twice the amount, or 9.90%. The maximum amount payable in 2018 is \$5,187.60 (\$2,593.80 x2).

In addition, you may have to pay your income taxes in instalments. If your net tax owing is more than \$3,000, you should pay quarterly to cover tax that you would otherwise have to pay in a lump sum on April 30 of the following year.

An instalment reminder is issued by CRA to help you determine if you have to pay income tax by instalments. The reminder will suggest an amount to pay and list the payment options. Your instalment payments for 2018 are due March 15, June 15, September 15, and December 15, 2018.

Finally

Remember that this guide is not intended to be the whole picture. The Canadian *Income Tax Act* is very complicated and changes often, so your specific situation should be reviewed with a tax professional before filing your tax return.

The artist is unique in the world of taxes. When you're shopping for an accountant, please make sure they have some experience in taxation for artists. Organize your income and expenses using software or work sheets (and this guide) to make the process easier, cheaper and to help you maximize your deductions.

Also ask your accountant about other tax saving strategies for self-employed individuals such as retirement planning, health insurance and the timing of deductions.

As previously stated, this is not a complete book on income tax or on income tax reducing strategies, but the techniques offered herein are proven, well used, and successful. I wish you good luck in moving forward to achieve your financial desires and goals in life and hope these suggestions will help.

Thank you.

References and Resources

The following references and resources provide additional information that you may find helpful.

Canada Revenue Agency Interpretation Bulletins

- IT 75R4 Scholarships
- IT-459 Adventure or Concern in the Nature of Trade
- IT 514 Work Space in Home Expenses

Interpretation bulletins provide guidance from CRA on their application of the *Income Tax Act*. They can be found on the CRA website at:

www.cra-arc.gc.ca/menu/ITSC_500-e.html

Canada Revenue Agency Forms and Publications

- P110 Paying Your Income Tax by Instalments
- RC4022 General Information for GST Registrants
- RC4110 Employee or Self-Employed
- RC4409 Keeping Records

Forms and Publications can be downloaded from the CRA website at:

www.cra-arc.gc.ca/formspubs/menu-eng.html