

DON'T BE CAUGHT OFF GUARD BY THE TAX AND LEGAL CONSEQUENCES OF YOUR NEW QUARANTINE HOBBY (PART 3 OF 3)

The coronavirus pandemic has forced most of us to stay home, and as a result, we are all looking for hobbies to pick up while we are social distancing. For some, quarantine hobbies have become Netflix binge watching or mastering bread baking. For others, creative passions and hobbies such as selling handmade crafts on Etsy or unwanted junk on eBay have become sources of income. If you are dabbling in a quarantine hobby that produces income, this article describes some good business practices that are important for every business.

Be sure to also check out Part 1 of our series [here](#), where we provide some tips for choosing between legal structures in order to better protect yourself and your business and Part 2 of our series [here](#), where we explore the tax issues relating to your business.

Set up a separate business checking account

Opening a bank account for your business is one of the most obvious ways to show the IRS that you really are in business. Even though you might be the only person accessing funds, it is a good idea to keep your personal and business finances completely separate. Not only will this help legitimize your activity as a business, but it will be immensely helpful come tax time.

If you maintain a separate account for only business transactions, you will have a clean record of all your business expenses at the end of the year. This will prevent you from accidentally forgetting that the book of stamps you purchased was actually for home use and help you easily identify tax deductible business expenses when you are filing your taxes. If you mix personal and business finances, this process will be much more time consuming and could result in some hefty accounting fees (if you need to pay an accountant to sort it all out).

Additionally, mixing your personal and business finances could cause you to lose your business's limited liability protection. Setting up different bank accounts for your business and personal needs helps establish the business as a separate entity and protects you, as the owner, from having to satisfy business debts with your personal assets.

Obtain an EIN

A federal employer identification number (EIN) is a nine-digit number the IRS assigns to businesses for tax filing and income reporting purposes. The IRS uses the EIN to identify the taxpayer. EINs must be used by business entities—corporations, partnerships, and limited liability companies. However, most sole proprietors do not need to obtain an EIN and can use their Social Security numbers instead. Even though a sole proprietorship does not need to obtain an EIN, it may be in your best interest to obtain an EIN anyway.

There are a few good reasons to use an EIN instead of your Social Security number. First, obtaining an EIN allows you to avoid having to provide your Social Security number to clients and other members of the public. Obviously, keeping your Social Security number private limits your exposure to identity theft. Additionally, using an EIN on your tax returns and payments to others also helps to show that you're a legitimate business—in other words, this isn't just a hobby, it's separate from your personal activities. Lastly, some banks require you to have an EIN before they will set up a bank account for your business.

The good news is that obtaining an EIN is easy and free! The fastest and easiest way is to apply for an EIN is directly through the IRS website. The IRS has an online EIN Assistant tool you can use. If you are not comfortable sending information via the Internet, you can download IRS Form SS-4, *Application for Employer Identification Number*, and send it to the IRS by mail.

Maintain a good business record-keeping system

To prove to the IRS you did, indeed, make those purchases for your business, you will need a paper trail to back up your claims. Therefore, maintaining a good business record-keeping system that keeps your receipts and purchases organized is vital. Technically, if you do not have these records on file, the IRS can disallow your deduction. The IRS recommends keeping the following types of expense documents for your business:

- Account statements and invoices;
- Canceled checks;
- Credit card receipts and statements;
- Cash slips for cash payments; and
- Receipts for all entertainment, gift, transportation, and travel expenses.

The amount of time you should keep these documents varies between three years to indefinitely depending on the type of tax return you file, but the longer you keep them, the better protected you'll be if you're audited. The general rule of thumb is at least seven years—so do not immediately throw away your receipts after you have filed your taxes!

If maintaining a paper trail and a heavy file cabinet in your basement isn't your thing, an

electronic record-keeping service like QuickBooks can help, since you always have a digital copy of your records available, and the calculations are always quick and accurate. Without a solid accounting software system, daily bookkeeping tasks will put a major strain on your time, and this burden will only become greater as your business grows. Regardless of the record-keeping system you choose, maintain an exhaustive record of all your finances in one place and strive to save and record receipts on at least a weekly, if not daily, basis.

Register the business with a state as a limited liability company, partnership, or corporation

Once you have chosen a legal structure for your business as detailed in [Part 1](#) of our series, make sure you register the business with the state in which you are doing business if you chose to operate as a limited liability company (LLC), partnership, or corporation. Businesses that operate as a sole proprietorship generally are not required to register, and some states may not require registration for a small partnership either. The forms and the information required to register will differ based on the type of business being registered. But generally, the forms allow you to register a name for your business, and they also require certain information, such as the address, key officers, and the name of a contact person who will receive legal notices.

Comply with other state and federal tax laws, including collecting sales taxes and paying annual state business renewal fees or franchise taxes

Annual statement or report. Many states require corporations and LLCs to submit annual reports so they can keep clear records regarding these entities. The annual report will include your entities name, your office address, and your registered agent information. The purpose of the annual report is to keep the state updated with your entities' contact information. If you fail to file your annual report, the state may automatically dissolve or shut down your business. A biennial statement may also be mandated by some states. A fee is generally required with a statement or report submission, typically ranging from \$10 to over \$300.

Franchise tax. Some states require corporations or LLCs to pay an annual tax to operate, which is usually called a franchise tax. The amount of the tax depends on the state collecting it and is determined through formulas based on varying criteria, such as annual revenue collection or the number of shares issued by a company.

Sales tax. You may be required to collect sales tax in your state as well. You generally collect sales tax for the state in which you conduct business on orders that are placed within or delivered to a location within that same state. So, if your studio is in Milwaukee, and you are shipping to a customer in Madison, you will be expected to collect state sales tax on that order and pay it to the state of Wisconsin. If you are shipping an order from Milwaukee to Atlanta, it is unlikely that you will need to collect state sales tax. However, for online sellers

in the e-commerce space, things are a little bit murky as to where you conduct your business, so be sure to read up on tax information for your primary state of business and any others you have dealings in. Additionally, in some states you may be required to obtain a sales tax permit to collect state sales tax. You can find information about each state's sales tax permit on that state's Department of Revenue website.

Consult with Legal and Tax Professionals

Before you launch your business, you should consult with legal and tax professionals to ensure you have considered all the legal and tax requirements. Legal counsel can help explain the implications of each legal structure and other important issues beyond the scope of this series, like whether you should trademark your company name or logo, or if you need patent, copyright or intellectual property protection for any of the products you are intending to sell. Tax professionals can help explain the tax implications of forming a sole proprietorship versus a partnership or a corporation and can help you manage and file your business taxes. While your local and federal government websites are an excellent place to begin your research, it is essential to have good counsel on call to solve legal and tax issues and to provide advice before diving into the world of a small business.

The thought of running your own business may seem a bit daunting at first, but our team at O'Neil Cannon is prepared and ready to help you. Please speak to your regular OCHDL contact, or the author of this article, attorney [Britany E. Morrison](#), to get your business up and running.