

Entertainment Audit Technique Guide

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Introduction

The purpose of this Entertainment Audit Technique Guide (ATG) is:

- To provide an overview of the activities encountered in examinations of individuals in the entertainment industry.
- To familiarize examiners with issues and terminology pertinent to individuals in the entertainment industry.
- To assist examiners with their examinations by providing audit techniques.

This ATG should help reduce the time needed to examine returns of individuals in the entertainment industry by providing some background on the industry and the applicable tax law. While this guide covers a variety of situations and issues, it is not all-inclusive.

Chapter 1 - Background

Overview

This audit technique guide is designed to provide assistance in auditing individuals in various aspects of the entertainment industry. The issues need to be developed in relation to the taxpayer's trade or business. Sometimes it is a challenge to determine the exact nature of the taxpayer's profession. It is, therefore, necessary to look beyond the job title and determine the actual duties and responsibilities of the taxpayer.

At one time, an individual's job title clearly denoted the duties associated. Now, there is a great deal of crossover between job titles. In the early years of film making, the director was under the control of the producer and had complete control of the actors, editors, etc. Now, many actors have creative control. Directors may have creative control. Editors may work directly under the control of the producer and independent of the director.

Individuals can function in different job titles on different projects. A taxpayer may be a property master on one project and a "prop man," assistant property master, or a set dresser on another. Many actors are also directors or producers, sometimes on the same project. It is, therefore, critical to determine the duties of a taxpayer in regard to each project. This will be important in determining which expenses are ordinary and necessary.

In the film industry, employees are categorized as "above the line" or "below the line." Above the line employees are thought of as creative talent, while below the line generally refers to technicians and support services (although it includes set designers and artists). The "line" is an accounting demarcation used in developing the budget for production. Some above the line costs are incurred even before a film goes into the production stage. Above the line costs include the story rights, the screen play, the producer, the director, and the principal cast. Generally, during the "pre-production" period, the expense for the principal cast is negotiated, but the cost of the story rights are actually paid.

This audit technique guide covers performers, producers, directors, technicians, and other workers in the film industry, the recording industry, and live performances. The same general rules apply and the same issues are found on most of these returns. While working in the entertainment industry, taxpayers are involved in performing for compensation, searching for work through auditions or any other reasonable means of attaining employment, or maintaining their position (skills, image, etc.) through reasonable expenditures for education, training, public relations, etc.

Historically, taxpayers in the entertainment industry tend to be aggressive or abusive when deducting expenses that may or may not be related directly to their business activities (i.e., personal expenses). Our goal is to bring the allowable deductions back within the confines of the Code. The distinction between ordinary/necessary and extravagant must be more clearly drawn.

Unions and Guilds

The entertainment industry has numerous unions and guilds. Each of these organizations has entered into a collective bargaining agreement on behalf of its members. These agreements or contracts address rates of compensation, reimbursements, allowances, hours required to be worked, materials to be provided, etc. Prominent performers and creative talents may negotiate additional terms for each project on which they work to supplement the union or guild contract (or have their attorney or business manager negotiate these items). Issues not addressed in these individual contracts are determined on the basis of the underlying union or guild contract.

When an individual is a member of a guild or union (i.e., pays dues), we can generally assume that individual is entitled to the benefits of the union/guild contract for the year(s) under examination. In the absence of any verification to the contrary, all reimbursements and benefits provided for in the contract will be deemed available to the taxpayer.

Reimbursements

When entertainment industry taxpayers work on union productions, their respective contracts typically require allowances or reimbursement compensation. Taxpayers claiming otherwise should prove they were not entitled to allowances, reimbursements, or compensation under their applicable contract. The major unions (SAG, DGA, etc.) have contracts that provide for extensive reimbursement and compensation for the more common expenses such as travel and meals. Many other expenses commonly seen are covered by the contracts as well (e.g., physical trainers; offices; security; travel and related expenses for spouses, significant others, children; etc.).

Taxpayers who claim a production was non-union must provide a copy of their contract with the producer or other proof.

Frequently, taxpayers claim that although expenses were reimbursable under the contract, they did not claim reimbursement because they feared they might not be hired for future projects. The IRS position is, nevertheless, that if the taxpayer could have received reimbursement, the

expense is not deductible even if the reimbursement is not claimed. *See Kennelly v. Commissioner*, 56 T.C. 936, 943 (1971), *aff'd*, 456 F.2d 1335 (2d Cir. 1972).

If the expense exceeds the potential reimbursement, the excess expense may be allowable if it is necessary. The most common example is the auto expense. If the taxpayer claims actual expenses, the expense can be reduced by the mileage reimbursement available (whether or not claimed from the employer) and the remainder may still be allowed as a deduction.

When the taxpayer is entitled to stay in a hotel that would be paid for by the employer but chooses to stay at another hotel at his own expense, the excess expense is not considered necessary. Personal preference is not a valid business reason to incur an otherwise unnecessary expense.

See Chapter 3, section titled [Fringe Benefits](#), for information on I.R.C. § 62(c) when reimbursement can create income.

Copyrights

An implied copyright is automatically created as soon as a copyrightable item is created. This protects the creative talent from having his or her work stolen. This applies to screenplays, scripts, compositions, etc. Additionally, finished works are generally protected by a formal copyright. The following materials may be copyrighted:

- Literary works
- Musical works, including any accompanying words
- Dramatic works, including any accompanying music
- Pictorial and graphic works
- Motion pictures and other audiovisual works
- Sound recordings

An idea or concept cannot be copyrighted. The copyright covers the artistic interpretation or specific treatment of the concept.

Period Covered

Any copyright, the first term of which was in existence prior to January 1, 1978, endures for 28 years from the date it was originally secured. Copyrights registered before January 1, 1978 can be renewed to endure for 95 years from the date the copyright was originally secured. In general, a copyright on a work created on or after January 1, 1978, lasts for the life of the author and 70 years after the author's death (with no renewal), or 120 years for corporate authorship.

Copyright Infringement

The use of copyrighted material without permission is an infringement of the owner's copyright. The copyright is an exclusive right which covers copying, reproducing, printing, reprinting, and publishing copyrighted works. It also covers the use of copyrighted material in audiovisuals.

Receiving Income

When copyrighted material is used, reproduced, or adapted to another medium, permission must be obtained. This generally results in royalties being paid to the copyright holder, fees being paid for the granting of a license, or the selling of an option. This income to the copyright holder is taxable. Royalty income is not passive per I.R.C. § 469(e)(1)(A).

If the taxpayer was regularly engaged in the trade or business that generated the royalty, when received by the taxpayer, the income is considered self-employment income and is subject to self-employment tax. See Treas. Reg. § 1.1402(a)-1(c); Rev. Rul. 68-498, 1968-2 C.B. 377 (discussing a writer who wrote many books and hence qualified to pay self-employment tax). Revising prior editions of a work one had created could also be sufficient to constitute a trade or business and the income would therefore be subject to self-employment tax. See *Langford v. Commissioner*, T.C. Memo. 1988-300, *aff'd*, 881 F.2d 1076 (6th Cir. 1989).

However, if the taxpayer was not engaged regularly in the trade or business that generated the royalty, then it is not subject to self-employment tax. See *Langford v. Commissioner*, T.C. Memo. 1988-300, *aff'd*, 881 F.2d 1076 (6th Cir. 1989). For example, "[i]f an individual writes only one book as a sideline and never revises it, he would not be considered to be 'regularly engaged' in an occupation or profession and his royalties therefrom would not be considered net earnings from self-employment." Rev. Rul. 68-498, 1968-2 C.B. 377.

The payer has an expense for the purchase of the option, fees for the granting of a license, or the payment of royalties. This expense would typically be subject to capitalization as a production expense.

Chapter 2 - Planning the Audit

General Approach to the Interview

The key to a successful audit, particularly with individuals in the entertainment industry, is developing a solid background and history of the individual's activities and responsibilities. Because people in this industry slide from one job category to another, it is imperative to determine what the taxpayer actually did to receive each item of compensation during the tax year. If a "singer" received all of his or her income from choreographing another performer's routines, his or her expenses should not include any "on camera" costs such as wardrobe, make-up, or hair. He or she should, likewise, not be incurring expenses for rehearsal studios or back-up musicians.

Information to Obtain

Whenever possible, secure copies of all contracts, project agreements, deal memos, working proposals, letters of understanding, etc. pertaining to the taxpayer's activities. This is important whether or not the income from these projects was received in the tax year. These agreements provide fundamental information on the nature of the taxpayer's income, expenses and

reimbursements. The contracts also disclose who has control and who retains any rights related to the project.

Request a copy of the taxpayer's resume. This will show what type of work the taxpayer has done, what sources of income (royalties, residuals, etc.) to expect, and the taxpayer's reputation or standing in the industry. The examiner should research the taxpayer on the internet. Most people in show business will list their credits and the examiner will be able to see some of the projects in which the taxpayer participated. The following are some internet sites the examiner can use: IMDb.com and Freebase.com. The examiner can also see if the taxpayer has his or her own website. The taxpayer's standing in the industry can be helpful in determining the nature and extent of expenses that would be incurred to maintain that standing. An unknown actor would not normally need to send gifts to a prominent producer. A well-known, highly sought after singer would not need to entertain a camera operator.

Allocation of Personal Expenses

The allocation between personal expenses and business purpose will depend on specific correlation between expenditure and income source. The background interview is very important for these cases. It will be the basis upon which expenses will be allowed.

Get an initial chronological background of the tax year by inspecting or researching all logs and records of travel and meals and entertainment. Try using a general month to month format. Get a sense of the taxpayer's main activities each month.

Through oral testimony from the taxpayer or third party contacts, you can retrieve the dates worked, requirements, and specific activities as they correlate for each Form W-2, Form 1099-MISC, etc.

Recordkeeping

In the case of personal expenses used for business purposes, the taxpayer's compliance with I.R.C. § 274 determines the deductions allowed. Taxpayers who do not comply with the substantiation requirements of I.R.C. § 274(d) are not allowed very many, if any, deductions. The criteria for I.R.C. § 274(d) are the amount of such expense or other item; the time and place of the travel, entertainment, amusement, recreation; the business purpose; and the business relationship to the taxpayer of persons entertained.

No deduction should be allowed if the taxpayer is merely receiving a general business benefit from personal expenses, rather expenses must be directly related to income. The detailed rules for determining what requirements a taxpayer must meet for the entertainment to be directly related can be found in Treas. Reg. 1.274-2(c).

The documentation limitation under I.R.C. § 274(d) supersedes the *Cohan* doctrine (*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)), which states that when possible the court should make a close approximation rather than disallow a deduction entirely.

If a taxpayer received both a Form W-2 and a Form 1099-MISC for income, determine what the Form 1099-MISC income is - that is, independent contractor, self-employment income, or reimbursement. Allow related expenses against this income. Allocate expenses between Schedule A and Schedule C when the taxpayer has both the Form W-2 and Form 1099-MISC income in the same line of work. If the taxpayer cannot establish which expenses directly result from each respective source of income, allocate the expenses as (W-2 entertainment income divided by total entertainment income) times allowable entertainment business expenses which equals Schedule A miscellaneous employee business expense. This formula is also shown below:

$(\text{W-2 Entertainment Income} \div \text{Total Entertainment Income}) \times \text{Allowable Entertainment Business Expenses} = \text{Schedule A Miscellaneous "EBE"}$

The balance of the entertainment business expenses may be allowed on Schedule C.

Self-Employment Tax Considerations

Net profit from self-employment over \$400 is subject to self-employment tax. Once expenses have been properly allocated, insure that any net profit or loss is considered in determining the taxpayer's net self-employment income. Remember to include income or losses from partnerships and other self-employed activities. Residual payments that do not have FICA withholding should be assessed self-employment tax if a net profit is realized after related expenses, if any, are deducted.

Royalties resulting from services performed (e.g., music performed, songs written, screenplay written, etc.) are subject to self-employment tax in the same manner as residuals. Royalties from merchandising or licensing, which did not involve any services, are not subject to self-employment tax.

Employee Versus Independent Contractor

The majority of entertainers and technicians are employees and will receive a Form W-2 with federal income tax and FICA tax withheld. The extent of control a studio or production company has over an entertainer continues to be the determining factor in classifying an individual as either an employee or an independent contractor. Treas. Reg. § 31.3401(c)-1(b) states in part:

Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.

Audit Techniques

When a taxpayer has received a Form W-2, but claims to actually be an independent contractor, be thorough in developing the facts. Consider the following factors:

- The taxpayer received the Form W-2 several years prior to the audit. Has the taxpayer taken any action to correct the situation?
- The taxpayer received all the benefits of an employee (health benefits, pension plan, unemployment). Has the taxpayer taken any action to waive these benefits?
- If the taxpayer is a member of a guild, does the taxpayer have an individually negotiated contract?
- If the only contract is the union or guild agreement, the taxpayer is an employee. The union/guild agreement was negotiated as a collectively bargained agreement on behalf of employees.
- Contributions made on behalf of the taxpayer to an union/guild pension plan indicate that the taxpayer is an employee.

With few exceptions, taxpayers issued Forms W-2 will report these wages on their Form 1040 and not on a Schedule C. No consideration should be given to performers who claim to be a statutory employee or a statutory non-employee which would allow expenses to be taken against income not subject to either the 2% AGI limitation or Alternative Minimum Tax. There is no such statute applicable to this industry.

One important exception, allowing an employee to claim expenses in arriving at adjusted gross income, is I.R.C. § 62(a)(2)(B). This section pertains to "qualified performing artists" as defined in I.R.C. § 62(b). A qualified performing artist means, with respect to any taxable year, any individual if:

- Such individual performed services in the performing arts as an employee during the taxable year for at least 2 employers,
- The aggregate amount allowable as a deduction under § 162 in connection with the performance of such services exceeds 10% of such individual's gross income attributable to the performance of such services, and
- The adjusted gross income of such individual for the taxable year (determined without regard to subsection (a)(2)(B)) does not exceed \$16,000.

Refer to [Chapter 17](#), Employment Tax, for more information on employment taxes.

Non-Filers

In the entertainment industry, income can fluctuate greatly from year to year. This creates a high potential for non-filers. There is no major difference between non-filers in the entertainment industry and those in any other industry. The same filing requirements and filing dates apply.

Some taxpayers in the entertainment industry relocate frequently in order to obtain employment. Third party letters to the unions or guilds can be helpful in locating the taxpayer. Agents and agencies can also be helpful in locating taxpayers in the entertainment and modeling professions. Musicians who perform under the name of a band are more difficult to locate, unless the band can be identified, which can probably be done by researching the taxpayer on the internet at such sites as Allmusic.com, Musicbrainz.org, and discogs.com. The same third party sources can also be helpful in reconstructing the taxpayer's income.

When working non-filer cases in the entertainment industry, keep in mind that some time delays are unavoidable. Out of town travel and location work are common for many of the professions in this industry.

Chapter 3 - Income Issues

Residuals

Income may be received by entertainers in many different forms. One of the most common forms is residuals. These are periodic payments received by actors and others for re-runs of commercials, episodic television, etc. The payer may be a film studio or one of a few payroll services. The agent's ten percent commission is usually charged only where the amount of the residual is above union scale. Payers typically file Forms W-2 and/or Forms 1099-MISC. The IRS should, therefore, have adequate records for these information returns. The primary collector and distributor of residuals for actors is Screen Actors Guild-American Federation of Television and Radio Artists (SAG-AFTRA). Prior to March 30, 2012, SAG and AFTRA were two separate unions. Although SAG-AFTRA does not issue the actual Forms 1099-MISC or Forms W-2, it provides the documents that support the residuals being reported on the information returns. Residuals can also be paid directly to a loan-out corporation. The residual computation can be very complicated but if there is a dispute about the amount of the residuals, it is between the union and the taxpayer.

Royalties and License Fees

Other common forms of income received by people in the entertainment industry are royalties or license fees. These are periodic payments received by copyright owners, such as songwriters, recording artists, and authors. They are paid by those who perform, exhibit, run, or otherwise distribute copyrighted works for a prescribed time period or purpose.

Royalties are portfolio income and nonpassive under I.R.C. § 469(e) and Treas. Reg. § 469-2T(c)(3)(i)(A). *See also* Treas. Reg. § 1.469-2T(c)(7)(i). Royalties should not be on either Form 8582 or Form 8582-CR (where they improperly permit deductibility of passive losses and credits). Passive losses and credits are generally deductible only to the extent of passive income under I.R.C. § 469(a) and § 469(d). There is a single exception in Treas. Reg. § 1.469-2T(c)(3)(ii)(E) for royalties derived in the ordinary course of a trade or business of licensing intangible property, which permits royalties to be treated as passive income. This exception is highly restrictive and rarely seen. It is further elaborated on in Treas. Reg. § 1.469-2T(c)(3)(iii)(B).

Fringe Benefits

Since advertising and promotion deals go on all the time in the entertainment industry, there are many opportunities for paying employees in something other than cash. These items may not always appear on the recipient's Form 1040, but they are taxable and should be included in

income under I.R.C. § 83 (fair market value of property received for services is included in gross income). They take the form of fringe benefits or goods for services.

A common form of fringe benefit is the perk. Performers sometimes receive wardrobe and other perquisites from producers. They might get to keep their costumes after the filming or get the advertiser's product after a commercial shoot. An established spokesperson for an automobile manufacturer typically receives a new car each year. There may be merchandise deals, where the compensation for a broadcast deal is in the form of barter. Frequently, employees of television, movie studios, and record companies receive free passes to concerts, shows, and screenings.

Beginning in 1989, if an employer reimburses employee expenses, there must be an arrangement requiring the employee to substantiate the expenses and/or return the unsubstantiated portion to the employer. Where there is no such arrangement in effect, I.R.C. § 62(c) requires that the unsubstantiated portion will be considered income to the employee.

Some performers also receive income for participation, endorsements, product tie-ins, and prizes (i.e., tractor-pulling, rodeo, TV game shows). Some of these sources can be identified by relating specific expenses to the source of the income produced. The examiner should review completed contracts with all of the addendums to verify that all compensation has been reported on the tax return.

Taxpayers in the entertainment industry are often eligible for unemployment compensation between jobs. These payments must also be included in gross income. Although these amounts are generally reported by the payer on a Form 1099-G, it is advisable to ask about periods of unemployment between jobs during the initial interview.

Advances

Advances and royalties are common for authors, songwriters, actors, and recording artists. The terms of advances, royalties, and other payments are described in an agreement between the author and publisher, for example. Refer to Chapter 4 sections titled "Capitalization Issues" and "Cost Recovery" for a discussion on how to treat payments of advances and royalties to artists.

An advance is a prepayment to an author, songwriter, etc. or third party on behalf of the author for future services. The author, songwriter, etc. uses the advance for personal and business expenses. The publisher or producer will recoup the advance by retaining future sales. Any additional amounts paid to the artist will be according to contractual terms.

A cash basis taxpayer should recognize the advance into taxable income in the year received. An accrual basis taxpayer should recognize advances upon the earlier of receipt, payment being due, or when earned. I.R.C. § 451(a); Treas. Reg. § 1.451-1(a). Rev. Proc. 2004-34 provides a method of accounting under which taxpayers using an accrual method of accounting may defer including all or part of certain advance payments in gross income until the year after the year the payment is received.

The tax treatment of advances is very factually driven. In *Schlude v. Commissioner*, 372 U.S. 128 (1963), the taxpayer was an accrual basis taxpayer. Yet the Court concluded, in consideration of the facts and circumstances of the taxpayer, that the taxpayer's method of accounting was improper and that the advances should be recognized in the year received.

A taxpayer cannot defer income from services performed until after recoupment of the advance paid to an artist. Income from services performed by a publisher or producer, for instance, should be immediately reported as income.

For example, a publisher signed a contract with a writer. Under the contract, the writer will write a manuscript for a book that the publisher will publish. At the time that the contract was signed, the publisher advanced the writer \$250,000 on royalties for the use of the writer's copyright for the book. A cash basis writer must include the \$250,000 in income in the year received. An accrual basis taxpayer should recognize the \$250,000 upon the earlier of receipt, payment being due, or when earned. The publisher must capitalize the \$250,000 as a production cost and allocate it to costs of goods sold as the book is published and sold (see Chapter 4, Payment of Advances and Royalties).

Reconstruction of Income

Some taxpayers fail to report all of their income. When an examiner is unable to use a direct method of verifying income, it may be necessary to reconstruct income. There are numerous ways to do this. Here are some that are unique to the entertainment industry.

If agent commissions are paid at 10%, then the income should be at least ten times the commissions. The 10% rate should be verified if there is a written contract.

Union dues may help to identify available union benefits and network associations to identify potential unreported income for work performed. Some unions do not send the artist a bill and hold the member responsible for paying dues timely.

Dues for most of the guilds in the entertainment industry are comprised of an annual fee and an additional assessment based on earnings. For example, the SAG-AFTRA dues are based on a sliding scale, determined by how much the member earned under SAG or AFTRA contracts. In 2014, the annual base dues were \$198.00 plus 1.575% of all individual earnings under SAG or AFTRA contracts between \$1 and \$500,000. Dues are calculated on an annual basis and paid in two installments.

Dues for the Writers Guild of America, West are based on a unit system for writing employment and/or sales within the guild's jurisdiction and with a "signatory" company (a company that has signed the guild's collective bargaining agreement). Depending upon the number of units earned, a writer may be eligible for either current (full) membership or associate (partial) membership. For example, for current membership a writer must acquire a minimum of 24 units in the three years preceding application. Upon final qualification for current membership, an initiation fee of \$2,500 is due. The quarterly declaration of gross earnings information from the writer is the basis for quarterly member dues (1.5% of applicable gross earnings plus \$25.00).

Guild dues statements and declaration of earnings statements will identify the artists' earnings. These statements can aid in the reconstruction of income.

Chapter 4 - Capitalization and Cost Recovery Issues

Capitalization Issues

When a taxpayer produces or creates a product (video, film, recording, etc.), the taxpayer will generally incur a great portion of the expenses before the product is ready to produce income. When this happens, the taxpayer is usually required to capitalize those expenses and recover (deduct) them over the period of time that the product is producing income. Several different provisions apply depending on whether the taxpayer is already in the business and the specific business the taxpayer is in. No matter what method is utilized, depreciation/amortization expenses cannot be deducted until the product is released to the public. [Exhibit 4-1](#) addresses the decision path for capitalization.

I.R.C. § 195 – Start-Up Expenditures

Expenses for investigating, creating, or acquiring a new business are nondeductible capital expenses. This applies to all expenses before the day the active trade or business begins. These provisions apply to someone starting out in the entertainment industry, before offering a completed product for sale, production, or distribution.

Start-up expenses are expenditures which would normally be deductible under I.R.C. § 162 if they were incurred in connection with operating a business. These expenses, however, do not include amounts deductible under other Code sections such as interest (I.R.C. § 163), taxes (I.R.C. § 164), and research expenses of a scientific nature (I.R.C. § 174).

I.R.C. § 195 allows a taxpayer to elect to deduct these capitalized expenses. I.R.C. § 195(b). If an election is made, the taxpayer may deduct the lesser of the amount of the start-up expenditures or \$5,000 (reduced, but not below zero, by the amount by which the start-up expenditures exceed \$50,000) in the year the active trade or business begins. *Id.* § 195(b)(1)(A). The remainder is then deductible ratably over the 180-month period beginning with the month in which the active trade or business begins. *Id.* § 195(b)(1)(B). This is called "amortization of startup costs." *See* Treas. Reg. § 1.195-1(a). This election must be made by the due date of the return (including extensions) for the year in which the business begins. I.R.C. § 195(d)(1). If the taxpayer does not make a timely election to amortize these expenses, they are carried on the books as a capitalized item until the taxpayer disposes of the business. *See id.* § 195(a). A taxpayer is deemed to have made an election to amortize start-up expenses for the year in which the active trade or business begins. Treas. Reg. § 1.195-1(b). A taxpayer can forgo the deemed election by affirmatively electing, on the tax return, to capitalize the start-up expenses instead. *Id.*

I.R.C. § 197 – Amortization of Goodwill and Certain Other Intangibles

Under I.R.C. § 197, intangibles are amortized for 15 years using the straight-line method. However, self-created work (I.R.C. § 197(c)(2)(B)) is excluded under this section. An I.R.C. §

197 intangible is created by the taxpayer to the extent the taxpayer makes payments or incurs costs for its creation, production, development or improvement. I.R.C. § 197 intangibles described in § 197(d)(1)(D) [government licenses], § 197(d)(1)(E) [covenants not to compete] and § 197(d)(1)(F) [franchises, trademarks and trade names] are amortizable § 197 intangibles even if they are self-created.

I.R.C. § 263A – Capitalization and Inclusion in Inventory Costs of Certain Expenses

I.R.C. § 263A generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs. I.R.C. § 263A(b)(2) provides that, for purposes of the uniform capitalization rules, the term "tangible personal property" shall include a film, sound recording, videotape, book, or other similar property.

Tangible personal property is further defined in Treas. Reg. § 1.263A-2(a)(2)(ii) as:

- Films, sound recordings, video tapes, books and other similar property embodying words, ideas, concepts, images, or sounds by the creator.
- "Other similar property" generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or third party in a form that is not substantially altered. However, intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

I.R.C. § 263A(f)(4)(B) defines the production period as the beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or ready to be held for sale. See also I.R.C. § 263A(f)(4)(C) which defines production expenditures as the costs (whether or not incurred during the production period) required to be capitalized.

Costs Required to be Capitalized by Producers—Treas. Reg. § 1.263A-2(a)(3)(i)

In general, except as specifically provided in I.R.C. § 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under § 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in § 263A(f)(4)(B)). Treas. Reg. § 1.263A-2(a)(3)(i). Examples of costs that are required to be capitalized prior to, during, and after production are:

- Term deals
- Research
- Fringe benefits
- Payroll taxes
- Travel and entertainment
- Computer
- Office supplies

- Photocopy
- Above the line personnel
- allocation of indirect costs such as utilities, tools, clerical, rental of equipment, etc.

Pre-Production Costs – Treas. Reg. § 1.263A-2(a)(3)(ii)

Pre-production begins when the project is green-lit. This is the phase where decisions are finalized for the specific production or project. Examples include, but not limited to, set location, set design, costumes, financing, producers, directors, cast members, cinematographer, screenplay, etc. Pre-production costs for a singer may include making the demo recording, creating and refining the artists' musical ideas, etc. to prepare for the major recording time in the studio.

If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property even though production has not begun. Treas. Reg. § 1.263A-2(a)(3)(ii). Research, travel, and other associated costs for the development or rewrites of scripts, screenplays, and teleplays prior to production are other examples of pre-production costs. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. *Id.*

Post-Production Costs – Treas. Reg. § 1.263A-2(a)(3)(iii)

Post-production is the phase where work is completed to prepare the work for release for public exhibition. Examples of post-production include, but are not limited to, adding visual and sound special effects, animation, music editing such as perfecting timing, pitch, etc.

Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the extent properly allocable to the property. However, see Treas. Reg. § 1.263A-3(c) for exceptions.

Exemption from I.R.C. § 263A

I.R.C. § 263A(h), provides an exemption for qualified creative expenses paid or incurred by certain free-lance authors (non-employees), photographers, and artists.

Qualified creative expenses are defined as expenses incurred by an individual in the trade or business (other than as an employee) of being a writer, photographer, or artist, if the expenses would be currently deductible without regard to I.R.C. § 263A. I.R.C. § 263A(h)(2). This does not mean that 100% of costs are deductible. For example, deductible costs do not include expenses related to printing, photographic plates, motion picture films, video tapes, or similar items. *Id.*

Writers, composers, photographers, and artists are defined in I.R.C. § 263A(h)(3) as:

Writer or Composer – A writer or composer includes an individual whose personal efforts create a literary manuscript, musical composition or dance score.

Photographer – A photographer includes an individual whose personal efforts create a photograph or photographic negative or transparency.

Artist – An artist includes an individual whose personal efforts create a picture, painting, sculpture, statue, etching, drawing, cartoon, graphic design, or original print edition. Criteria to determine whether any expense is paid or incurred in a trade or business as an artist are: (1) the originality and uniqueness of the item created (or to be created) and (2) the predominance of aesthetic value over utilitarian value of the item created (or to be created). I.R.C. § 263A(h)(3)(C)(ii).

Expenses that are directly tied to the creative item of a writer, photographer, composer, or artist may still require capitalization. For example, production and engineering costs incurred to produce a sound recording are not § [263A\(h\)](#) "qualified creative expenses," and therefore the costs of producing a sound recording are not exempt from the general rule of § [263A](#). A demo tape is a sound recording, is tangible personal property, and is subject to capitalization unless excepted by the Code. *See* TAM 9643003, 1996 WL 616051 (IRS TAM).

Payment of Advances and Royalties

An advance is a prepayment to an author, songwriter, etc. or third party on behalf of the artist for future services. Royalties and license fees are periodic payments to copyright owners such as songwriters, recording artists, authors, etc. paid by those who perform, exhibit, run, or otherwise distribute copyrighted works for a prescribed time period or purpose.

When a taxpayer advances funds to an artist in consideration for the acquisition of copyrights, the advanced payment is a non-deductible expense and must be capitalized to the cost of acquiring an intangible asset. Treas. Reg. § 1.263(a)-4. The taxpayer should amortize the advance over the useful life of the copyright using the taxpayer's amortization method. For example, Bob wrote a manuscript for a book. He sold the manuscript and all associated copyrights to a publisher for \$250,000. The publisher must capitalize the \$250,000 paid as a cost to acquire an intangible. Bob must include the \$250,000 in income in the year received (see Chapter 3, Advances section).

When advances are for royalties for the use of the artist's copyrights, economic performance occurs as royalties are used to produce copies of the work. The advances are capitalized as production costs under IRC § 263A. The advances would be allocated to costs of goods sold as the copies are sold.

The same would be the case for advances to compensate the artist for services expected to be performed. The advance is incurred when economic performance first occurs and the all events test is met. I.R.C. § 461(h)(1); Treas. Reg. § 1.461-4(a)(1). Economic performance occurs as services are rendered by the artist. *See* I.R.C. § 461(h)(2)(B). Once the all events test is met, the advances are capitalized to the asset cost or production.

For example, a publisher signed a contract with a writer. Under the contract, the writer will write a manuscript for a book that the publisher will publish. At the time that the contract was signed, the publisher advanced the writer \$250,000 on royalties for the use of the writer's copyright for the book. The publisher must capitalize the \$250,000 as a production cost and allocate it to costs of goods sold as the book is published and sold. Generally, the writer must include the \$250,000 in income in the year received. See Chapter 3, Advances section.

Cost Recovery Issues

Expenses which represent the basis of an asset used in or produced in a trade or business may be recovered using one of several possible methods. The appropriate recovery system or period may depend upon the terms of sale or exploitation of the asset. If all rights to a completed project (i.e., film, movie, etc.) are sold as a package, the recovery of the capitalized costs will be allowed as part of adjusted basis reducing the amount realized (or cost of goods reducing gross receipts).

Placed In Service

Treas. Reg. § 1.167(a)-11(e)(1)(i) defines "first placed in service" as the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function.

For example, motion picture rights are placed in service when the film is initially released for public exhibition. Manuscript rights, having the same characteristics for purposes of depreciation as motion picture film rights, are placed in service when books produced from the manuscript are first released for distribution and sale. Rev. Rul. 79-285, 1979-2 C.B. 91, 1979 WL 51039.

Elective Safe Harbor - Notice 88-62

Under Notice 88-62, 1988-1 C.B. 548, a taxpayer can make an election to aggregate and capitalize all qualified creative costs and amortize and deduct 50% of total qualified creative costs in the year incurred and 25% in each immediate succeeding two tax years.

This method does not require the creative property to be placed in service and the election is made on the first tax return when I.R.C. § 263A applies by reporting expenses according to this method. If a taxpayer does not do this, the taxpayer must file a Form 3115 to request permission to change his or her method of accounting. A taxpayer cannot use this method until approval is received.

This three-year safe harbor is available only for the qualified creative costs paid or incurred in producing creative properties, defined as films, sound recordings, video tapes, books (including, for example, articles and poems), photographs, plays and other dramatic works, musical and dance compositions (including accompanying words), graphic and pictorial compositions, fine art paintings and sculptures, and other similar fine art products (but not including jewelry). No other properties other than those defined in Notice 88-62 are eligible for this safe harbor.

Costs incurred by a taxpayer in a hobby are not qualified creative costs eligible for this safe harbor because such costs are not § 263A costs and qualified creative costs only consist of costs incurred in a trade or business or an activity conducted for profit.

Qualified creative costs consist of: (1) all costs required to be capitalized under § 263A and the regulations thereunder with respect to the production of creative properties (§ 263A costs); and (2) all other costs incurred and otherwise deductible by the taxpayer in the trade or business of producing creative properties.

Moreover, qualified creative costs include the costs of producing properties that are sold (or otherwise disposed of in their entirety) by the taxpayer in the same taxable year that such costs are incurred. For example, costs incurred by a taxpayer in writing an article (or producing a photograph) that the taxpayer sells in its entirety to a magazine in the same year that the costs are incurred would be qualified creative costs and thus subject to this three-year safe harbor.

This method only applies to qualified creative costs incurred by a self-employed individual in the production of creative properties where the personal efforts of such individual predominantly create such properties. Qualified creative costs do not include the costs paid or incurred by a person in the capacity as an employee, nor do they include costs incurred by an individual in producing creative properties where the personal efforts of such individual do not predominantly create such properties (e.g., where the properties are predominantly created by persons other than the individual such as employees or independent contractors). Qualified creative costs do not include costs incurred by a partnership, trust, or corporation, unless certain criteria are met under the Notice.

Internal Revenue Code § 181

Film or television producers can elect to deduct certain costs under I.R.C. §181 instead of capitalizing them if certain requirements are met. The deduction does not apply to qualified film and television production beginning after December 31, 2016. Productions commencing after December 31, 2015 also include live theatrical productions.

IRC §181 was enacted as an incentive to keep production companies or most of the work in the United States. The production does not need to have been placed in service. However, the taxpayer must be able to show a reasonable basis for believing the production will be green-lit. Treas. Reg. §1.181-1(a)(1)(i). Only the owner of the production may elect to deduct production costs under I.R.C. §181. The owner is deemed to be the taxpayer otherwise required to capitalize production costs into the basis of the production under IRC §263A. Treas. Reg. §1.181-1(a)(2)(i). Further, an owner is a person that acquires a finished or partially finished production. Treas. Reg. §1.181-1(a)(2)(ii). Under certain circumstances, an owner must recapture costs. Treas. Reg. §1.181-4(a) outlines the situations when recapture is required.

Under I.R.C. §181(d), if 75% of the total compensation of the production is qualified compensation (as defined in I.R.C. §181(d)(3)), a qualifying film or television production is:

- Property described in I.R.C. §168(f)(3) - i.e., any motion picture film or video tape.
- In a case of a television series:
 - each episode shall be treated as a separate production, and

- only the first 44 episodes of such series shall be taken into account.

A qualifying live theatrical production is a production where 75% of the total compensation (as defined in I.R.C. §181(d)(3)) is qualified compensation. A qualifying live theatrical production is a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a taxable entity in any venue which has an audience capacity of not more than 3,000 or a series of venues the majority of which have an audience capacity of not more than 3,000.

Qualified live theatrical productions include seasonal live staged productions produced or presented by a taxable entity for not more than 10 weeks of the taxable year, which has an audience capacity of not more than 6,500 or a series of venues the majority of which have an audience capacity of not more than 6,500.

Multiple live staged productions (e.g., touring companies), may qualify under I.R.C. §181 if the taxpayer qualifies under this provision and the productions are separate phases of a production or separate simultaneous stagings of the same production in different geographical locations (not including multiple performance locations of any one touring production). Each live staged production shall be treated as a separate production.

The term “phase” refers each to the initial staging of a live theatrical production and subsequent additional stagings or touring of such production which are produced by the same producer only if each is treated as a separate activity by the taxpayer under I.R.C. §181.

If each of the following is treated by the taxpayer as a separate activity, the term “phase” refers to

- the initial staging of a live theatrical production
- subsequent additional stagings or touring of such production which are produced by the same producer as the initial staging.

Qualified compensation means compensation for services performed in the United States by actors, production personnel, directors, and producers. I.R.C. §181(d)(3)(A). Qualified compensation does not include participations and residuals as defined in I.R.C. §167(g)(7)(B). *Id.* §181(d)(3)(B).

Taxpayers are allowed to expense up to \$15 million of qualifying film and television production costs. I.R.C. §181(a)(2)(A). The limit is increased to \$20 million if the production costs are "significantly incurred" in areas eligible for designation as a low-income community or distressed or isolated communities. *Id.* §181(a)(2)(B).

A production is not qualified if records are required under 18 U.S.C. §2257, Record Keeping Requirements, Sexual Exploitation and Other Abuse of Children, to be maintained with respect to any performer in such production. *Id.* §181(d)(2)(C).

To make the election, an owner must attach a statement to a timely filed Federal income tax return (including extensions) for the taxable year in which costs of the production are first incurred. Treas. Reg. §1.181-2(b)(1).

For a discussion on the sufficiency and appropriateness of the taxpayer's I.R.C. §181 election, see *Staples v. Commissioner*, T.C. Memo. 2013-262, and *Storey v. Commissioner*, T.C. Memo. 2012-115.

Income Forecast Method

If, as is true in most productions, the project is exploited over a period of years (released in theaters, television, DVD, etc.), the most appropriate means of recovering costs is through the income forecast method. See I.R.C. § 167(g); Prop. Treas. Reg. § 1.167(n)-0 to -7; Rev. Rul. 64-273, 1964-2 C.B. 62; Rev. Rul. 60-358, 1960-2 C.B. 68. The income forecast method can only be used for films, videotapes, sound recordings, copyrights, books, patents, or other property specified in the Regulations. I.R.C. § 167(6). It cannot be used with respect to an intangible amortizable under § 197. *Id.*

The income from the property to be taken into account in determining the depreciation deduction under this method is the amount of income earned in connection with the property before the close of the tenth taxable year following the taxable year in which the property was placed in service (i.e., 11th year). I.R.C. § 167(g)(1)(A). Therefore, this method requires an estimate of total income to be derived from the film over the ten years following the year the film is placed in service. This estimate will include not only anticipated revenue from theatrical releases, but also television, cable, video, etc., if the arrangements are entered into prior to depreciating the film down to its salvage value.

The adjusted basis should only include amounts for which the requirements of § 461(h) are satisfied. *Id.* § 167(g)(1)(B). The taxpayer may include participations and residuals in the adjusted basis for the taxable year in which the property is placed in service, but only to the extent the participations and residuals relate to income the taxpayer estimates will be earned in connection with the property before the end of the tenth taxable year after the taxable year the property is placed in service. *Id.* § 167(g)(7)(A).

The Income Forecast Method computation is the net income for the taxable year divided by the forecasted total income to be received before close of the tenth year, following the year in which the film is placed in service, multiplied by the cost of the film equals the depreciation deduction for the taxable year. The computation is also shown in the diagram below:

(Net Income for Taxable Year ÷ Forecasted Total Income to be Received Before Close of 10th Year Following Year in which the Film is Placed in Service) × Cost of the Film = Depreciation Deduction for Taxable Year

The depreciation deduction for the tenth taxable year should equal the adjusted basis of such property as of the beginning of the tenth taxable year. I.R.C. § 167(g)(1)(C). The taxpayer shall pay (or be entitled to receive) interest computed under the look-back method for any recomputation year. *Id.* § 167(g)(1)(D). The computation of interest under the look-back method is described in I.R.C. § 167(g)(2).

The recomputation year is defined as the third and tenth taxable years, beginning after the taxable year in which the property was placed in service, unless the actual income earned in connection with the property for the period before the close of the third or tenth taxable year is within 10% of the income earned in connection with the property for such period which was taken into account under § 167(g)(1)(A). *Id.* § 167(g)(4). A taxpayer is exempt from the look-back method for property that has a cost basis of \$100,000 or less. *Id.* § 167(g)(3).

I.R.C. § 167(g)(8) – Special Rules For Certain Musical Works and Copyrights (Expired)

The costs of master recordings used for substantially more than one year to produce records must be capitalized and recovered through depreciation. Rev. Rul. 69-475, 1969-2 C.B. 40, 1969 WL 19107. Beginning in tax year 2006, a taxpayer may elect to amortize over a five-year period any expense paid or incurred in creating or acquiring any musical composition (including accompanying words) or any copyright with respect to a musical composition that is required to be capitalized. I.R.C. § 167(g)(8)(A), (C)(i). If a taxpayer makes the election, it is effective for all musical compositions and musical composition copyrights placed in service in that tax year. *Id.* § 167(g)(8)(A), (D). This election expired and may not be made for any taxable year beginning after December 31, 2010. *Id.* § 167(g)(8)(E).

"Applicable musical property" is defined as any musical composition (including any accompanying words), or any copyright with respect to a musical composition. I.R.C. § 167(g)(8)(C)(i). The five-year amortization is not allowed for property with respect to which expenses are treated as qualified creative expenses to which [I.R.C. § 263A\(h\)](#) applies, property to which a simplified procedure established under [I.R.C. § 263A\(i\)\(2\)](#) applies, or property which is

an amortizable [I.R.C. § 197](#) intangible as defined in [I.R.C. § 197\(c\)](#). *Id.* § 167(g)(8)(C)(ii). The five-year amortization period begins in the month the property is placed in service. *Id.* § 167(g)(8)(C)(ii).

Abandonment Loss

A taxpayer may deduct production costs for creative properties deemed worthless either before or after release for public exhibition. Studios, for example, do not usually discard, release to the public domain, or otherwise dispose of the creative properties not set for production or sold. Generally, studios retain these properties indefinitely. In other words, the creative properties still have value. As such, a taxpayer cannot deduct production costs of a project that they later abandon unless they prove that it was abandoned. Treas. Reg. § 1.165-1(b) states that a loss can be deducted when it is evidenced by a closed and completed transaction, fixed by identifiable events. In addition, the loss must actually have been sustained in the year of the deduction and in a trade or business or a transaction entered into for profit. I.R.C. § 165(a), (c). Substance and not mere form govern in determining a deductible loss. Treas. Reg. § 1.165-1(b). Under Treas. Reg. § 1.165-1(b) and (d)(1) a taxpayer must identify event(s) showing a closed or completed transaction establishing worthlessness that is observable to outsiders and irrevocably cuts ties to the project.

[Rev. Rul. 2004-58](#) provides that, unless a taxpayer has formally established an affirmative act of abandonment, or an identifiable event evidencing a closed and completed transaction fixed by an identifiable event establishing the worthlessness of the property, the taxpayer cannot claim a loss deduction under I.R.C. § 165 for the capitalized costs of acquiring and developing the property.

Putting a script on the shelf for a while with the possibility of selling it at a later date, is not abandoning it. Merely not attempting to exhibit a film is not abandoning it, since it may still be exploited in the future. A taxpayer must show intent to abandon and make an affirmative act of abandonment in such a manner that the asset is not retrievable.

In *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974), the Ninth Circuit Court of Appeals articulated a two prong test to establish abandonment: 1) an intention on the part of the owner to abandon the asset, and 2) an affirmative act of abandonment. If the property is held by the taxpayer and is available for future use (or intended for future use), the deduction is not allowed. *A.J. Indus., Inc.*, 503 F.2d at 670-671. In *Gulf Oil Corp. v. Commissioner*, 914 F.2d 396, 402 (3d Cir. 1990), the Third Circuit Court of Appeals observed that § 165 losses are referred to as abandonment losses to reflect that some act is required that evidences a taxpayer's intent to permanently discard or discontinue use of the property.

The "identifiable event" required by Treas. Reg. § 1.165-1 "must be observable to outsiders and constitute 'some step which irrevocably cuts ties to the asset.'" *United Dairy Farmers, Inc. v. United States*, 267 F.3d 510, 522 (6th Cir. 2001) (quoting *Corra Resources, Ltd. v. Commissioner*, 945 F.2d 224, 226 (7th Cir. 1991)). Internal documentation is not sufficient to establish the identifiable event.

Worthlessness is not when a taxpayer retains a script for the purpose of:

- Preventing a competitor from using it, or
- Defending against potential copyright infringement suit, or
- Maintaining good relations with the writer, or
- Using it if it has value in the future.

The examples above are demonstrations of a script that still has value. Therefore, the taxpayer would not be allowed to deduct an abandonment loss under I.R.C. § 165.

Audit Techniques:

- Review taxpayer and industry websites for continued attempts to market or exploit a project to show that it is not worthless.
- Ask for contracts, option agreements, etc.
- Request details of an identifiable event that destroys the potential value and usefulness of the property or an affirmative act of abandonment.

Revenue Procedure 2004-36

When a taxpayer maintains its books and records according to generally accepted accounting principles (GAAP), there will be differences in the books and records for tax purposes and GAAP purposes. When a taxpayer follows AICPA Statement of Position (SOP 00-2), Accounting by Producers or Distributors of Film, production costs are immediately expensed when a production is not green-lit within three years of when the costs are incurred. SOP 00-2 provides guidance on generally accepted accounting principles for films and is applicable to all producers or distributors that own or hold rights to distribute or exploit films.

Rev. Proc. 2004-36, 2004-1 C.B. 1063, allows film producers to amortize certain creative property costs ratably over a 15-year period beginning in the year the creative property costs are written off for book purposes under AICPA Statement of Position (SOP) 00-2, Accounting by Producers or Distributors of Film. A change in a taxpayer's treatment of creative property costs is a change in method of accounting to which I.R.C. § 446(e) and § 481 apply.

The interval between the time a film idea is first conceived and theatrical release varies from film to film and may take several years. A typical film production timeline is as follows:

1. Script idea.
2. Negotiations with studio.
3. Green-light for production.
 - a. Green-lit less than 3 years after first cost incurred is capitalized for tax and GAAP purposes.
 - b. Green-lit more than three years after first cost incurred is immediately written off for GAAP purposes. GAAP SOP 00-2. When this occurs, Rev. Proc. 2004-36 applies for tax purposes and straight-line, half-year convention, amortization over 15 years is used.
4. Principal photography.
5. Post production.

6. Theatrical release (a taxpayer may begin to amortize/depreciate capitalized costs at this stage).

Exhibit 4-1 - Decision Path for Capitalization

STEP 1: Is the taxpayer carrying on a trade or business?

YES - Proceed to Step 2

NO - Expenses may be limited or not allowed – Consider I.R.C. § 183.

STEP 2: Is the taxpayer already in the trade or business?

YES - Proceed to Step 3

NO - Proceed to Step 4

STEP 3: Is the taxpayer creating or producing an asset (script, film, movie, C.D., etc.)?

YES - Proceed to Step 5

NO - Expenses are not capitalized. Allow I.R.C. § 162 expenses.

STEP 4: Is the taxpayer incurring start-up costs for the trade or business?

YES - Capitalize start-up expenses under I.R.C. § 195. Include all expenses that would have been allowed if the taxpayer were in a trade or business except for interest (I.R.C. § 163) and taxes (I.R.C. § 164). The taxpayer may elect to amortize the start-up expenses. If an election is made, by the due date (including extensions) of the return for the first year in the business, then the taxpayer can deduct the lesser of the startup expenses or \$5,000 (subject to phase-out); the remainder is deducted over a 180-month period beginning with the month in which the taxpayer is actually in business.

NO - Expenses are not allowed.

STEP 5: Does the taxpayer retain ownership or rights in the completed project?

YES - Proceed to Step 6

NO - Expenses are not capitalized. Allow I.R.C. § 162 expenses.

STEP 6: Is the taxpayer an artist, free-lance writer, or composer?

YES - Allow current creative expenses, capitalize only "basis" items. Qualified creative expenses include trade or business expenses (I.R.C. § 162) incurred in the activity of being a writer, artist, photographer, or composer. These expenses do NOT include expenses incurred to produce

motion pictures, video tapes, sound recordings, or similar items. Therefore, a "writer" may have some expenses allowable and others capitalized if the writer is also involved in pre-production (budgeting, casting, etc.), for the production of a movie from the screenplay being written. A composer may have qualified creative expense and also incur production expenses for preparing to record (or for recording) the music as it is composed.

NO - Capitalize all direct expense and allocable portion of indirect expenses under I.R.C. § 263A. Do not capitalize:

- Marketing and selling expenses such as copying, distribution contract negotiation, promotion expense, and advertising.
- Bidding expenses for contracts not obtained (job search).
- Administrative or general expenses not related to a particular production activity.

Chapter 5 - Passive Activity Issues

I.R.C. §469

The passive loss rules of I.R.C. § 469 impact entertainment industry cases in several ways:

- Rentals of equipment to studios, production teams, etc.
- Characterizing royalties as passive income so that they are offset by otherwise non-deductible passive losses.
- Claiming losses from entertainment or other activities in which the taxpayer does not materially participate.

Under I.R.C. § 469, a taxpayer is not allowed to offset any personal service or portfolio income with losses from passive activities. A passive activity is any rental activity and any activity in which the taxpayer does not materially participate. I.R.C. § 469(c)(1)-(2). To materially participate, the taxpayer must be involved in the day-to-day operations of the activity on a regular, continuous, and substantial manner. *Id.* § 469(h)(1). A taxpayer can establish material participation by satisfying any one of the seven tests found in Temp. Treas. Reg. § 1.469-5T(a):

- The individual participates in the activity for more than 500 hours during the year.
- The individual's participation in the activity for the taxable year constitutes substantially all of the participation in the activity of all individuals (including individuals who are not owners of interests in the activity) for the year.
- The individual participates in the activity for more than 100 hours during the taxable year, and the individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for the year.
- The activity is a significant participation activity . . . for the taxable year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours.

- The individual materially participated in the activity ... for any five taxable years (whether or not consecutive) during the ten taxable years that immediately preceded the taxable year.
- The activity is a personal services activity ... and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year.
- Based on all facts and circumstances ... the individual participates in the activity on a regular, continuous, and substantial basis during such year.

Rental of Equipment

Identifying the Issue

In the entertainment industry, we often see many individuals (stunt persons, lighting specialists, props persons, etc.) involved in productions who own and use their own equipment as part of their job. Along with their services, the studios contract with these individuals to rent this equipment for periods of time as short as one day or as long as the duration of the production. The lessors of the equipment then mix the income and expenses of this rental activity with the income and expenses of their personal service activity on a Schedule C. In other instances, the rental activity is reflected on the Schedule E as a rental, but the taxpayer claims the losses as part of the \$25,000 rental real estate allowance.

Law

Under I.R.C. § 469, any rental activity is automatically defined as a passive activity, regardless of the taxpayer's participation. I.R.C. § 469(c)(2). If the average period of customer use is 7 days or less, the activity is not considered a rental, and regular material participation rules must be used to determine if the activity is a passive activity. *See* Temp. Treas. Reg. § 1.469-1T(e)(3)(ii).

In addition, the gross rents received from the activity must be more than 20% of the total gross income from both the personal service portion and the rental portion of the contract. If the gross rents received are less than 20%, the entire activity is considered a personal service activity. Alternatively, if the gross rents received from the activity exceed 80%, the entire activity will be considered a rental activity. *See* Temp. Treas. Reg. § 1.469-4T(d)(1)-(2).

What are the exceptions to the rental definition?

- Average customer use is 7 days or less (e.g., charter boats, B&Bs, vacation condos).
- Average customer use is 30 days or less and significant personal services are provided.
- Extraordinary personal services are provided in connection with property (e.g., hospital).
- Rental is incidental to a non-rental activity. Rents are less than 2% of adjusted basis or FMV.
- Property is available during defined business hours for nonexclusive use by customers.
- Property is provided (contributed) to a partnership or S corporation in which the taxpayer has an ownership interest. If property is leased (instead of contributed) to the partnership or S corporation, this exception does not apply.

Temp. Treas. Reg. § 1.469-1T(e)(3)(ii). If the taxpayer's activity falls into any of the above exceptions, the activity is not considered a rental activity and the ordinary material participation rules apply. For more details, see the Passive Activity Loss Audit Technique Guide.

Audit Techniques

Inspect any available contract(s) with the lessee (studio, production crew, etc.). Determine the average period of rental use for the equipment. Look to the intent of the contract. For example, if a studio rents a prop for the duration of filming a movie, but the payment is computed and paid on a weekly basis, the period of use is the length of filming, not one week. If the equipment is typically rented out for only a day or two, the activity is not a rental and should be considered a regular trade or business activity. If the equipment is typically rented out for more than 7 days, the activity is likely a rental activity, and must be separately considered.

Compare the gross rents received to the compensation for personal services on the same contract. If the gross rents received is greater than 20% of the total of gross rents and personal services compensation, the activities must be divided into a rental portion and a personal service portion.

Separate the income and expenses into two activities - rental versus personal service. Remember to allocate those expenses properly associated with the rental (depreciation, repairs, transportation, etc.) to the rental and those properly associated with the personal service activity to that activity. Audit the income and expenses as you normally would using I.R.C. § 61 and § 162.

Compute any passive loss limitation on the rental activity. Remember that the taxpayer is generally renting equipment (personal property) rather than real estate (real property); any losses incurred from this activity are not eligible for the \$25,000 real estate rental allowance.

Royalty Income

Identifying the Issue

Artists and performers often receive current payments for services rendered in past years. These are commonly referred to as royalties or residuals. Sometimes these amounts are erroneously reported on the Schedule E as "royalties," and at other times they appear correctly on the Schedule C, with expenses written off against the income.

Alternatively, some persons in the entertainment industry (such as executive producers or others) may receive residual payments from use of productions in which they were only an investor. These payments should be reported as Schedule E royalties. If properly recognized on the Schedule E as "royalties," the taxpayers will tend to circumvent I.R.C. § 469 by netting this royalty income with rental losses, or with other partnership or S-Corporation losses.

Law

Taxpayers are only allowed to offset passive income with passive losses. They cannot use passive losses to offset other types of income (active or portfolio). Under I.R.C. § 469, any compensation received for personal services (even for personal services rendered in past years) is not passive income.

Compensation received from an activity in which the taxpayer did not materially participate, however, is passive and can be offset by other passive losses.

Audit Techniques

- Determine the nature and source of the payments received. If the payments are for activities in which the taxpayer materially participated, then they may not be offset by passive losses. If the source of the payment is an activity in which the taxpayer was a passive investor, the royalty income (and any related expenses) are portfolio items, generating neither passive/non-passive gains or losses.
- Recompute the passive loss limitation to consider any recharacterization of income/loss.

Other Activities

Identifying the Issues

Successful entertainers, producers, editors, etc., often invest their disposable income in other, unrelated business activities. Sometimes these "business activities" closely approximate an activity not engaged in for profit such as race horses, cattle ranches, etc. (These should be questioned under the provisions of I.R.C. § 183.) At other times, the investments are in those activities which are intended to be used to decrease taxes paid by the taxpayer, without incurring significant risks. The entertainment professional is usually very involved in the entertainment industry. He or she may be away from home for long periods of time filming and/or performing, and is generally not able to participate in the other investments. In addition, the entertainment professional often has a business manager who makes all business decisions for him or her, including whether or not to make additional investments. Because of the unique time requirements of a profession in the entertainment industry, often these other business activities (partnerships, S corporations, Schedules C, or Schedules F) are likely to be passive activities for the taxpayer and any overall losses should be appropriately limited.

Other persons may be investors in the various business activities of the entertainment industry and may be classifying these activities as non-passive. A minority producer or silent investor, for example, may have invested significant amounts of capital in a production, but may have little to do with the day-to-day decisions necessary to complete the activity. These persons may be experienced with financing transactions but have no real experience or knowledge in the entertainment field. Even if knowledgeable, they may be fully engaged in other professions from which they earn the funds to invest in the entertainment industry.

Law

I.R.C. § 469(a) disallows (suspends) any overall losses from passive activities of the taxpayer. A passive activity is a trade or business activity (**not "an activity not engaged in for profit"**) in which the taxpayer does not materially participate. I.R.C. § 469(c)(1). (See above for tests of material participation.) The rules apply regardless of how the taxpayer owns the business (whether as a Schedule C or F activity, a partnership, or S corporation).

Audit Techniques

Determine the nature of the activity and how the taxpayer/entertainment professional is participating.

If the activity appears to be in the nature of an activity not engaged in for profit, pursue the I.R.C. § 183 issue first. If it can be established that the activity is an activity not engaged in for profit rather than a true trade or business, the losses are disallowed permanently. If the taxpayer meets enough of the requirements in the regulations to call the activity a true trade or business, consider I.R.C. § 469 next.

Determine if the taxpayer is materially participating in the activity. (See Temp. Treas. Reg. § 1.469-5T(a) for the criteria.) Temp. Treas. Reg. § 1.469-5T(fd)(4) allows the taxpayer to use any reasonable means to substantiate his or her participation, including diaries, log books, or narrative summaries. The narrative summary must be substantiated using some reasonable means, however, not just some unsupported statements.

When considering these facts, use all the data you have already determined about the taxpayer's travel, life-style, schedule, personal interests, etc. Ask additional questions about his or her statements concerning his or her participation. For example:

- If the taxpayer was busy making two or three movies or performing during the year at distant or foreign locations, how can he or she be materially participating in an unrelated partnership near his or her home?
- If the taxpayer's life-style typically involves many late nights or other activities which take up long hours each day (such as filming a weekly or daily television show), what time is there left over to devote to other business activities?
- If the taxpayer hires many specialists to make all the decisions concerning the activity (such as breeders and trainers for horse racing activities), how is the taxpayer participating?
- What personal knowledge does the taxpayer have about the practical operation of the activity? (For example, if the taxpayer owns a cattle ranch, what does he or she know about ranching? What experience does he or she have in this business?)
- How can the taxpayer be putting in 500 hours in many different activities, including his or her primary profession? Remember, full-time employment during a year is generally 2,080 hours.
- What role does the business manager play in the operations of the other activity? The participation of the taxpayer's spouse will be counted as his or her participation (I.R.C. § 469(h)(5)), but not the participation of any other family member or his or her business manager.

Often the taxpayer's representative will not be able to fully answer your questions about how the taxpayer spends his or her time. If the representative cannot fully and clearly respond to these questions, an interview with the taxpayer may be necessary.

If the taxpayer cannot establish that he or she has materially participated in the other trade or business, the activity should be classified as passive. If there are losses flowing from this passive activity to the return, the allowable passive loss, if any, must be recomputed.

For taxpayers who are investors in entertainment businesses (minority producers, silent investors, etc.), determine if the taxpayer is materially participating in the business or simply investing capital. When participation for these persons is considered, remember that they should be in activities that involve day-to-day operations of the business. Merely visiting the set to "see how things are going" does not constitute participation. In addition, merely reviewing financial reports or statements, or compiling financial data about operations for one's own use is an investor activity and generally will not count as participation. The participation must be "substantial" and bona fide, not merely as an interested investor.

Conclusion

The rules of I.R.C. § 469 can be encountered in entertainment cases in a variety of ways. The ones stated here are most common, but are by no means all inclusive. If a question concerning passive loss limitations is encountered, and the answer is not clear, research the issue further or seek other technical advice. Also see the Passive Activity Loss Audit Techniques Guide.

Chapter 6 - Travel and Transportation Issues

General

Travel and transportation expenses can be incurred in all of the profit generating activities for taxpayers in the entertainment industry. In determining the allowable deduction, it is necessary to distinguish between travel and transportation expenses.

- Travel expense generally includes expenses while away from home overnight.
- Transportation is generally the expense of locomotion within your tax home.

Travel

Travel and mileage can be incurred in all three of the profit generating activities for taxpayers in the entertainment industry (performing, job searching, and maintaining skills). Because of the nature of the industry, often the first step necessary to establish travel expense is to establish the taxpayer's tax home.

Tax Home

Generally, an individual's tax home is the general area or entire city in which the business is located. The location of the taxpayer's family home does not matter. In some instances, a taxpayer may be considered as traveling away from home even while working in the city in which that individual and his or her family live.

Revenue Rulings 60-189 and 73-529 provide that, generally, a taxpayer's "home," for purposes of I.R.C. §162(a), is the taxpayer's regular or principal place of business, without regard to the location of the taxpayer's residence. Revenue Ruling 93-86 addresses temporary (expected to be one year or less) versus indefinite regular or principal place of business.

A taxpayer's principal place of business encompasses the entire city, or general area, in which the taxpayer most frequently works.

If the taxpayer works in more than one location in the tax year, the guidelines for determining which location is the taxpayer's tax home are:

Markey v. Commissioner, 490 F.2d 1249, 1256 (6th Cir. 1974) set forth the following three factors to determine which location is the taxpayer's tax home when a taxpayer works in more than one location in the tax year:

- Total time spent in each place.
- Degree of business activity in each area.
- Relative amount of income in each area.

The fact that a taxpayer's business is of such a nature that he or she has no principal place of business will not preclude a taxpayer from having a tax home at the taxpayer's regular "place of abode." There are three objective factors, set forth in Revenue Ruling 73-529, used to determine (with respect to the tax year) whether the claimed abode is "his regular place of abode in a real and substantial sense." These factors are:

- The taxpayer performs a portion of his or her business in the vicinity of the claimed abode and at the same time uses the claimed abode for lodging.
- The taxpayer's living expenses at the claimed abode are duplicated because of business necessitated absence.
- The taxpayer either:
 - has not abandoned the vicinity on which both his or her historical place of lodging and claimed abode are located.
 - has family members currently residing at the claimed abode.
 - uses the claimed abode frequently for lodging.

If all three objective factors are satisfied, the service will recognize the taxpayer's "tax home" to be at the claimed abode.

If two of the three objective factors are satisfied, all the facts and circumstances must be "subjected to close scrutiny" to determine whether the taxpayer has a tax home or is an itinerant.

If a taxpayer fails to satisfy at least two of the three objective factors he or she will be regarded as an itinerant who has his "home" wherever he or she happens to work, and thus, cannot be "away from home" for purposes of I.R.C. §162(a).

Employment Related Travel

Travel incurred while the taxpayer is gainfully employed may or may not be reimbursed. It is up to the taxpayer to prove the job involved a non-union and possibly a non-reimbursed employment situation (see Chapter 1, Reimbursements section). If there is no reimbursement available and it was necessary to travel or incur mileage to a location that was not the principal work site, the taxpayer is probably entitled to a travel or car expense or allowance.

If the taxpayer is a member of a guild or union, he or she is probably entitled to reimbursement, per most union contracts. In general, however, it is up to the taxpayer to prove that reimbursement was not available for each job.

Domestic Travel

When a taxpayer incurs travel within the United States, after verifying that, the travel will qualify under I.R.C. §162 as business related, it is necessary to determine the amount of the expense that is allowable. For domestic travel, the cost of traveling to and from the business location will be allowed in full, if the primary purpose of the travel is business.

Lodging and meals will be allowed for business-related days. If the taxpayer makes additional stops at other locations, it is necessary to determine which of the locations and days are business and which are personal. Treasury Regulation § 1.162-2 explicitly considers the amount of time spent on each type of activity; if the trip is considered primarily personal, then only business expenses at the destination are deductible (not transportation to and from or lodging).

Foreign Travel

Travel outside the United States must also be shown to meet the business relationship requirements of I.R.C. §162. However, once shown to be allowable under I.R.C. §162, additional restrictions apply. The primary purpose test applied to domestic travel does not generally apply to foreign travel. Not only must the lodging and meals be limited to business days, but also the basic cost of traveling to and from the foreign location must be allocated based on the number of bona fide business days, and the total number of days in foreign travel status. Treas. Reg. § 1.274-4(f). There is an exception that can allow a "primarily business" trip to not have to be allocated if the trip is less than a week and less than 25 percent of the total time was personal I.R.C. §274(c)(2); Treas. Reg. § 1.274-4(b) .

Transportation

As with any other business, some taxpayers may incur deductible transportation expenses in the course of their business. The same substantiation rules apply to people in the entertainment industry as to any other taxpayers.

Commuting expense is not deductible even though it is ordinary and necessary. Even where the taxpayer goes back and forth from home more than once a day (as an actor might have to do), the expense of the commute does not become deductible. *O'Hare v. Commissioner*, 54 T. C. 874 (1970); *Sheldon v. Commissioner*, 50 T.C. 24 (1968). The exception to this rule is where the taxpayer's home is her or his principal place of business; in that case travel to and from home would no longer be "commuting" and could thus be deductible. See *Curphey v. Commissioner*, 73 T.C. 766,777-78 (1980). (Nevertheless, see office in the home to determine if the taxpayer qualifies.)

Many taxpayers in the entertainment industry have many short-term jobs. The usual claim is that these are all temporary jobs; and therefore, "temporary job sites." When the taxpayer has no "regular business location," the entire local commuting area is his or her regular business location and transportation to any place in that area is commuting.

The latest authority for temporary jobs is Revenue Ruling 99-7, 1999-5 I.R.B. 4, 1999 WL 15135, 1999-1 C.B. 361.

If the taxpayer has at least one regular work location and the taxpayer's residence is not the principal place of business, the deductibility of transportation expenses depends on whether the temporary work is in the same trade or business as the taxpayer's regular work location under this Ruling. If the temporary work is in a different trade or business, the taxpayer may only deduct transportation expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works. If the temporary work is in the same trade or business, the taxpayer may deduct all transportation expenses incurred between the taxpayer's residence and the temporary work location regardless of location. The Ruling also codifies the one-year test for the meaning of "temporary".

Taxpayers who must travel from one business location to another are entitled to the expense of going between job sites. Producers often provide a bus for cast and crew to nearby locations but some may prefer to drive themselves. Where an employer has made a benefit available to the taxpayer, but the taxpayer prefers to use his or her own, there is no deduction. *Kessler v. Commissioner*, T.C. Memo 1985-254.

Taxpayers in the entertainment industry are entitled to a deduction for mileage incurred while searching for employment. They must comply with the rules of I.R.C. § 274(d) in order to qualify for the deduction. This is especially true for travel incurred while trying to promote one's self. The use of historical success will also be of importance when considering the allowance of such travel. The taxpayer must prove that in the past there has been a measure of success while travelling to promote himself or herself. A narrative may be a good start.

Auditions are a common reason taxpayers who perform in the entertainment industry incur travel and mileage. Usually if this expense is well documented, the taxpayer is entitled to the deduction.

Continuing education is common in the entertainment industry. Taxpayers are usually allowed applicable car expenses for qualified education expenses. See Chapter 7, Educational and Research Expense section.

Chapter 7 - Recordkeeping Issues

Meals, Entertainment, and Gifts

Generally, taxpayers in the entertainment industry may be entitled to deduct expenses for business meals, entertainment, and gifts. Once the expense has been shown to be ordinary and necessary, in the taxpayer's business, the specific recordkeeping requirements must be met.

Meals and Entertainment

To deduct meals and entertainment expenses, the taxpayer must first establish that the expenses are directly related to the active conduct of the taxpayer's trade or business per I.R.C. § 274(a)(1)(A) and ordinary and necessary to his or her business or profession per I.R.C. § 162(a). The taxpayer must also meet the requirements of the substantiation rules of I.R.C. § 274. Taxpayers can only deduct 50 percent of the allowed expense. Further, regarding meals specifically, there is a limitation that it is "not lavish or extravagant under the circumstances" per I.R.C. § 274(k)(1)(A).

Gifts

Taxpayers (husband and wife are considered to be one taxpayer under I.R.C. § 274(b)(2)(B)). The taxpayer must show that the gift was ordinary and necessary to their profession.

Under I.R.C. § 274(d) taxpayers must further show the following elements:

- Cost of the gift
- Date of the gift
- Description of the gift
- Business purpose or reason for the gift, or nature of business benefit expected to be derived as a result of the gift
- Occupation or other information relating to the recipient of the gift, including name, title, or other description sufficient to establish a business relationship to the taxpayer

Treas. Reg. § 1.274-5T(b)(5).

In addition to the elements to be proved, the law limits the deduction to \$25 per person per year. This limit does not apply to any item for general distribution which costs less than \$4 and has the giver's name imprinted on it.

Educational and Research Expenses

Continuing education may be deductible by taxpayers in the entertainment industry. Qualifying expenses include books, supplies, tuition, and applicable car expense. The course must directly relate to the taxpayer's trade or business but should only maintain or improve skills and must not qualify the taxpayer for a new trade or business. *See* Treas. Reg. § 1.162-5. *See e.g., Lang v. Commissioner*, T.C. Memo. 2010-152 (voice over actor allowed to deduct voice over substantiated amounts related to voice over classes, including various acting books).

In an effort to maintain or improve skills, some taxpayers claim a number of unusual expenses. Some of the larger items claimed include the cost of owning and maintaining airplanes, motorcycles, and horses. Taxpayers' claims that their expenditures on these items are business-related may arguably have a germ of truth but these items also present so great an opportunity for abuse that they merit careful scrutiny of the particular facts and circumstances of each case. Also, those items are generally considered listed property under I.R.C. § 280F. Consequently, to claim expenses related to such property, the taxpayer must show not only that these expenses are ordinary and necessary to their trade or business under I.R.C. § 162, they must also meet the strict substantiation requirements of I.R.C. § 274.

If the taxpayer is an employee, then under I.R.C. § 280F(d)(3), he or she receives the tax benefits of "listed property" only to the extent it can be shown that the property was used for the convenience of the employer, and was required as a condition of his employment.

Instead of I.R.C. § 162, the taxpayer may invoke I.R.C. § 212, contending that the plane, car, or house was "income producing property," the upkeep of which is deductible under IRC § 212. To claim a deduction under I.R.C. § 212, the taxpayer must still prove that ownership of the property was profit-motivated under I.R.C. § 183. Ask for history of the income earned by this property (presumably rentals).

It is in this area that taxpayers often attempt to justify attending the theater or concerts, or viewing movies and videos without meeting the requirement of I.R.C. § 274. For more on viewing, see Chapter 8, Keeping Current.

Research expense is incurred for a variety of reasons. If a taxpayer is incurring the expense for a specific project, there must be sufficient documentation to trace the expense to that project. If there is no reasonable expectation of income being produced on that project for the current tax year, the expense should be capitalized. If the research is in anticipation of specific employment, there should be sufficient evidence presented to how the expectation or possibility of employment. In all cases, the expense must be ordinary, necessary, and reasonable.

Some tax practitioners attempt to deduct the otherwise capital expenditure as current research expenses under I.R.C. § 174. This is not a valid position. Treasury Regulation § 1.174-2(a) provides that the term "research or experimental expenditures," as used in I.R.C. § 174, means expenditures incurred in connection with a taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The regulation further provides that the term does not include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

Telecommunication Expense

This deduction is common among taxpayers in the entertainment industry. The expense must be ordinary and necessary to the taxpayer's trade or business. More specifically, it must be necessary, which will be the key to deductibility.

Cell phones were removed (taken out of I.R.C. § 280F) as listed property starting with tax year 2010. They also can be treated as a de minimis fringe benefit when provided by the employer primarily for non-compensatory business purposes. Notice 2011-72, 2011-38 I.R.B. 407.

To determine the allowable deduction amount, the taxpayer must show specifically how the allocation was derived. A general verbal explanation is not sufficient. Specific allocation through monthly sampling would probably be the best technique.

Telephone expense incurred by a taxpayer on behalf of an employer, must be required by that employer. In general, most productions do not require performers to use a phone for most of the work that a production entails.

If the expense is incurred for job search, the taxpayer must document which calls are business calls.

Chapter 8 - Personal Expense Issues

Keeping Current

Entertainers have been known to make a convincing argument about how much they have to spend to "stay on top" or keep current; nevertheless, most of these items typically overlap too much with personal expenses to constitute business deductions.

The following steps identify whether a typical personal expense is deductible under I.R.C. § 162.

1. Determine whether the expense is allowable under I.R.C. § 162.
2. If the expense is not allowable under I.R.C. § 162, the deduction is not allowed. If the expense is allowable under I.R.C. § 162, next determine whether the records satisfy the requirements of I.R.C. § 274.
3. If the records do not satisfy I.R.C. § 274, the expense is not allowed. If the records do satisfy I.R.C. § 274, the expense is allowed.

Cable TV

Taxpayers in the entertainment industry often try to deduct amounts paid for cable television. They must be able to show how cable TV, as a whole, specifically benefits their employment. I.R.C. § 274 places strict limits on deductions for items which are "generally considered to constitute amusement, entertainment, or recreation." Such items are thus deductible only where there is a clear tie to particular work.

Cable TV may also be deducted as an educational or research tool. To qualify as an educational tool, it must directly benefit the taxpayer's trade or business. This must be shown through written documentation. In addition to the recordkeeping requirements of I.R.C. § 274(a), there should be some note-taking showing exactly what educational benefit was achieved. This may take any form that is reasonable for the particular event. The easier it is to trace the expense to a particular event or class, the better the chances of an allowable deduction.

If the taxpayer has a spouse or children in the household, their personal use of the cable television should also be considered in determining any allowable deduction.

Movies and Theatre

The same situation exists for movies and theatre. Movies and theatre are deducted as entertainment or education/research. Either way, the same documentation requirements exist. The taxpayer must specifically identify how the movie or play directly applied to his or her career at the time through the appropriate documentation. Even where a deduction for a particular event is allowed such as a theatre ticket to a certain play to research an upcoming film role, only one ticket would generally be deductible.

Writers Guild, Directors Guild, and various professional groups offer regular screenings of new releases to members; thus, membership fees paid by the taxpayer may already cover at least some of these "necessary" expenses. Members of the American Film Institute (AFI) and various other organizations receive free passes to the cinemas. Thus, it cannot be assumed that all tickets represent an actual cash outlay.

Appearance and Image

Taxpayers in the entertainment industry sometimes incur unusually high expenses to maintain an image. These expenses are frequently related to the individual's appearance in the form of clothing, make-up, and physical fitness. Other expenses in this area include bodyguards and limousines. These are generally found to be personal expenses as the inherently personal nature of the expense and the personal benefit far outweigh any potential business benefit.

No deduction is allowed for wardrobe, general make-up, or hair styles for auditions, job interviews, or "to maintain an image."

Wardrobe

To deduct clothes as a business expense, the following three requirements must be met: (1) the clothes must be required by the employer, (2) the clothes must not be suitable for general or personal wear, and (3) the clothes must not be worn for general or personal wear. *Hynes v. Commissioner*, 74 T.C. 1266, 1290 (1980); *Yeomans v. Commissioner*, 30 T.C. 757, 767 (1958).

When the production companies do not provide or pay for the wardrobe; expenses for costumes and "period" clothing are generally deductible. However, most union contracts provide for

compensation to be given performers who require special wear. The taxpayer must prove that his or her contract did not include such reimbursement for the expense to be allowable.

Make-up

The studio usually provides make-up for performances. Stage make-up that the taxpayer buys for an audition or a live theatrical performance may be deductible, if it is not a general over-the-counter product.

Physical Fitness

Deductions for general physical fitness are not allowable. Usually, if physical fitness is required for a specific job, the studio will be responsible for the cost (by either paying it directly or indirectly by reimbursement/allowance). If the taxpayer was employed in a capacity that required physical conditioning, allow expenses for the duration of employment if no reimbursement or compensation was available.

Security

Physical security is also too personal an item to be deducted, unless there is a clear business-related aspect to the service. For example, to control fans or paparazzi during a star's personal appearance (but for such occasions, the producer of the event would probably bear those costs).

Bodyguards and home security are deemed to be personal expenses. The fact that the taxpayer is in a high profile profession is still a matter of personal choice and does not convert a personal security expense into a business expense. The expense does nothing to increase the income of the taxpayer and provides a personal benefit of "peace of mind."

I.R.C. §§ 162 and 274 address heightened substantiation for listed property (but which doesn't include cell phones anymore), I.R.C. § 262 prohibits personal deductions: "no deduction shall be allowed for personal, living, or family expenses" and it does expressly prohibit the first telephone line to the residence.

Court Cases

The Supreme Court has often cited the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Indopco, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281, 87 L.Ed. 1607 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493, 60 S.Ct. 363, 366, 84 L.Ed. 416 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440, 54 S.Ct. 788, 790, 78 L.Ed. 1348 (1934).

There are over 1,000 court cases that address the nondeductibility of personal expenses. A few that pertain specifically to the Entertainment Industry are:

Tilman v. United States, 644 F. Supp. 2d 391 (holding videos, clothes, gym memberships, computers, recording equipment, haircuts, and manicures are nondeductible personal expenses)

- *Oliver v. Commissioner*, T. C. Summary Opinion 2008-124 (television, newspapers)
- *Richards v. Commissioner*, T.C. Memo. 1999-163 (holding research trips, television, videotapes, magazines, audio equipment were nondeductible personal expenses)
- *Kroll v. Commissioner*, 49 T.C. 557 (1968). (holding that expenses of the mother of a child actor were inherently personal and nondeductible personal expenses and that private school expenses for the child actor were also not deductible.)
- *Sparkman v. Commissioner*, 112 F.2d 774 (1940) (holding that where the taxpayer, who was motion picture actor and radio performer, purchased two sets of artificial upper teeth, in order to eliminate a hiss which had developed in his speech and to restore to taxpayer perfect enunciation which was necessary in his profession, but taxpayer did not prove that the teeth were to be used for business purposes only, amount paid for the teeth was not an "expense incurred in carrying on a trade or business" but was a "personal expense" and no part thereof was deductible in computing for taxation purposes the taxpayer's net income.)
- *Westerman v. Commissioner*, T.C. Memo. 2011-204 (holding the taxpayer was not entitled to deduct some studio time expenses, automobile, travel, or meals and entertainment expenses, but was entitled to deduct guitar repair, practice studio and disk expenses)
- *Hynes v. Commissioner*, 74 T.C. 1266 (1980). (holding that taxpayer, a staff announcer and television news writer, could not deduct expenses of wardrobe, laundry, or dry cleaning, which were not significantly different from those of other business people limited to conservative styles and fashions even though he was required to maintain "physical appearance suitable for services as a television announcer," but was not reimbursed by employer the costs).

Chapter 9 - Other Issues

Office In The Home

In the entertainment industry the issue of home office frequently arises. Taxpayers usually claim their home office is used for keeping records, making telephone contacts, rehearsing, and a myriad of clerical chores. While this may well be true, the issue of deductibility remains.

I.R.C. § 280A severely restricts the deduction for office in the home. To claim a deduction for business use of a taxpayer's personal residence under I.R.C. § 280A(c)(1), the taxpayer must establish that a portion of his dwelling unit is (1) exclusively used, (2) on a regular basis, (3) for the purposes enumerated in subparagraphs (A), (B), or (C) of I.R.C. § 280A(c)(1), and (4) if the taxpayer is an employee, the office is maintained for the convenience of the employer.

Hamacher v. Commissioner, 94 T.C. 348, 353-354 (1990).

Regular use means on a continuing basis, not just occasionally.

Exclusive use means that the area that serves as an office must be a distinguishable area used only for qualified business use. Moreover, all use of the office must be qualified use. (See multiple businesses.)

Under I.R.C. § 280A(c)(1), qualified business use must be one of the following:

- As the principal place of business.
- As a place to meet with patients, clients, or customers in the course of the trade or business.
- A separate structure not attached to the dwelling unit.
- A designated storage space for inventory in the trade or business of selling products at retail or wholesale.

Principal Place of Business

Principal place of business includes a place used for administrative and management activities if there is no other fixed location where such activities are substantially conducted. I.R.C. § 280A(c)

If you meet the exclusivity requirement, the next most frequent of the above issues in the entertainment industry, is the principal place of business. In *Commissioner v. Soliman*, 506 168, 175-177, (1993), the Supreme Court laid out a two-part test to determine whether a taxpayer's residence qualifies as a principal place of business: (1) the relative importance of the activities undertaken at each business location; and (2) the time spent at each location. However, after the Supreme Court's decision in *Soliman*, Congress added language following I.R.C. § 280A(c)(1)(C), to define "principal place of business" for tax years after 1998, as including "a place of business which is used by the taxpayer for the administrative or management of any trade or business of the taxpayer if there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business." The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 932(a), 111 Stat. at 881; *Thunstedt v. Commissioner*, T.C. Memo. 2013-280 (holding that taxpayer was not entitled to home-office expense deduction, although he used his home in connection with his art business, absent evidence of what portion of his home was used exclusively on a regular basis as the taxpayer's principal place of business.); *Beale v. Commissioner*, T.C. Memo. 2000-158 (holding the taxpayer was not entitled to deductions for home office expenses, as he failed to prove that his residence was his "principal place of business").

Deductible Amount

The home office deduction cannot exceed the gross income from the activity, reduced by the home expenses that would be deductible in the absence of any business use (mortgage interest, property taxes, etc.) and the business expenses not related to the use of home. I.R.C. § 280A(c)(5).

The Simplified Method – Calculating the Home Office Deduction under Rev. Proc. 2013-13

For tax years beginning on or after January 1, 2013, taxpayers may elect to compute the home office deduction by using the simplified safe harbor method provided under Revenue Procedure 2013-13. Rev. Proc. 2013-13, 2013-6 I.R.B. 478. Under the safe harbor, taxpayers may claim a home office deduction equal to \$5 times the number of square feet of the home office, subject to inflation and not to exceed 300 square feet. This safe harbor is an alternative to the calculation and allocation of actual expenses, so actual expenses cannot also be deducted. It may not be used for taxpayers is reimbursed by an employer for home office expenses.

Employees

As with any industry, an employee will only be able to deduct office in the home when all requirements are met and the home office is for the convenience of the employer. An employee's use of a home office is for the convenience of his employer where: (1) the employee must maintain the home office as a condition of employment; (2) the home office is necessary for the functioning of the employer's business; or (3) the home office is necessary to allow the employee to perform his duties properly. *Hamacher v. Commissioner*, 94 T.C. 348, 358 (1990). The home office must not "be a purely matter of personal convenience, comfort, or economy with respect to the employee."

Personal Service Corporation

Individuals who have formed a personal service (C) corporation may still deduct business use of their home, but the creation of the corporate entity would give rise to separate issues, for example, the corporation would have to rent the premises from the taxpayer. This may, in turn, give rise to self-rental issues.

Multiple Business Activities

When a taxpayer has multiple business activities that use the home office, all of the activities for which the office is used must meet the requirements of I.R.C. § 280A(c)(1). If any of the activities uses the home office and does not meet the requirements, the exclusive use test is not met and no deduction is allowed. *Hamacher v. Commissioner*, 94 T.C. 348, 358 (1990).

The taxpayer in *Hamacher*, was an actor who performed on stage, screen, and radio as an independent contractor. He was also employed at one theater as an acting instructor and administrator. His employer provided him with an office at the theater, but the taxpayer also set up an office in his home. The home office was used in connection with both his employment and his self-employed activities.

The Tax Court found that the employer did not require the taxpayer to do any work at home. The home office may have been helpful but was not for the convenience of the employer. It was not necessary for the court to determine if the home office would have qualified solely in conjunction with the taxpayer's self-employment. Since the use with regard to the taxpayer's employment was not qualified, the exclusive use test was not met and no office in the home deduction was allowed either on the Schedule A or Schedule C.

In addition to the obvious expense for office in the home, this issue has impact on the deductibility of business mileage for what would otherwise be commuting expense (see Chapter 6 – discussion on "Transportation").

Activities Not Engaged In For Profit

It is common in the entertainment industry for "creative people" to be driven by strong compulsions for personal recognition and a passion for artistic expression. These are strong motivating factors which have little or no bearing on whether or not a profit is realized. I.R.C. § 183 limits expenses related to activities which are not engaged in for profit. This provision effectively eliminates losses from these activities. If the taxpayer is showing losses in multiple tax years, this provision should be considered.

Examiners are advised to be reasonable in deciding when to apply this provision. Refer to the ATG for I.R.C. § 183: Activities Not Engaged in for Profit).

Job Search

Taxpayers in the entertainment industry commonly incur expenses while searching for employment. The allowable deductions in this area are generally the same expenses allowed for any other industry. Commonly allowed expenses include photo-resume, composites, video resumes, demos, and publicity photos. There may also be some unusual self-promotion. The expense must be ordinary, necessary, and reasonable. Make sure the expense relates to the taxpayers' specific trade.

Photo and Video Resumes

Photo resumes (generally done in a studio) and video resumes (generally composites of work the taxpayer has done) are used to show potential employers the taxpayers' skills and versatility. These resumes generally include a reasonable expense for recording, editing, and copying. It is generally expected that they would be reasonable expenses incurred every year.

Demos

In contrast, we have the "demo." Unlike a demo which is shopped to sell a "production" (song, video, etc.), this demo is used to promote the talents of the taxpayer to potential employers. Some of these demos are like full productions in cost and expended effort, except they are not made for sale. When a major expense is incurred to produce "demos," it must be determined if these assets have a useful life of more than one year. These tapes (video or audio) are used for job seeking or marketing the taxpayer and are, therefore, not subject to I.R.C. § 263A. They are, however, I.R.C. § 1231 assets; used in a trade or business, with a useful life of over one year, and of a character which is subject to depreciation under I.R.C. § 167 (and I.R.C. § 179 and the limitation thereunder). It is, therefore, necessary to determine the useful life of these demos. This can be done by checking when a replacement demo was produced. By verifying that the demo was actually submitted (or shopped), it may be determined that the demo is still being submitted

and has no determinable useful life. Generally audio tapes are used from 1-4 years and videos from 2-5 years. This may vary with the nature and subject matter recorded.

Showcasing

Another way performers try to obtain employment is by "showcasing." This involves staging performances without compensation, or even at a cost to the performer.

Showcasing expenses can be verified by canceled checks along with contracts, letters of agreement, or other documentary evidence of the arrangement between the performer and the producer or club. In the absence of documentary evidence, a third party contact can verify the nature of the expense and any income received by the performer.

When a performer pays an exceptionally high fee to perform, the probability of the performer receiving a percentage of the door must be considered.

Actors, Directors, Producers

Many showcase opportunities exist for actors, directors, and producers to exhibit their skills. Frequently, a producer or other entrepreneur will arrange a production consisting of unrelated one-scene performances. The individuals who wish to demonstrate their skills can pay the producer to perform one of the scenes. Depending on the location, expected attendance, and history of success, the cost to the individual actor can run from \$35 to \$200.

A director may pay for the entire scene and recruit his or her own actors. This generally costs the director up to \$1,000. The director may recover some of his or her expenses from the actors or he or she may absorb the cost.

Many acting coaches or teachers highlight each series of workshops with a public performance. The coaches invite directors and producers to attend the performance. These performances are considered another opportunity for the actors to demonstrate their skills.

Comedians

Similar showcasing opportunities exist in the area of stand-up comedy. Many comedy clubs offer 20 minute to one-hour segments for a little or no fee. This usually runs from \$50 to \$500 depending on the reputation of the club.

Musicians

Showcasing opportunities for musicians can create another source of income. Commonly, musicians are provided an opportunity to perform in a club with only a moderate fee or without a fee. In exchange for performing, the musician is expected to encourage his or her fans to attend the performance. The musician is then entitled to a percentage of the door.

Agents

Some agents are now charging a fee for a performer to audition. These fees are generally around \$35. If the performer is successful, the agent will then represent that performer. This is a new development in the entertainment industry and not all agents believe it to be ethical. It is, however, acceptable for the performer to pay these fees to acquire representation or employment.

Fees and Commissions

Fees paid to an agent (artist's representative) are allowable business expenses under I.R.C. § 162.

Agent fees are usually 10 percent of gross for any jobs secured by the agent. These fees are generally limited to 10 percent by SAG-AFTRA. Some foreign productions or agents may receive up to 15 percent commissions.

The term "plus 10" is used when the agent negotiates for the producer to pay an extra 10% for the agent's fee so it doesn't come out of the performer's pocket. This is done typically with commercials and industrial shoots and not with movies and episodic TV.

Most performing artists have contracts with their agent or representative, but this is not mandatory. An oral agreement is sometimes used since the rate is standard. Residuals are subject to the 10 percent commission only if they are "over scale." Therefore, minor amounts will not result in fees to agents. When the residuals are subject to agent fees, the commission is paid to the agent who obtained the work, not the agent at the time of the payment. The agent generally does not issue a year-end statement to the performer. This is to avoid any appearance of being the employer. Most payments (wages or fees) which are subject to commissions are paid by the employer directly to the agent. The agent keeps his/her fee and pays the difference to the performer.

Business management fees are not standard. They may vary from 5 to 15 percent of gross or they may be a flat monthly fee. Many actors have their manager pay all their personal bills and handle their personal affairs as well as their business matters. Business management fees are allowable in proportion to the percentage of business versus personal use. Facts and circumstances will determine the percentage of business use.

Moving Expenses

Taxpayers can deduct their moving expenses, subject to certain dollar limits, if that move is closely related to the start of work at a new location, and the taxpayer meets the distance test and the time test. I.R.C. § 217.

Distance Test

The move will meet the distance test if the taxpayer's new main job location is at least 50 miles farther from his or her former home than the old main job location was.

Time Test

If the taxpayer is an employee, he or she must work full-time for at least 39 weeks during the first 12 months after arriving in the general area of the new job location. The taxpayer does not have to work for the same employer for the 39 weeks. However, the taxpayer must work full-time within the same general commuting area. The 39 weeks do not have to be consecutive.

Only those weeks during which the taxpayer is a full-time employee or during which he performs services as a self-employed individual on a full-time basis qualify as a week of work. Treas. Reg. § 1.217-2(c)(iv). Section (a) of the regulation deals with employees and (b) deals with self-employed. Under either scenario, the definition of full-time is determined based on the practices of the industry at the time and place.

Treas. Reg. § 1.217-2(c)(4)(iv)(a) provides:

Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. Where employment is on a seasonal basis, weeks occurring in the off-season when no work is required or available may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off season period and such period is less than 6 months.

For example, a taxpayer who does voiceover work is considered full-time at 4 hours per day. Actors tend to not meet the 39 week test because their move deals with a short term job, or jobs, or the hope of finding a job. Time between jobs is not counted as part of the 39 weeks, unless it is part of a scheduled break in production and the taxpayer's contract includes continuous employment before and after the break. Only if a hiatus is included per contract, will it be included as part of the required 39 weeks.

For self-employed individuals, the regulation provides that where a trade or business is seasonal, weeks occurring during the off-season when no work is required or available may be counted as weeks of performance of services on a full-time basis only if the off-season is less than 6 months and the taxpayer performs services on a full-time basis before and after the off season. Actors looking for work would not constitute an "off-season". The performers would work full time if the work were available.

A move to another region that meets the distance test for greener pastures does not qualify unless the time test is met. There is no exception for actors or other entertainment related professions who were looking for work, but did not find it.

Personal Service Companies and Personal Holding Companies

Many entertainers form corporations known as "loan-outs". The purpose of the "loan-out" is to loan out the services of its (usually 100%) shareholder. These corporations are often personal holding companies (PHCs) and in the case of actors are also personal service companies (PSCs). PSC is a C corporation that is taxed at a higher single rate and does not have a progressive tax rate. In a "loan-out" company if the contract specifically names the shareholder as the one to perform the job, it is considered to be PHC income (refer to I.R.C. § 542 etc). PHCs can be

"loan-outs" for actors, writers, directors, producers, etc. PSC as it relates to the entertainment industry is for people who are in front of the camera. PHCs pay additional Personal Holding Company Tax. In the entertainment industry, PSC and PHC companies usually will not have excessive compensation issues. The purpose of the tax rate is to encourage these PSCs and PHCs to pay wages, usually to the shareholders, in order to have zero taxable income on the corporate returns.

Chapter 10 - Music Business

Overview

The next section of this Entertainment Audit Technique Guide will give the examiner an overview of the music industry. It generally will show:

- How the industry is structured.
- What is involved in making and marketing a record, tape, or compact disk.
- How income is generated by artists and their operations.
- Books and records that should be available in each industry segment.
- Common industry terminology.
- Accounting practices used in the industry versus proper tax treatment of various issues.
- Suggested audit techniques regarding specific issues or accounts.

This audit technique guide is a general overview of the industry; it is not all-inclusive. Examiners should exercise their own initiative, consistent with applicable statutes, regulations, administrative pronouncements, and case law. No interpretation of the law discussed in this audit technique guide is to be cited as authority to taxpayers or used in the disposition of any case. Interpretation of the law should be made by the individual examiner working the case.

Guidelines reflected in this audit technique guide do not alter any existing technical or procedural instructions contained in the Internal Revenue Manual (IRM). If there are inconsistencies between these guidelines and the IRM, the IRM should be followed.

This section of the audit technique guide contains information on the following segments of the music industry:

- Songwriters
- Publishers
- Performers
- Record producers
- Managers
- Videos

Following is a list of issues not necessarily unique to the music industry but probably would not be found in other industries.

- Depreciation on capital improvements to personal residence to maintain the "image" of a big star.
- Expense to maintain a get-away or vacation home where songwriters would write or receive their inspiration.
- Stage clothes expenses that were not different from ordinary street clothes.
- A retired songwriter treated royalties as wages rather than income subject to self-employment tax because the songwriter believed that they were no longer active in the music industry.

See [Chapter 17](#), Employment Tax, for more information on employment status and employment tax relief.

General Information

Because the music business attracts various individuals such as songwriters, producers, entertainers, executives, artists, etc., unique problems in an income tax examination may occur. Therefore, there is a need to discover how the industry operates, what sources of income are available to these types of taxpayers, and how the income flows through the industry to the individual.

Record companies will sometimes pay "up front" to produce a record (see Advances in Chapter 3 and Payment of Advances and Royalties in Chapter 4). The record company recovers its full cost from record sales before the artist gets anything. After costs are recovered, a percentage is deducted for return of records and the cost of the record jacket. The artist will get a certain percentage of the suggested retail after the above amounts are deducted. It is suggested that examiners review the contract to determine if it calls for a percentage of retail or wholesale.

Performing Rights Organizations (PROs) monitor, collect, and pay performance and mechanical royalties to its members. Payment schedules vary by organization. Many payments are made on a quarterly or semiannual basis. All PROs issue Forms 1099 for royalties paid to their members.

The American Society of Composers, Authors and Publishers (ASCAP) is a non-profit PRO founded in 1914. ASCAP is the only United States PRO created and controlled by composers, songwriters and music publishers. The Board of Directors consists of members who are elected by its members.

The Society of European Stage Authors and Composers (SESAC), the smallest of the three United States' organizations, is a for-profit PRO founded in 1930. Today, SESAC no longer is an acronym and is not an abbreviation for anything. SESAC was founded in 1930 to serve European composers not adequately represented in the United States.

The Broadcast Music, Inc. (BMI) is the largest PRO in the United States. BMI is a non-profit organization founded in 1939 because ASCAP increased their fees and the founders also wanted to represent genres like jazz, blues, and country. There are smaller and some foreign Performing Rights Organizations. A listing is contained at the end of this guide.

Payment schedules vary by organization. Most payments are made on a quarterly or semiannual basis. All PROs issue Forms 1099 on the royalties paid to their members.

There are different types of royalties, which include mechanical and performance royalties. Wikipedia.org discusses mechanical royalties and [mechanical licenses](#) as "having their origins in the 'piano rolls'" on which music was recorded in the early part of the 20th Century. A piano roll is defined by Wikipedia.com as a "music [storage medium](#) used to operate a [player piano](#), piano player or [reproducing piano](#). A piano roll is a continuous roll of paper with perforations (holes) punched into it. The perforations represent note control data. The roll moves over a reading system known as a 'tracker bar' and the playing cycle for each musical note is triggered when a perforation crosses the bar and is read."

Although, its concept is now primarily oriented to royalty income from sale of compact discs (C.D.), its scope is wider and covers any copyrighted audio composition that is rendered mechanically; that is, without human performers:

- Tape recordings
- Music videos
- Ringtones
- Musical instrument digital interface (MIDI) files
- Downloaded tracks
- Digital Versatile Disc (DVD), Video Home System (VHS), Universal Media Disk (UMD)
- Computer games
- Musical toys, etc.

Wikipedia.org defines performance royalties as:

"Performance in the music industry (and) can include any of the following:

- A performance of a song or composition – live, recorded or broadcast
- A live performance by any musician
- A performance by any musician through a recording on physical media
- Performance through the playing of recorded music
- Music performed through the web (digital transmissions)

It is useful to treat these royalties under two classifications:

(a) those associated with conventional forms of music distribution which have prevailed for most part of the 20th Century, and

(b) those from emerging 'digital rights' associated with newer forms of communication, entertainment and media technologies (from 'ring tones' to 'downloads' to 'live internet streaming'.")

Mechanical royalties are paid for the reproduction of songs in the form of CD players or sheet music. This also includes synchronization fees for videos and music for motion pictures and television films. The publishers keep one-half of the royalties and distribute one-half to the writers. The writers normally get a payment statement twice a year as well as a Form 1099 from the publisher. Quarterly accountings and payments are made. The predominant licensor, collector, and distributor for mechanical royalties is the Harry Fox Agency.

The royalties received that relate to works created by the artist are subject to self-employment tax and should be recognized on Schedule C. The royalties that are related to the works that were not created by the artists are not self-employment income and should be reported on Schedule E.

Digital Music

Prior to the 1995 Digital Performance Right in Sound Recordings Act, there was no entitlement to compensation for the sound-recording copyright owners (SRCOs). For example, if you would have heard, UB40's "Red Red Wine" on the radio, songwriter Neil Diamond and the publisher would have been compensated through SESAC, but the band and its record label would have received nothing.

The Digital Performance Right in Sound Recordings Act of 1995 (DPRA) law mandated royalties to performers which led to the creation of SoundExchange in 2000. SoundExchange is a digital Performance Rights Organization. This non-profit organization has the monopoly on collecting and distributing digital performance royalties to artists and copyright holders (as distinguished from the publishing copyright discussed earlier).

Royalties are distributed through SoundExchange, for example, at roughly 45% to the performer, 50% to the SRCO which is most likely the label, and 5% to the non-featured performers. However, these royalties apply to satellite radio (e.g., Sirius XM), internet radio (e.g., Pandora, Spotify), and cable music channels, but not AM/FM radio. Eliminating the exception that was maintained for terrestrial (land based) radio has been the subject of legislation in recent years but nothing has passed.

The broadcasters are free to negotiate with the rights holders, a person or organization that owns the legal rights to something, which is what Apple has done with its iTunes Radio. Apple pays .0013 cents per song and 15% of the advertising revenue. By contrast, Pandora has paid as much as 2.91 cents/hour as of 2010. It should be noted that these amounts change frequently, as does the business.

The examiner should keep in mind that SoundExchange is a PRO and that if the taxpayer created recordings as a featured or backup performer, there's a good chance they might be receiving some royalties from non-terrestrial airplay. The amounts won't be great though unless the artist is prominent in the business.

SoundExchange represents more than 70,000 artists and 24,000 copyright owner accounts. An artist does not have to be a member to collect royalties based on the statutory license of DPRA

but SoundExchange also maintains reciprocal agreements with more than 20 international counterparts and it appears that free membership is required to take advantage of that benefit.

Downloads

Regarding downloads, the payments would appear to work the same way as for a print CD, just with another middleman and with more options for the independent artist. Apple, for example, keeps 35 cents of every typical 99-cent download (25 cents of that goes to the credit card company). The remaining 65 cents goes to the label with a typical 8 to 11 cents passing on to the artist. These amounts change frequently and cannot be relied upon for accuracy. Apple doesn't work directly with an independent artist. CDBaby and Tunecore are middlemen that charge the artist to post the music to iTunes (\$55/album for CDBaby), take a percentage (9% for CDBaby), and pass the rest on to the artist (63 cents per 99 cents a song). Part of the service of the middlemen is the obtaining of a UPC code for the music, a requirement for any online service.

Besides royalties, artists may earn income through performances, live and recorded. Overseeing this type of income are unions which provide services to their members which includes collecting fees earned by their members. The unions are a good source from which you can obtain income information. A directory of members in local unions is available upon request from unions located in your area. The directories are categorized by instruments played, phone numbers, and social security numbers. The American Federation of Television and Radio Artists (AFTRA) is the union for the artists. Unions usually have a record of each job or session performed that was reported to them. Many payments to artists go through unions; or dues are withheld from the payments and sent to the union. The union has a set pay scale that its members receive for their performance on union sessions. In order to capture all of the income, including non-union jobs, indirect methods to reconstruct income may be required.

Artists, performers, and promoters may have income from concerts (ticket sales, concession sales, etc.), much of which is in cash and particular attention should be given to this during the examination. A promoter buys talent and places it in an auditorium, stadium, etc. Promoters usually pay the talent 50 percent up front (in the form of check or wire transfer) and 50 percent at the gate (often in the form of cash). The examiner will need to request all of the performance contracts to determine how and when the artist is paid.

The promoter may lose money booking acts that do not sell tickets. The promoter has to pay the auditorium or stadium a guarantee for the dates scheduled or a guarantee plus a percentage of the box office. A manifest (box office report prepared on the night of the concert) is used to determine the box office sales and therefore the split of the money from the concert. The artist's manager, the promoter, and the ticket agent check the manifest to determine that each receive the proper percentage. Some states periodically audit these reports. For concession sales, the auditorium staff attempts to take an inventory of souvenirs before and after a concert but this procedure is difficult and time consuming. The promoters (who may or may not be entitled to the percentage of the concession) usually rely on the integrity of the artist's staff to give a proper accounting of souvenir sales. Artists receive a percentage of the souvenir sales which are normally handled by bus drivers and/or band members. Some artists hire companies to conduct these souvenir sales.

The performing artist is usually a very creative person as far as talent goes, but may lack knowledge in understanding bookkeeping, taxes, and cash flow. Live performances are often the main source of income for the artist (especially unknown artists). Artists generally do not receive significant income from television performances. These appearances are made for the purpose of obtaining exposure. Their record sales go hand in hand with concerts, each supporting the other. Artists can receive numerous Forms W-2 and Forms 1099 because they (particularly band members) work for many companies during the year. There may be some question as to whether they are employees or self-employed since their role changes back and forth. Court cases seem to divide on whether the band members' actions were controlled by the band. In *re Hamlin, Hadsell, Tanner*, 1974, 74-2 U.S.T.C. (CCH) ¶9578, the bankruptcy court determined that there was no employer-employee relationship between the band, The Board of Regents, and each of its individual band members where the band members operated cooperatively, within the meaning of the fourth example of Rev. Rul. 68-107, 1968-1 C.B. 427, deciding together on songs and schedules. In *Teschner V. Commissioner*, T.C.Memo 1997-498, the taxpayer played on a tour with a band and was subject to its schedules and song choices and was required to deduct expenses only on Schedule A.

For an artist to work a concert, he or she needs the services of a variety of people. Depending on the drawing power of the artist, he or she will get 60 to 80 percent of the concert receipts and the promoter will get 20 to 40 percent. Some artists negotiate for a percentage of the gate while others contract for a guaranteed flat fee. Examiners should inspect contracts to find this information. The booking agent for the artist receives 10 percent of the artist's income from shows. A personal manager gets around 15 percent and a business manager gets about 5 percent of the artist's gross income. Copies of the booking agent's itinerary for the artist should be checked against road receipts. Some artists also have a road manager who travels with them and handles all the road arrangements. The road manager also keeps up with the trip tickets or settlement sheet on income and expenses while on the tour. Banquets and conventions are good money making opportunities for the artists. They should be on the booking agent's itinerary for the artist along with the regular concerts and fair dates.

Radio plays a special role in the music industry. There would not be a hit record if there weren't radio. The program director and music director at each station control the music that is played. Some stations use the services of programming consulting companies to help determine the music that is played on that station. Many stations play only 40 to 60 different records a day. These records are played over and over again. It is difficult for new artists to get their records played on radio stations. Therefore, there is a potential for payoffs (bribes) to station disk jockey's (DJ's) to get them to play certain songs. Initially, bribes occurred only on soul and pop music radio stations; however, it is currently prevalent throughout the industry. The form of the payment is not only cash payment but also luncheons, special entertainment, hotel suites, trips, and gifts.

There are a number of special problems in the music industry. The first is the cost that it takes to generate income. Vast sums are spent for travel, clothes, instruments, bands, buses, motels, and uniforms. There are periods of feast and famine. There is extensive bartering activity in the industry. It occurs in the form of swap outs (advertising for cars, advertising for tickets, etc.). There is a saying in the industry, "If you don't promote, something awful happens-nothing!" The

top 10 to 20 percent of the artists get 80 to 90 percent of the industry gross income. The other 80-90 percent get the remaining portion.

There are many checks and balances in the industry on income reporting, but some activities such as playing small clubs for the door receipts, love offerings at concerts and churches, and concession sales at the small locations, etc., present situations where income may go unreported.

The following general questionnaire should be used in all industry examinations along with the applicable segment questionnaire. (Note: These are recommended questions. The list is not all inclusive.)

General Questionnaire

- Explain all the different roles you play in the music industry. (Such as performer, songwriter, studio musician, recording artist, promoter, etc.)
- Are you a partner, shareholder or member of any entity? (Such as partnership, corporation, or LLC etc.)
- Are you self-employed for any of your activities? (Were Schedule "C" and "SE" filed?).
- From what sources do you receive income?
- How are these sources of income reported to you? (Form W-2, Form 1099, statement, settlement sheet, contractual agreement, partnership Schedule K-1, etc.)
- Who keeps up with all your records and where are the records currently located?
- What type of expenses do you incur?
- Who keeps up with your expenses and where are the supporting records located?
- What contractual agreements do you have through your business? (Request copies of contracts).
- Have you been examined previously? If so, what were the results?
- What assets have you purchased that you use in your business?
- How have these assets been handled for tax purposes?
- Do you ever receive cash payments? If so, what is done with the money? (Used to pay bills, deposited into a bank account, etc.)
- Are you a union member? If so, what union(s)?

Music Industry Research and Publications

The Country Music Foundation Library located in the basement of the Country Music Hall of Fame in Nashville, Tennessee, is an excellent source of music research. The library has current and back issues of trade magazines such as Music Row Magazine, Billboard, Music City News, etc.; current and back newspaper articles from around the country; music "textbooks" covering how to get started in the music business; what managers, agents, producers, publishers, etc., do; music careers; music business terms; how to open doors on Music Row; and books on each individual facet of the music business, including how the companies are set up and what their employees' functions are. The Library also keeps clippings of newspaper articles by music industry segment from all over the country.

The manager of the library can assist in pulling the research materials. However, you must call for an appointment before visiting.

Trade Magazines

[Close Up](#), the CMA magazine (print and online), includes up-to-date news in country music, new signings, etc.

[Music Row](#), Nashville's Music Industry Publication, includes music business news, new companies, new signings, music industry directory, recent concert grosses, financial pages, etc.

[Billboard](#), a weekly trade publication listing top songs, records, etc., includes current music news.

[Cash Box](#) is an online music magazine.

[Pollstar](#) is a weekly guide furnishing tour itineraries, box office results, contact directories, news items, management of stars, etc.

[Performance Magazine](#) is a list of concert and performance dates.

Books

The Music Business, Crown Publishers, includes how to get started, what manager, agents, and publishers do, recording process, how records are sold and distributed, how to get recording contracts. Also includes a glossary of music business terms.

The Songwriter's and Musician's Guide to Nashville, Writer's Digest Books, includes list of music business companies in Nashville, how to open doors in Nashville and on Music Row, when and where certain music organizations meet in Nashville.

Successful Artist Management, Billboard Publications, includes finding a manager/artist, contracts, duties of attorneys, accountants, and advisors, music publishing, merchandising, endorsements, money management.

Music Publishing, Writer's Digest Books, includes publishing and copyright law, royalties, inside the publishing company, future of music publishing, sample contracts.

Succeeding in the Big World of Music, Little, Brown, & Co., includes functions and business responsibilities of music industry personnel such as producer, engineer, writer, arranger, publisher, manager, etc.

This Business of Music and More of This Business of Music, excellent source of the music business from getting into the business to tax implications of certain aspects of the business. These books are being used as the source books for many people in the music business. Copies of these books are available in the Music Industry group.

Other Source Books

Encyclopedia of Music Business Sound Advice

Nashville Red Book

Music Industry Index

Dictionary of Music Production and Engineering Terminology

NOTE: These books are available through either the public library or the Country Music Foundation Library.

Music Industry Directories

AFM Membership Directory, musicians

SAG-AFTRA Membership Directory, TV and recording artists

Music Business Directory

Nashville Redbook

Tennessee Production Directory

NOTE: Other Territories should check with their local unions to obtain their directories.

Music Industry Organizations

The following is a list of unions, guilds, trade associations, and performing rights organizations that are involved in the music industry.

Unions and Guilds (listed in alphabetical order)

[Actor's Equity Association](#) (AEA or Equity) - A labor union that represents more than 49,000 actors and stage managers in the United States. Actors' Equity is a member of the AFL-CIO, and is affiliated with FIA, an international organization of performing arts unions.

[American Federation of Labor-Congress of Industrial Organizations](#) (AFL-CIO) - A labor union that is the umbrella federation for United States unions, with 56 unions representing about 12.5 million workers. (Aflcio.org)

[American Federation of Musicians](#) (AFM) - A union that represents, negotiates, administers, and protects contractual rights of more than 90,000 professional musicians in the United States and Canada.

[**American Guild of Musical Artists \(AGMA\)**](#) - A labor union that represents opera and concert singers, production personnel and dancers at principal opera, concert and dance companies throughout the United States. AGMA is affiliated with AFL-CIO and a branch of the Associated Actors and Artistes of America "Four A's". (Musicalartists.org)

[**American Guild of Variety Artists \(AGVA\)**](#) - A labor union, affiliated with AFL-CIO, that has 2,800 members and represents performing artists and stage managers for live performances in the variety field. The variety field includes (not an all-inclusive list) comics, jugglers, magicians, circuses performers, theme park performers, comedians & stand-up comics, cabaret & club artists, nightclub singers, skaters, etc. (Agvausa.com)

Associated Actors and Artistes of America (4As) - 4As is the federation of trade unions for performing artists in the United States. The following unions belong to the 4As (not an all-inclusive list):

- American Guild of Musical Artists (AGMA)
- The Actor's Equity Association (AEA)
- Screen Actors Guild-American Federation of Television and Radio Artists (SAG-AFTRA)
- American Guild of Variety Artists (AGVA)

[**Screen Actors Guild-American Federation of Television and Radio Artists \(SAG-AFTRA\)**](#) - These two unions merged in 2012. This union represents over 160,000 professional performers and broadcasters in all media distribution platforms through contract negotiation and enforcement, expansion of work opportunities, and other services.

[**The Songwriters Guild of America \(SGA\)**](#) - An organization that fosters and protects its membership of American songwriters.

Trade Associations

[**Music Business Association \(Musicbiz\)**](#) - Prior to 2013, it was known as National Association of Recording Merchandise. Music Business Association is a trade association representing the interests of the merchandising segment of the recording industry with including retailers, rack-jobbers (take orders but have manufacturers ship merchandise directly to final consumers), and independent distributors.

[**National Academy of Recording Arts and Sciences \(NARAS\)**](#) - The academy is the sponsor of the Grammy Awards and its 8,000 members include singers, musicians, songwriters, composers, engineers, and industry professionals.

[**Recording Industry Association of America \(RIAA\)**](#) - A trade association whose members create, produce and market 85 percent of all recordings produced and sold in the United States.

National Music Publishers Association (NMPA) - The National Music Publishers Association is a trade association with over 3,000 members. The association's mission is to protect, promote, and advance the interests of music creators.

Harry Fox Agency (HFA) – The National Music Publisher's Association established HFA to act as an information source, clearinghouse and monitoring service for licensing musical copyrights. The Harry Fox agency currently represents U.S. music publishers with mechanical licensing, collections, and distribution.

National Association of Broadcasters (NAB) - A trade association that serves and represents radio and television broadcasters.

Nashville Songwriters Association International (NSAI) - The organization is dedicated to protecting the rights and serving professional songwriters in all genres of music. The organization has over 5,000 members in the United States and six other countries.

Country Music Association (CMA) - A trade association of more than 7,100 members that promotes and develops country music worldwide and host the annual CMA awards.

Gospel Music Association (GMA) - A service organization of more than 4,000 members, including international representation, that promotes gospel music.

Content Delivery and Security Association (CDSA) - Formerly known as International Tape Association. Content Delivery and Security Association is a trade association of magnetic and optical media manufacturers and related industries.

National Association of Music Merchants (NAMM) - A trade association of the music products industry, representing retailers of musical instruments and allied products as well as manufacturers, distributors, and jobbers of instruments and accessories.

Entertainment Merchants Association (EMA) - Formerly known as Video Software Dealers Association. Entertainment Merchants Association is an international trade association of DVD and video game retailers, distributors and suppliers.

Performing Rights Organizations

American Society of Composers, Authors and Publishers (ASCAP) - The society lobbies, licenses, collects and distributes fees, on behalf of more than 500,000 writers and publishers, for the rights to public performance of their copyrighted musical works.

Broadcast Music Inc. (BMI) - A licensing organization that lobbies, licenses, collects and distributes royalty fees for the publicly performed works of its membership of more than 600,000 U.S. writers, publishers and international affiliate societies.

[Society of European Stage Authors and Composers \(SESAC\)](#) - A performing rights organization of songwriters and publishers that licenses and collects fees for the use of its members' works.

[Sound Exchange](#) – An independent digital performance rights organization that collects and distributes digital performance royalties to artists and copyright holders.

Chapter 11 - Songwriters

General Information

Songwriters are the creative persons of the music industry. A songwriter may compose music, write lyrics or do both. A songwriter may only write one song during their career or a number of songs which is called a catalog. Writing a song is only the first step. Many difficulties arise in publishing and promoting a song. Because of the difficulties of getting a song published, many unknown writers have contracts to write exclusively for one publishing company. The contract will have a detailed description of a financial (royalty) agreement.

Songwriters who have signed exclusive writer's contracts generally are paid a cash consideration either in a lump sum, weekly payments, or other special consideration. Under exclusive writer's contracts, payments are commonly termed advances and are recouped from royalties which otherwise become payable to the writer.

There are two types of advances:

Specific - these are recouped from the royalties of specific works.

General - these are recoupable from the earnings of an entire catalog.

Songwriters receive income from publishers and performing rights organizations. In general, royalties come from the use of songs during live performances or on radio and television (performance royalties). The sale of records, sheet music (mechanical royalties) and the use of songs in plays and movies also generate royalties (synchronization royalties). Royalties paid for the use of songs are collected by performing rights organizations and distributed to the publisher who in turn pays the songwriter usually 50 percent of the royalties. If a songwriter has collaborated with another songwriter, the royalties will be split per an agreement between the songwriters. If there is no agreement, the industry and the courts have placed an equal value on the music and the lyrics.

Some songwriters will do their own publishing through a corporation they have formed or as a self-employed publisher. If the songwriter is his or her own publisher, royalties will not have to be split between the writer and the publisher. This means the income to the songwriter would be twice what it would be if they were not their own publisher. The disadvantage to being your own publisher is the added costs of a publisher such as: creating demo tapes, executing contracts, and promotion.

Recordkeeping

Performing rights organizations (BMI, ASCAP, SESAC) and the agencies collecting mechanical royalties keep records of royalties and provide songwriters with statements of the royalties earned in a given year. Generally, songwriters keep a full set of books, including cash receipts and disbursement journals. In addition, they generally have the statements of royalties earned, provided by BMI, ASCAP, SESAC and others. These statements can be issued quarterly, semi-annually or annually.

If there are any deficiencies in a songwriter's records, it usually is not in the area of songwriting. For example, many songwriters are studio musicians and the income from that activity is not always reported on the return.

During the initial interview, find out if the individual belongs to any music industry union. The unions generally keep records of the amount of income that musicians make from union jobs and this information is available to the union member upon request.

Examination Plan

It is essential that each examination have a well planned initial interview. A good interview will tie down all potential sources of income. The planning process should consider large and unusual items, potential copyright sales, potential unreported income, and potential shifting of income between related entities.

Interview questions have been developed for the music industry. There is a general questionnaire that relates to the entire industry and there are questionnaires that relate to specific segments of the industry. The general industry questionnaire is located in Chapter 10, and the songwriter questionnaire is located in Chapter 11. (Note: These are recommended questions. The lists are not all inclusive. The examiner should use his/her judgment when preparing for and conducting the interview.)

Initial document requests should contain at least the following items:

- Provide statements from ASCAP, BMI and SESAC showing royalties received.
- Provide all contracts with publishers and collaborators regarding royalty arrangements or any other arrangements.
- Provide any employment contracts.
- Show what arrangements are made for royalty advances and how they were handled on the return.
- Provide all agreements with performing rights organizations.
- Provide agreements with agencies collecting performance, mechanical or synchronization royalties.
- Provide statements from the unions to which you belong showing the income you earned during the years under examination.
- If the songwriter has performance income (union and/or non-union), provide copies of calendar.

Audit Issues

Gross Income and Capital Items

Most songwriters receive the bulk of their income from royalties. Royalties can be substantiated with the statements from publishers and performing rights organizations. There may be an issue where advances from royalties not yet earned have not been reported as income. Advances are not amortizable. Income from services performed by the songwriter or publisher should be immediately reported as income from services and not deferred until after recoupment of the advance. I.R.C. § 61.

Royalties are nonpassive under I.R.C. § 469(e) and Treas. Reg. § 1.469-2T(c)(i)(A). See also, Treas. Reg. § 1.469-2T(c)(7)(1). Royalty income should not be included on Form 8582 as passive income. There is a single exception in Treas. Reg. § 1.469-2T(c)(3)(ii)(E) that permits royalties to be treated as passive income. This exception is highly restrictive and rarely seen.

Examiners should be aware of other sources of income, such as, income earned where an individual went through his or her union for their engagement. Remember the union will provide a statement of income earned to the member.

Another issue involves the treatment of the sale of copyrights. Pursuant to I.R.C. § 1221(a)(3), a copyright in the hands of the taxpayer whose personal efforts created the copyrighted property is excluded from the definition of a capital asset. However, a taxpayer that purchases a copyright from the originator holds the copyright as a capital asset. The nature of the income is important due to limitations on the deductibility of capital losses, an individual taxpayer with excess capital losses would prefer capital gains over ordinary income since capital losses can only be offset against capital gains and up to \$3,000 per year of the individual's ordinary income. Corporate taxpayers with capital losses prefer capital gains since none of their capital losses are deductible against ordinary income. Additionally, the maximum rate at which a taxpayer's net capital gains can be taxed may be less than the maximum rate for ordinary income. I.R.C. § 1(h) prevents the taxation of a non-corporate taxpayer's net capital gains at a rate higher than 28 percent.

Expenses

This area usually contains numerous issues such as:

- Office in the home expenses have been deducted in excess of income or the office in the home is not used exclusively for business.
- Vacation homes, etc., are used by songwriters as a retreat and a place to think. This is not allowable as an ordinary and necessary expense.
- Travel expenses are not properly substantiated, and, in many cases, include personal expenses.
- Songwriters may claim deductions for contributions to a pension plan based on wages paid to a spouse.

Employment Tax Issues

Songwriters are generally considered self-employed individuals. Situations may exist where retired songwriters are receiving royalties from past works. The taxpayer may no longer be active in the business but would still owe self-employment tax on any royalties.

Although royalties may be reported on Form 1099-MISC as royalty income, generally the income should be recognized as self-employment income on Schedule C.

Related Returns

Generally related returns are partnerships, corporations, and LLC's formed by a taxpayer to handle the different segments of the industry in which he or she may be involved. These related companies may be used to shift income between entities to get the most beneficial tax treatment.

Songwriters Questionnaire

- Do you spend all of your time writing music or do you participate in other facets of the music industry? If other facets, what are they (publishing, producing, promoting, performing, etc.)?
- Do you ever participate in sessions? If so, how do you account for the income you receive from the sessions?
- How many songs have you written? What types of music do you write (pop, country, rock, gospel etc.)? What songs are in your catalog?
- Do you perform as well as write music?
- Do you write lyrics and music?
- If you collaborate, do you have a written contract stating how royalties are to be divided? Please provide a copy.
- How do you market your songs?
- Do you publish your own material?
- If not, do you write exclusively for any one publisher?
- If you do have an exclusive writer's contract, were you paid a cash consideration to enter into the contract?
- Do you have a contract(s) with your publishers?
- Have you ever requested an audit of your publisher's records? If so, did you recover additional royalties?
- Are any of your songs published in any foreign countries? If so, are they registered with any foreign publishers and or sub-publishers?
- How are foreign receipts collected?
- Has any money due from a foreign source(s) been frozen by the foreign country? If so, have you invested the money in any assets within the country? How and when are you to receive your money?
- Do you have any agreements with the performing rights organizations?
- With whom are the songs registered (BMI, ASCAP, SECAC)?
- What unions and guilds do you belong to?
- Do the unions and guilds collect any income on your behalf? If so, do they issue Forms 1099, and to whom?
- Do you have a royalty agreement? If so, provide a copy.

- Did you receive Forms 1099 for all your income?
- Do you receive any performance royalties, mechanical royalties or synchronization royalties? If so, from whom?
- Did you receive any advance royalties? If so, from whom and for how much? How and when is this income recognized?
- Are these recoupable from specific songs or from general work?
- Have you considered all royalties received as self-employment income?
- Are you aware of any compulsory licenses of your music? If so, how are royalties paid by them received?
- Who owns the copyright to your songs?
- Have you sold any of the rights in any of your songs? If so, when and to whom? How did you report income from this sale?
- Have you assigned any rights in your songs? If so, did you receive any compensation for the assignment?
- Did you have any income from contracts for hire?
- Do you work with any arrangers? If so, how are they paid?
- Who makes demos of your songs? Who incurs the costs of the demos? If someone other than yourself incurs costs, are they recouped from your royalties?
- Do you have an office in your home? If so, gather information about exclusive use, size of office, etc.
- With regard to expenses paid, determine if they are current costs or if they should be deducted from future royalties.
- Have you made any commercial jingles? If so, from whom do you collect royalties?
- Are you involved in any litigation?

Chapter 12 - Publishers

General Information

Publishing is defined as a group of rights and responsibilities pertaining to compensation including the right to:

- Make demo tapes of the song in an arrangement or style that demonstrates its potential for popular success.
- Market the work to potential performers, recording artists, labels, radio or television advertisers, and motion picture producers.
- Negotiate, write, and sign all contracts or agreements by which various users acquire their respective rights for desired uses of a composition.
- Collect and distribute all income from the composition to outstanding creditors and to all the owners of equity, called participants.

Just as a songwriter has a catalog, a publisher has a catalog. The writer's catalog consists of songs he or she has written. The publisher's catalog consists of songs from all writers whose work they publish. Publishers generally get 50 percent of the royalties from the songs they publish excluding certain minor items. The remaining 50 percent of the royalties are paid to composers and lyricist. For example, if the total income from a song is \$1,000, the songwriter

will get \$500. The publisher retains \$500 from which he or she must pay the costs of making the demo tape and selling the song to the record company.

Recordkeeping

The larger publishing companies are usually corporations that have good internal control and keep complete sets of books. Smaller publishers are generally songwriters as well and they do not always keep good records. The initial interview is crucial in these examinations. The initial interview for corporations should establish the quality of internal control. Whereas, the interview for individual returns should establish all sources of income and determine how personal expenses are paid. It is common for personal expenses, particularly travel, to be charged as expenses on Schedule C.

There is a unique situation involving publishers in the music industry. There are three primary performing rights organizations: ASCAP, BMI, and SESAC. A publisher may have some songs registered with each of these performing rights organizations. To register with different organizations, a publisher must use a different name for each organization. Therefore, a publisher that has songs registered with multiple performing rights organizations will have separate and distinct entity names they would use when they register with each organization. These may operate as divisions within one company or they may be separate corporations, partnerships, or LLCs. Although good records are kept, there may be issues in related companies that use a different accounting method.

Examination Plan

The most important part of the exam plan is the initial interview. Other areas of importance are employment taxes and high expenses. In addition, close attention should be paid to related entities. The examiner has to verify that the expenses that were charged back to the songwriter and not also deducted as a separate expense somewhere else on the return.

There is usually little opportunity for unreported income in the publishing business. The income received is from royalties paid by the performing rights organizations. These organizations submit statements as to the royalties paid. The statements are also available to the songwriter who will receive half of the royalties paid to the publisher. Therefore, where the songwriter and publisher are unrelated, there is little likelihood of receipts being unreported or diverted.

Besides the documents normally requested, an initial document request should include the following:

- Documents relating to any sales of copyrights or catalogs.
- Royalties statements.
- Forms 1099 or other documents supporting royalty expenses.
- Contracts with songwriters.
- Statements from all performing rights organizations.

Audit Issues

Gross Income

The primary issue in this area is differences in methods of accounting for income between related entities. Gross income tests for individuals will be basically the same as for any other examination.

Expenses

Adjustments in the expense areas will usually be in travel and entertainment expenses. In addition, smaller publishers may claim office in the home expense which should be reviewed.

Employment taxes

Inquiries should be made about the employment status of persons involved with the following:

- Performers of demo songs,
- Producers of master demos,
- Makers of master recordings,
- Nonunion musicians,
- Arrangers.

Related returns may include separate publishing entities to conform to the requirements of the performing rights organizations. If the songwriter is a shareholder, issues with regard to related party transactions including royalty advances may warrant examination.

Publishers Questionnaire

(Not all inclusive)

- What functions are performed by you as a publisher?
- Do you engage in any other functions besides publishing? (record production, promotion, arranging, etc.)
- How do you market songs?
- Do you negotiate contracts for rights in songs? How do you charge for this?
- Do you incur promotional costs? If so, are they recoupable from the songwriter?
- Do you have songs that are published in foreign countries? If so, how are royalties in those countries collected? Do you have a sub-publisher? (Consider international issues.)
- Has any money due from foreign sources been frozen by the foreign country?
- If so, have you invested it in any assets within the country? When and how will you receive the money?
- To what unions and/or organizations do you belong?
- Do you receive finder's fees for promoting songs?
- Do you have any songwriters under exclusive writer contracts? If so, who?
- Did you have to pay a fee to secure the exclusive writer contracts?

- Do you own any copyrights? If so, how were they acquired? How were they valued? Do you amortize them? Have you entered into negotiations to acquire copyrights prior to their renewal period?
- Have you sold any copyrights?
- With whom do you have songs registered (BMI, ASCAP, SESAC, etc.)? How do you determine which performing rights organization to register with? What company names do you use for each organization with whom you are registered? Are these separate corporations, partnerships, LLCs, etc.?
- Do you receive royalties for the following: mechanical royalties; synchronization royalties; performance royalties; television and motion pictures; compulsory licenses? If so, who pays these royalties? Do you receive Forms 1099?
- Do you receive and disburse songwriters' royalties? If so, do you reduce the amount due to songwriters by any expenses? Please provide a copy of a typical royalty statement provided to the songwriters.
- How do you determine the amounts to be paid to songwriters?
- Do you enter into royalty agreements? With whom?
- What type of accounting is made to you for royalties you receive? Please provide a copy of a typical royalty statement that you receive from each performing rights organization.
- Do you receive advance royalties? If so, from whom?
- Do you pay advance royalties? If so, to whom?
- Do you issue Forms 1099? If so, do you issue to all recipients or only those who receive in excess of \$600?
- What employees do you have? What services do they perform?
- Do you make demos of songs? Whom do you employ to perform on the demos?
- How are they paid? Are they considered employees? If not, why?
- Do you make master recordings? Whom do you hire to make the master recording? Are they considered employees? If not, why? Are you a producer? If not, who do you employ to produce masters?
- Do you make payments to any musician's union pension and/or welfare funds?
- Do you issue paychecks to the musicians who work for you?
- Do you work with nonunion musicians? Are they considered employees? If not, why?
- Do you work with any arrangers? If so, are they employees?
- Are you involved in any litigation?

Chapter 13 - Live Performers

General Information

The category "live performers" includes taxpayers ranging from the big name stars to band members and/or local nightclub performers. Examinations found there is a vast range in the way these various taxpayers conduct business.

Stars

"Stars" usually have business managers, road managers, booking agents, etc. working for them. These individuals manage virtually all of the stars' business activities. The stars typically have

little or no knowledge regarding many of the questions we ask in an examination about their tax return. (For example, how was your reported income determined? How were deductible business expenses determined?) The business manager often has adequate firsthand knowledge of both the operating and administrative/accounting aspects of the business and is the best source of information. Therefore, the business managers should be the primary sources for the initial interview and in most cases will be representing the taxpayer during the examination.

Other Performers

Most band members travel with the stars. In addition, most of them perform other activities within the music industry when they are not "on the road", such as doing studio work (recording sessions), performing in local night clubs, song writing, record producing, etc. Being a band member or a night club performer is considered a stepping stone to greater things within the music industry. Therefore, these individuals are usually juggling activities trying to "make it" in the industry. An examiner should not be surprised to see income and expenses from these activities combined and reported on the tax return.

Recordkeeping

Stars

Recordkeeping for the "star" is generally very good. Usually the stars have a business manager or others who handle their business affairs. An acceptable bookkeeping system is usually in place. It is not uncommon for a star to be paid in cash. Even though the "star" may have a business manager, minimum income probes for cash businesses should still be observed. Examiners should always request the taxpayer's calendar and all contracts that were in effect during the taxable year.

A star's performances are usually booked by a booking agent under a contractual agreement. The contracts may state that the star is to be paid a set fee, a percentage of ticket sales, or a combination of the two. These contracts are an excellent source to use to verify income. In addition, an itinerary is prepared for road trips and is given to road crews, band members, bus drivers, etc. Reconciliation of the contracts with the itineraries to the income reported on the books is a good starting place to verify gross income.

A road manager's responsibilities include receipt of payment following a performance. A portion of the payment will be paid through the booking agent when the engagement is booked. The remainder will be paid immediately following the performance. The road manager's role is particularly important when a contract calls for the star's payment to be based on a percentage of ticket sales. It is not unusual for the payments to be made in cash. It is also not unusual for "on the road expenses" to be paid from performance proceeds. An examiner should be alert to these practices to ensure that income and deductions have been properly claimed.

Other Performers

Musicians who have not reached an income level sufficient to hire business managers often have poor Recordkeeping systems. This doesn't appear to be due to an intent to cheat or defraud the Government; rather, it seems to be due to the taxpayers' basic lack of knowledge for these types of matters.

Examination Plan

When preplanning an examination of a performer, there are numerous sources of information available. See Chapter 10, Music Industry Research and Publications. As with any case, adequate preplanning and preparation for the examination is necessary to conduct a quality examination.

Besides the usual records requested in all examinations, the initial document request should include all contracts, statements of income earned from the taxpayer's union, appointment or engagement calendars, and itineraries. Another source that can be utilized to determine performance income for big name entertainers is Billboard magazine which publishes a weekly chart entitled, [Boxscore](#) which is compiled by an affiliated publication, Amusement Business. The chart shows artist names, gross ticket receipts, the number of tickets sold, capacity of the hall, ticket prices, and geographic locations. If the examiner is relying on Billboard's concert grosses, then those amounts should be reconciled to the taxpayer's books and records. Another site that appears to track concerts is [Songkick](#). This site goes back many years and has data regarding not only stars but also less known performers.

Additionally, most performers utilize a booking agency to book performance engagements. The taxpayer's agency will have a listing of concerts which reflect the contract amounts, dates, etc. and these agencies are another good source of verifying income.

For band members, night club performers, etc., consider contacting the union(s) in which the taxpayer is affiliated. The unions keep detailed records regarding earnings of its members. The unions are usually very cooperative in providing the IRS with information.

Audit Issues

Gross Income

There are numerous ways a performer can earn income which may never be reported on a Form 1099 nor would the performer's union have a record of it. For example, night club performers may receive cash payments. This is particularly true with a small club, or a one night performance. In addition, it is a common practice in the industry for stars to allow band members and other road crew members to man the concession booths at concerts, where T-shirts, hats, etc. are sold. These individuals are generally allowed to keep the profit from the sales. Taxpayers who might be engaged in these activities should be questioned regarding this.

Expenses

One of the most common audit adjustments is the disallowance of personal expenses being claimed as business deductions. "Stars" frequently take the position that since they are in the

limelight all the time, virtually everything they do is "business" and is part of the image making and maintaining process. For example, a performer may claim deductions for improvements to and maintenance of their personal residence because tour buses drive by and the "look" is necessary for the benefit of fans. Performers may claim deductions for vacation homes and boats which are used by the taxpayer and their colleagues as places to go and "create". There may also be deductions for clothing (stage clothes and street clothes), make-up and hair, physical fitness, and security which the performer claims as necessary expenses to create and maintain their image.

While a taxpayer's argument is not totally without merit and can even be made to sound reasonable when presented to an examiner, the examiner should remember that expenses of a personal nature are deemed personal unless a taxpayer can prove otherwise. The fact that a taxpayer may derive a peripheral business benefit from an expense does not convert a personal expense to a business deduction.

When on tour, it is a common practice for the big name entertainer to provide the transportation and lodging needed for everyone. Therefore, if an examiner finds a band member, road crew member, etc. claiming "away from home expenses" check to make sure the expenses are not reimbursed or paid by the entertainer. Consideration should be given to contacting the star's business manager to determine the policy in place at that time.

Employment taxes

Compliance in the area of employment taxes for performers is generally at an acceptable level. Business managers for the "star" generally insure that employees and contract laborers are properly treated. Refer to [Chapter 17](#), Employment Tax, for more information on employment taxes.

Related returns

Always ask about any related party activities, related businesses or ventures. Ask to see the tax returns to determine any related issues.

Specialists

Examiners should always consider use of a specialist when appropriate in an examination. Frequently, you will find big name entertainers traveling abroad for performances. Use of an international examiner should be considered whenever income from foreign sources is received and seems questionable.

Live Performers Questionnaire

(Not all-inclusive)

- How are live performances scheduled? (Is a booking agent used? Do you schedule your own performances, etc.?)

- Obtain copies of the performance schedule/calendar/itinerary for the year under examination and copies of the engagement contracts, if available.
- Do you usually perform for a fixed fee, or a "percent of the gate", or some other method? Explain, in detail, how this works.
- Are you paid in cash, check, or some other method for performance?
- How do you account for the payments? (Is the money deposited? Is a ledger maintained, etc?)
- Do you use any of the performance proceeds to pay any of your on-the-road expenses?
- How are souvenir sales during live performances handled? (Do you manage your own or do you contract it out?)
- Whom do you use to actually man the souvenir booths, and how are they paid?
- Exactly how are proceeds from sales of souvenirs accounted for?
- Do you belong to any unions? Please provide the names.

Employment Tax Questions:

"Stars"

- How do you treat members of your band - as employees or independent contractors?
- How do you treat members of your road crew (technicians, wardrobe, assistants, drivers, etc.) - as employees or independent contractors?
- Who pays for traveling expenses of band members and road crews?

"Band Members, Road Crew"

- When hired to perform in a band, how are you classified by people you are working for - employee or independent contractor? What is your understanding of the reason for this treatment?
- Do you pay your own travel expenses when "on the road"? Are you reimbursed or given any allowance for these expenses? Are you eligible for reimbursement?

Chapter 14 - Producers

General Information

Producers are the individuals that bring the musicians, engineers, arrangers, and crews together for a recording. The producer also draws up contracts and budgets and presents them to the record company for approval.

Music producers usually do the following:

- Act as talent scout for new artists.
- Choose the appropriate musical material.
- Select and oversee arrangers, engineers, studios, and musicians.
- Control costs and budgets.
- Assure delivery of a recording.

Producers are usually paid fees in two installments, first half prior to a production and second half upon completion of a production. Contracts, if available, between the producer and music company should be reviewed to verify income.

Producers may also receive royalties on recordings they produce. These royalties generally are a percent (3 percent to 5 percent) of record sales after the music company has recovered all its cost in making the recording and royalties have been paid to the artists. Forms 1099 are not always issued to the producers; therefore, you must inspect all contracts and reconcile to any Form 1099.

If a producer has a client that is well known the producer usually does not incur any of the expenses of a production. These contracts call for a detailed budget, with the recording company incurring all expenses including reimbursement to the producer for any of the producers out of pocket expenses. Inspect all contracts to verify who is responsible for costs over budget and who receives benefit for coming in under budget. A producer can be held responsible for costs over budget unless the recording company approves the excess costs.

Things to look for:

Music video productions are generally contractual arrangements. Some productions are done for a flat fee making all costs the responsibility of the producer. If the production is done for an individual rather than a record company the artist usually retains the rights to the video.

Many videos and music recordings are produced using free-lancers as backup, technical crews or musicians. Free-lancers are nonunion. Look for Form 1099 sent to the free-lancers. Consider employment tax issues.

Custom sessions are situations where an unknown artist has a master recording produced. At this point there is no recording contract with a record company. The producer would receive a flat fee for production.

Some productions, mainly "events" (for example, conference) are produced on a cost plus basis. The main customers or clients in these situations are corporation needing a special event video.

There are several different kinds of compensation arrangements in the industry. Be sure to request and review all contracts. Some producers may own their own studio. There may be additional income from studio rental. There may also be additional income for arranging for engineers, back up musicians, etc.

Watch for label deals and pressing and distribution deals known as "profit participation deals." On label deals the producer may receive royalties for the producers' trade name and label to appear on the record. The producer may also have a profit participation deal where they actually press the recording and arrange for distribution rather than receive royalties, i.e. sell the recordings to the music company/distributor for a wholesale price less distribution fees (between 18% -25%; less if it is a well-known artist).

Potential sources of income for producers:

- Recordings - royalties
- Talent scout activities
- Label deals - royalties
- Pressing and distribution deals - profit participation
- Studio rental
- Demo sessions

Recordkeeping

Records that should be available:

- Contracts
- Budgets
- Disbursements journals
- Royalty statements
- Ledgers
- Bank statements, etc.

The larger producers should have all the above and more. Small independent producers may have no books and records. You may have to resort to indirect methods to verify income. Forms 1099, Forms W-2, and third party statements may be the only records of income.

Examination Plan

In preplanning producer examinations, make sure contracts are requested up front along with royalty agreements and royalty statements. Budgets should be requested along with comparisons of actual expenses and budgeted expenses.

The initial interview questions are crucial in determining the sources of income of the producers. Include in your questions some comments regarding how the income is generated and recorded especially regarding royalties.

Check the union membership directories for membership in musicians' and writers' unions. Producers can be involved in producing, writing, performing, etc.

In preplanning expenses, make note to scan all contracts to see who is responsible for any costs over budget or who benefits if a production comes in under budget.

Audit Issues

Gross Income

Pay particular attention to royalty agreements, for example, percentages, method of payment, and timing of payments. Look for the terms of the contracts between producer and clients to see who is responsible for cost being over or under budget and who receives any excess budget not used. Determine if the producer has the opportunity for other types of income, such as, studio rental,

talent scouting, writing, etc. Question the producer about any label deals, pressing and distribution deals, agreements with other producers on joint production arrangements.

Watch for reimbursements to producers from record companies for out-of-pocket expenses. Some producers are involved in "custom sessions" where unknown artists pay the producer a set fee for producing a master recording for the artist. All production expenses are borne by the producer. Any royalties on these artists will be at a lower percentage because the artists are unknown. These sessions are often done on a "cash" basis. Studio rental expenses should be matched with income as part of income verification.

Expenses

The examination of the area depends on the contract arrangement between a producer and a record company. Determine who is responsible for expenses, over budget costs, and incidental costs. Determine if any of the expenses borne by the producers are reimbursed to the producers. Determine if any "custom" sessions are done.

Watch certain promotional type expenditures made by producers for the benefit to the artist. Past examinations have shown that some producers will purchase expensive gifts, such as autos, for artists as incentives or for "promotional" reasons without observation of the \$25 gift limitation (watch for the "Promotion" deduction). These items should be questioned as to whether they are ordinary and necessary business expenses to the producer.

Travel and entertainment expenses

An evaluation should be made as to how an amount was paid and what documentation is available.

Capital expenses

Costs incurred to produce masters should be capitalized. The income forecast method may be required to amortize record masters unless the 3-year safe harbor alternative can be used. The safe harbor allows depreciation/amortization of costs at 50 percent in the first year, 25 percent in the next two years.

Demonstration recordings are handled differently. Costs to produce demo recordings are not capitalized and depreciated. Taxpayers can make a choice to either fully deduct the costs in the year expended or to make an allowance for research and experimental expenses that is similar to depreciation. This allowance, used for assets that have no determinable useful life, spreads the expense of the demo record over a period of 60 or more months.

Employment taxes

Producers arrange for engineers, musicians, arrangers, back-up vocalists, etc., when producing a recording. Some producers have these individuals on staff while others use union members or free-lancers. Examiners should observe local procedures before asking specific questions on any

contract or verbal agreement the producer has with engineers, musicians, etc., to determine the control the producer has over these individuals.

Remember, in raising the issue of employee versus independent contractors, a safe haven is created for the taxpayer when we determine that the taxpayer is not an employer. Refer to [Chapter 17](#), Employment Tax, for more information on employment taxes.

Royalties

Another issue examiners should consider is the handling of royalties received. Royalties received are subject to self-employment tax if received by the creator of a work or by the person who earned them. Past examinations have shown that taxpayers have placed these royalties on Schedule E, or included them on the face of the Forms 1040. Watch for instances where royalties are placed on the returns to make sure applicable self-employment taxes are collected. For further discussion refer to Chapter 3.

Related returns

Many producers are engaged in other areas of the music business; for example song writing, publishing, and performing. These producers could have separate entities set up for their other activities. For example, a producer's production activities could be in corporate form while his song writing could be a Schedule C business. Always ask about any other related party activities, related businesses, or ventures. Ask to see the tax returns to determine any related issues.

Use of specialists

Be aware that the music industry is a complex industry. If valuation issues or international issues are present, contact an engineer or international specialist for assistance.

Producers Questionnaire

(Not all inclusive)

- Do you have your own studio, engineers, arrangers, etc.? If not, whom do you use in your recordings - free-lancers or union members? If free-lancers are used, how are they paid (by union scale or some lesser scale; cash or check)? How do you find your studio, engineers, arrangers, etc.?
- For which artists have you produced? What kind of producing and other services did you perform for them (music recording, demo, etc.)? For which artists have you produced or provided other services during the current year?
- Are you involved in any talent scout activities?
- With which recording companies do you have contracts? Which artists are contracted with which recording companies? How are excess costs over budget handled? Are the excess costs the producer's responsibility?
- Are you involved in any label "deals"? If so, do you have fixed and/or royalty compensation from the record company?

- Are you involved in any pressing and distribution deals (profit participation deals)?
- What percentage of royalty do you normally receive from a recording company? Do you receive a higher percentage from a major artist?
- Do the record companies provide a stated recording fund for each production or do you use a predetermined budget?
- Are advance royalties ever paid to you or the artist? Is there a set scale for these advances? Are the advances recoupable from producer royalties?
- Do you give a "producer guarantee" (to pay excess cost over recording fund)?
- How do you handle "demo" production costs?
- Do you participate in "custom" sessions? If so, whom do you use to back up the artist, - free-lancers or union members? Are the freelancers paid union scale? If not, why?
- Do you have renewal contract options with recording companies?
- Who gets the excess recording fund, if any, after the production is complete?
- Do you control the music publishing rights on original recorded material?

Employment Tax Questions

- When producing or recording, what is the arrangement? Does the recording company pay a flat fee for a finished product or are you hired to produce a product and paid a salary for your services?
- If paid a flat fee, what is your arrangement with musicians and performers hired to make a record? Are they paid by the hour, day, or a flat rate?
- Are these musicians and performers treated as employees or independent contractors?
- If you are paid a salary for your services, do you act as an agent for the recording company for the purposes of hiring musicians and performers?
- If acting as an agent for a recording company, how are musicians and performers hired for recording treated - employees or independent contractors?
- What is your source for obtaining musicians and performers used to produce records? (local unions, word of mouth, etc.)

Chapter 15 - Managers

General Information

The classification of "management activities" includes a wide variety of occupations. For the purposes of this guide, the discussion is being limited to the occupations which were found to be most prevalent in the industry: booking agent, business manager, road manager, and personal manager.

A booking agent finds or receives offers of employment for their clients and negotiates a contract. A booking agent is compensated by a commission, which is normally 10 to 15 percent of the gross contract. The rate depends on the particular talent union involved and the duration of the engagement negotiated. The commission usually applies for the life of the contract and any renewals. Booking agents are independent contractors and the entertainers are their clients. Large booking agencies may have thousands of clients.

A booking agent obtains clients in multiple ways. These include representing someone he or she knows, auditions, contests, offer services to new talent or talent approaches the agent.

It is the usual practice of recognized, successful artists to employ a business manager. This person will often be an accountant or a tax attorney who will manage the taxpayer's business, personal and investment accounts and keep a close watch over the tax consequences of the artist's affairs. Fees for these services range from 2 to 6 percent of the gross receipts handled, unless a monthly or annual flat fee is arranged. Business managers are independent contractors and not employees of the artists. Business managers usually maintain books and records of the artists and often represent the taxpayer during the examination.

A road manager is usually engaged by the personal manager or business manager to travel with an artist. It is the road manager's responsibility to handle the numerous business matters "on the road" such as transportation, hotels, collections, as well as stage, sound, and lighting needs. A road manager can be an employee or an independent contractor.

Personal managers give advice and counsel to artists in the following areas:

- The selection of literary, artistic, and musical materials.
- Any and all matters relating to publicity, public relations, and advertising.
- The adoption of the proper format for the best presentation of the artists' talents.
- The selection of booking agents to procure maximum employment for the artists.
- The types of employment which the artists should accept and which would prove most beneficial to their careers.
- The selection and supervision of accountants and attorneys other than those used by the business manager.

Personal managers are usually independent contractors and not employees of the artist. A personal manager can receive 10 % to 15% of the artist's gross receipts.

Recordkeeping

The managers previously discussed are often much more business-minded than others in the music industry. Therefore, they are more knowledgeable of the recordkeeping requirements.

Examination Plan

The single most important consideration when planning the examination of a manager in the music industry is to design a plan to determine the manager's relationship to the entertainer(s). To successfully examine a manager, you must first know exactly what they do, who pays them, and how the payment is computed. An initial interview questionnaire developed for the audit of a manager should be used as a starting point and expanded as warranted.

Early in the examination of the manager, it is essential that the specific duties of a taxpayer be determined. It is also vital that the means in which the taxpayer is paid and his or her relationship

to the entertainer be established. This can best be achieved in the initial interview. Follow-up questions may be asked on document requests.

Audit Issues

Gross Income

Most managers receive Form W-2 as employees, or Forms 1099 as contract laborers. IRP transcripts should be utilized. Comparison of the Forms W-2 and/or Forms 1099 with the taxpayer's testimony as to his or her activities may indicate that very little additional testing of income is warranted. Of course, other means of verifying income may be deemed necessary and should be employed as warranted such as review of client contracts, etc.

Expenses

Business expenses should be tested to ensure that the managers are not being reimbursed by the entertainer for any out-of-pocket expenses. It is a common practice for managers to be reimbursed by the entertainers for any out-of-pocket expenses. Expenses should be reviewed for items that are capital in nature. Reimbursements can be recorded as income or a credit to an expense account.

Employment Taxes

Compliance in the area of employment taxes is generally at an acceptable level. Refer to [Chapter 17](#), Employment Tax, for more information.

Related Returns

Frequently an examiner will find it necessary to pick up related returns of taxpayers in the music industry due to the close working relationships between taxpayers within the industry. When examining a taxpayer in the music industry, an examiner should be alert to any information which may indicate potential adjustments on a related return.

Management Questionnaire

(Not all inclusive)

- Explain in detail your management responsibilities.
- For whom do you perform these duties?
- Are you an employee of the artist or do you work as an independent contractor?
- How are you paid for your services? (cash, regular paycheck, by the job, commission, etc.)
- What contractual agreements have you entered into as part of your job? Provide copies.
- What expenses do you incur in performing your job? Are you reimbursed for any of these expenses by anyone else or any other entity? How do you record the reimbursements (income or offset to expenses)?

- How many clients do you have?

Chapter 16 -Videos

General Information

In the late 1980's, music videos became a major part of the music industry. A music video is usually released along with the release of a new recording. A music video is a short visualization of the artist and his or her music. The music videos have been a significant influence in the marketing and sales of music recordings.

Music videos are contractual in nature regarding exclusive rights to exploitation and royalty percentages. Income is derived from commercial network TV, cable TV, local TV, clubs, and jukeboxes sales. Some recording companies now offer package deals to an artist to produce his or her recordings as well as the videos to accompany and enhance the recordings. Video rights are major issues in contract negotiations. The rights to the exploitation of the videos and the financing of the videos are negotiation points.

Most of the time a contract between a recording company and an artist is considered an employment contract for purposes of the Copyright Act. This does not necessarily mean that the artist is an employee of the recording company for employment tax purposes. The contract and the relationship between the recording company and the artist should be evaluated to determine if an employer-employee relationship exists. (Local procedures should be observed for making employment tax referrals.)

Under many of the contracts between an artist and a recording company, the recording company will advance the costs of the video production. Costs to produce a video range from \$15,000 to \$150,000. However, most costs are below \$100,000 unless the artist is a big name artist. Recoupment of these costs depend on whether the video is produced for promotional or commercial reasons. The contract should specify if the video is promotional or commercial. The recoupment will directly affect the compensation to producer and artist.

Video producers may also be the music producer or they can only produce videos. Video producers may also be involved in corporate and/or promotional video productions and can be negotiated as a cost-plus contract. Video producers who only produce videos generally charge a flat fee to a recording company or artist.

Recordkeeping

As with music producers, video producers enter into a contract to produce music videos. Many times the video production agreement will be embodied in the music production agreement. Royalty statements should be available and easily matched to contract agreements.

Many of the smaller producers keep no formal set of books. At times you may have only bank statements and canceled checks. Pay particular attention to the contracts and agreements.

In reading the contracts, note who is responsible for costs over budgets (if budgets are used) and who receives any excess budget over costs. If flat fees are charged, note who is responsible for any excess costs or if incidental costs are reimbursed.

Examination Plan

Requests for contracts should be noted in your examination plan along with budgets and royalty statements.

The initial interview questions should be tailored to identify all potential sources of income and different types of videos produced and the compensation arrangements.

Make sure you plan to ask specific questions about cost and budget arrangements and/or any reimbursement agreements.

In addition to the standard items requested in the initial IDR, all contracts, royalty statements and/or agreements should be requested.

Audit Issues

- Gross Income - Again, the contracts are a key element in determining income based on the arrangement of the parties. Contracts will normally include fee arrangement, excess cost agreements, reimbursement, cost under budget agreements, and incidental cost agreements.
- Determine if the producer is involved in other activities such as equipment or studio rental, promotion activities, etc. Watch for related entities set up to do other business ventures; for example, video productions as a corporation and song writing as a Schedule C.
- Expenses - The examination of this area depends on the contract arrangement between video producer and artist and/or recording company. Determine who is responsible for the expenses of production and incidentals, just as under music producers.
- Employment taxes - As in music producing, the video producer will arrange for all backup personnel such as actors, cameramen, set directors, etc. involved in a music video. By inquiring about the nature of the relationship between these individuals and the producer, you can make a sound decision as to any employment relationship. Refer to the section on employment tax for more information on employment status.
- Related returns - Always ask about any related party activities, related businesses or ventures. Ask to see the related tax returns to determine any related issues.
- Specialists - Examiners should always consider use of a specialist when appropriate in an examination. Use of an international examiner should be considered whenever income from foreign sources is received and seems questionable.

Videos Questionnaire

(Not all inclusive)

- Is a video produced with each new recording? How is it determined when and for which recording that a video is produced?
- Do you have agreements with any companies for exclusive rights to your videos? If so, for how long?
- Do you have rights from any artists? If so, who and what are the nature of the agreements?
- Who is responsible for financing and producing the videos?
- Who has the copyright to the music videos?
- Are your music videos considered "work made for hire"?
- Who retains the exploitation rights on: home video sales, TV, promotional use, third party broadcast licensing, nightclubs?
- Do you have any licensing agreements with music video library agencies?
- Are you producing primarily promotional or commercial videos, or a combination?
- Who bears the initial cost of producing a video? Is there a video production fund or budget?
- How do you recoup your video production costs? (Artist record royalties, video receipts, etc.)
- How are royalties handled regarding a video production?
- How are the videos distributed? Who is responsible for the distribution?

Employment Tax Questions

(If you ask these questions, you are beginning an employment tax examination and local procedures should be observed)

- When hiring performers and technicians, how are they classified – employees or independent contractors?
- How are performers and technicians obtained - union or word of mouth, etc.?
- If traveling expenses are incurred by the performers and technicians, who pays the expenses?
- Are you paid for a finished product or does the client have input and control over the process of making the video, for example, approval of people hired, rate of pay for performers, technicians, etc.?

Chapter 17 - Employment Tax

General Information

Many taxpayers in the entertainment industry make payments in the course of their business for services performed by others. It is necessary to determine whether the service provider is an employee of the taxpayer or an independent contractor. The first step is to find out what service was performed. If an actor pays a publicist, there is usually no employer-employee relationship. If a producer hires a secretary or an assistant, there is a greater probability of an employer-employee relationship. The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification--independent contractor or employee--can be a valid and appropriate business choice. For an in-depth

discussion, see the training materials titled "Technical Basic Employment Tax" Training 34103-002 (11-2014) Catalog Number 67477V found at <http://www.publish.no.irs.gov>.

Section 530 of the Revenue Act of 1978 was enacted by Congress to provide businesses relief from federal employment tax obligations if certain requirements are met. The first step in any case involving worker classification is to determine whether the business is entitled to relief from retroactive and prospective liability for employment taxes under section 530 before pursuing the employment status of the workers. It is not necessary for the business to claim section 530 relief for it to be applicable. To correctly determine the tax liability, examiners must explore the applicability of section 530 even if the business does not raise the issue. Publication 1976, *Do you Qualify for Relief under Section 530?*, must be provided to the taxpayer at the beginning of any examination involving worker classification. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business' employment tax liability, not the worker's employment tax liability and any interest or penalties attributable to the liability for employment taxes.

In order to qualify for section 530 relief, the business must meet both the consistency and reasonable basis tests.

The consistency test requires that: 1) the business timely filed all required Forms 1099 with respect to the worker for the period and filed on a basis consistent with treatment of the worker as not being an employee (reporting consistency); and 2) that the business treated all workers in similar positions the same (substantive consistency).

Under the reasonable basis test, the business must have had some reasonable basis for not treating the worker as an employee. A taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if the treatment was in reasonable reliance on one of three safe havens: 1) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer; 2) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or 3) a long-standing recognized practice of a significant segment of the industry in which the taxpayer was engaged. A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee.

Guides for determining a worker's employment status are found in three substantially similar sections of the Treasury Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding (FITW), respectively.

The regulations provide that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. The control must be present but does

not need to actually be exercised. The examiner will need to weigh the facts and circumstances of each case and determine worker status accordingly.

The training materials mentioned above provide more information on the method of analysis used in determining employment status. They explain the kinds of facts to be considered, including those evidencing behavioral control, those evidencing financial control, and those evidencing the relationship of the parties.

Employees – Household Employees

Many taxpayers in the entertainment industry employ the services of household employees for either personal reasons or to maintain an image. This is a personal expense and not an allowable business deduction.

A "household employee" is a worker who performs domestic services. Domestic services are services of a household nature performed by an employee in or about a private home of the employer. A private home is a fixed place of abode of an individual or family. A separate and distinct dwelling unit maintained by an individual in an apartment, hotel, or other similar establishment may constitute a private home. *See Treas. Reg. § 31.3121(a)(7)-1(a)(2)*. Domestic services include services performed in or about a private home by workers such as cooks, housekeepers, babysitters, caretakers, handymen, gardeners, and chauffeurs. *See Treas. Reg. § 31.3121(a)(7)-1(a)(2)*.

Wages paid to household employees may be subject to employment taxes. Different rules are applicable for whether the wages are subject to Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), or federal income tax withholding (FITW).

If the employer pays an employee an amount equal to or in excess of the applicable dollar threshold in any calendar year for domestic services, all cash payments made by the employer to the employee in that year are wages subject to FICA. *See IRC § 3121(a)(7)(B)*.

As of calendar year 2014, an employer must pay FICA tax if the employer paid \$1,900 or more for the year to any one employee. Cash wages in excess of \$1,900 are not subject to FICA tax if paid to the household employer's spouse, child under 21, parent, or any employee under 18.

There is an exception to the exclusion of wages paid to the parent of the employer and paid to a household employee under the age of 18.

The employer must pay FUTA tax if total wages paid are \$1,000 or more in any calendar quarter during the year or during the previous year, to all household employees. Cash wages for household employment paid to the employer's spouse, child under the age of 21 or parent are not counted toward the \$1,000 threshold and are not subject to FUTA. *See IRC § 3306(c)(5)*.

The employer owes FUTA on the first \$7,000 paid in a year to each employee.

Employment taxes for domestic service employees are paid and reporting annually on Schedule H, *Household Employment Taxes* and flow right to the 1040. The amounts calculated are the full rate. It is up to the employer to withhold the employee portion. The employer must also have an EIN, provide a W-2 to the employee, and send a copy of the W-2 to the SSA (or the employee won't get credit as their information is not entered on the Schedule H; this is different from SE tax which flows to the SSA right from the 1040). A Schedule H can be filed separately if the taxpayer is not required to file an income tax return. A separately filed Schedule H carries its own assessment statute date that is **not** based on the filing requirements of the taxpayer's Form 1040.

Chapter 18 - Reference Material

Abbreviations

AEA Actors Equity Association

AFI American Film Institute

AFM American Federation of Musicians

AFTRA and SAG have merged to **SAG-AFTRA**

AGVA American Guild of Variety Artists

AICP Association of Independent Commercial Producers, Inc.

AMPAS Academy of Motion Picture Arts and Sciences

ASCAP American Society of Composers, Authors, and Publishers

BMI Broadcast Music Inc.

CMA Country Music Association

DGA Director's Guild of America

GMA Gospel Music Association

IATSE International Alliance of Theatrical and Stage Employees

NAB National Association of Broadcasters

NARAS National Academy of Recording Arts and Sciences

NARM National Association of Record Merchandisers - NARM is now the Music Business Association which they abbreviate as MusicBiz, not as MBA

PGA Producer's Guild of America

RIAA Recording Industry Association of America

SAG Screen Actors Guild - **AFTRA** American Federation of Television and Radio Artists.

WGA Writer's Guild of America

General Terms

Advance - A fee paid to an artist prior to completion of a production to be recovered later out of royalties earned.

Artists and Repertoire - Department of a recording company responsible for acquiring new talent - includes everything up to the point of album release, not just acquisition of new talent.

Audition - A short performance to demonstrate a performer's talent, generally in an attempt to be hired for a production.

Best Boy - Second in command of either electrical operations or camera and lighting movement or placement. The Gaffer (works under the Director of Photography) is the head electrician responsible for lighting design and the Best Boy Electric is his assistant or foreman. The Key Grip (also under the DP - Director of Photography) is in charge of grip (dollies, cranes, etc.) and his assistant is also called the Best Boy Grip.

Billboard - A leading trade industry magazine whose "charts" are used extensively in the recording industry.

Bootlegging - The illegal recording of an artist without permission.

Box Rent - Also called Kit Rental. Payments made to individuals for the use of personally owned tools. This term includes make-up kits and supplies, carpenter tools, etc. These payments are generally not included in wages but are separately stated on a Form 1099.

Chart - Listing of recordings according to their relative popularity.

Collective Bargaining Agreement - A negotiated contract between representatives of organized workers and their employers, which determines wages, hours, and working conditions.

Copyright - The right to exclude others from reproducing a literary, musical, dramatic, or artistic work.

Counterfeiting - Illegal practice of copying a recording (tape, record, etc.) and selling the copies as originals.

Demographic - A statistical representation of an audience segment; section of an audience sharing a common characteristic.

Director - Supervises and guides the actors in a production.

Distributor - Involved in the marketing of a film product in any of the media including theaters and television. Often, films have domestic and international distributors.

Editor - Prepares a production for presentation by cutting and combining selected film shots and sound tracks.

Emmy - An achievement award given annually by the American Federation of Television and Radio Artists: awarded by the Academy of Television Arts and Sciences (primetime), the National Academy of Television Arts and Sciences (tech, sports, daytime, and news) and the International Academy of Television Arts and Sciences (international).

Exploitation - Marketing of a project or talent for profit.

Extra - Performer in a minor role, generally without solo speaking. Also called "atmosphere player".

Free Goods - Recordings supplied by manufacturers at no charge as an incentive for sales.

Gaffer - Electrician with responsibility for lighting on a set.

Grammy - An achievement award given annually by the National Academy of Recording Arts and Sciences.

Grand Rights - A license issued by a copyright holder for use of the copyrighted material in musical drama.

Grip – Stagehand.

Guild - An alliance of persons of the same trade.

Key Grip - Responsible for all functions pertaining to camera movement required on a set

Kit Rental - See Box Rental

License - Agreement granting the right to use a copyright owned by the grantor.

Location - Site where picture is shot, other than the studio.

Master - The original finalized film, video, or audio recording, from which copies are made.

Needle Drop - Fee paid to music suppliers for using their music as background. It can also refer to a soundtrack when it is interrupted by a recorded song.

Nielsen Audio - A radio ratings service

Oscar - An achievement award given annually by the Academy of Motion Picture Arts and Sciences (AMPAS).

Payola - Illegal giving or receiving of any gratuity to obtain favorable radio or television airplay. Also refers to the gratuity itself.

Producer - Finances and supervises the overall production of a film, video, audio recording, or live performance.

Residuals - Payments required, to writers, directors, or actors, from rebroadcast, or exploitation in a secondary market, of a recorded production.

Royalties - Payments to an author or composer from the proceeds of a sale or performance of his/her work.

Scale - The minimum fee stated in the union contract for work done in a particular job category.

Showcase - A setting to display a performer's or a director's talent.

Union - An alliance for mutual interest or benefit.

Music Terms

[Musicians Business Dictionary](#) - Website with music definitions

Advance - A fee paid to an artist as part of the royalty compensation package.

A and R (Artists and Repertoire) - Department of record company responsible for talent acquisition.

AM - In electronic communications, a type of radio station whose signal is encoded by modifying the amplitude of its carrier wave (as opposed to an FM signal which modifies the frequency). Because AM also amplifies static, it is typically used for talk and not for hi-fidelity music.

ANALOG - The electronic representation of a sound wave as a physical copy. The term refers more to the type of representation of the sound wave. Specifically, differs from digital in that the electronic representation varies continuously whereas digital is represented by finite packets.

AOR - Album Oriented Rock - A radio program usually consisting of various selections from rock albums. The meaning has morphed now into what's called "classic rock". It began when FM was new and radio stations were prohibited from playing the same material used by their sister AM stations.

Billboard - A leading trade industry magazine whose charts are used extensively.

Bootlegging - The illegal practice of recording an artist without permission and then offering the recording for sale.

C.D. Compact Disc - A format for recordings using electronic digital technology.

Chart - Trade newspaper listing of records according to their relative popularity. Charts are an important barometer of a record's success.

CHR Contemporary Hit Radio - A radio programming scheme much like Top 40. Popular as an antidote to payola by forcing DJ's to play a particular playlist. As of 2014, it refers to stations that still play the most popular music of the day across genres.

Contractor - The person, required by union contracts, to hire performers. This applies to singers and the rate is either 50% or 100% more than scale depending on the number of singers.

Cooperative Advertising-coop - An advertising scheme wherein a record company will share advertising costs of a product with a retailer. This becomes shared advertising with mutual benefits.

Counterfeiting - The illegal practice and process of copying a CD and then offering the copies for sale as originals.

Creative Services - Department within a record company responsible for album covers, posters and other visual sales tools.

Cross-collateralization - A clause within recording contracts allowing the profits from each successful recording to be used to pay for the expenses of unsuccessful recordings under the same contractual arrangement.

Crossover - A record intended for a specialized audience but finds success with other such audiences.

Cut out - A record or tape that has reached the sales saturation in the marketplace. These items are then sold at tremendous discounts to dealers with the expectation that additional profit will be realized after the maximum of new record sales point.

D.A.T. - Digital Audio Tape - A high quality recording/playback technology which uses pulse-code modulation to encode information onto a tape.

DBS - Direct Broadcast Satellite - A method of program distribution which uses a high power satellite to transmit a signal to a highly defined coverage area. Refers to the satellites that services such as Dish, DirectTV, and Sirius/XM use in addition to many others serving other parts of the world.

DeFacto Network - A broadcast scheme wherein independent broadcast stations, not affiliated with a dedicated network, provide access to program suppliers for limited times. There are network-owned stations and affiliates in TV.

Demographic - A statistical representation of an audience segment; section of an audience sharing a common characteristic.

Digital - In recording and playback the technology wherein the encoded/decoded information is represented as a binary code, series of ones and zeros.

Doubling - A recording technique which requires a musician or singer to perform the same music twice on a different recording track ("double tracking"): this means recording the same part twice to get a richer sound when they are superimposed.

Electromagnetic recording - The process in which program material is magnetically encoded onto a medium usually magnetic tape.

FCC (Federal Communications Commission) - Government agency responsible for licensing all radio, television, satellite, and telephone communications.

FTC (Federal Trade Communication)- Government agency responsible for regulation of interstate commerce.

F. M. (Frequency Modulation) - See A.M.

Free Goods - Records supplied by manufacturers at no charge as an incentive for sales. As with cut outs, there are no royalties.

Freelancer - A writer or an artist who sells his services to employers without a long-term commitment to any one of them.

Grand Rights - A license issued by a copyright holder for use of the copyrighted material in musical drama.

Grammy - Award given annually by NARAS.

House Producer - A producer who is usually an employee of a record company.

Independent Recording Company - A recording company that does not provide full manufacturing and distribution services. Specifically, a record company not owned by a major company (Universal, Sony, and Warner): they may affiliate with one of them for distribution or they may contract for distribution independently.

Independent Promotion Person - Free-lance professional used by companies to augment its own staff.

Independent Producer - Free-lance creative production executive hired by companies on a project by project basis.

Jukebox - A coin operated electronic record/CD player.

List price - The retail price of a project.

Master - The finished production reduced to digital format. Subsequent copies are made in several formats for resale.

Mechanical - A license given by a copyright owner authorizing the reproduction of music.

Mom and Pop - A very small retail outlet.

Needle drop - A fee assessed by music supplier for using their music as background.

Nielsen Audio - A radio ratings service.

One Stop - A sub-distributor whose clients are usually smaller record retail outlets and jukebox operators.

P and D (Pressing and Distribution) - An arrangement between large and small companies wherein the large company will provide these service to the smaller one for a fee. Alternatively, the artist could contract for the manufacturing but retain the rights and costs of everything else.

Payola - The illegal giving or receiving of any gratuity to obtain favorable radio or television air play.

Rack Jobber - A music merchandiser responsible for selling records in non-music outlets. They rent floor space in larger stores (Walmart, etc.) and stock the racks themselves.

Returns - Unsold CDs sent back to manufacturers for cash credit to buyer's account.

Royalties - A contractual payment to an artist or producer representing a percentage of all actual record sales.

Sampling - An electronic digital process in which an original analog sound is converted to a binary code for later playback in an electronic storage device eg. using another artist's material in a new recording.

Scale - A fee assessed by unions on behalf of its members representing the minimum payment to be charged for work.

Top 40 - A radio music programming technique wherein a station restricts the records it plays to a limited number -40 records- with each given exposure based upon its popularity. This doesn't necessarily refer to only 40 songs anymore but to playing what is popular.

UPC (Universal Product Code) - An identifying mark on packaging which is used by digital scanning devices for inventory control.

Wholesale - The price manufacturers charge for a product to its distributors. This price represents the manufacturers expense in producing the product plus a profit.

Overview of Common Issues in the Entertainment Industry

For taxpayers in the entertainment industry, there are three general areas of activity that are likely to have tax consequences: performing for compensation, searching for work, and maintaining their skills, status, or image.

Performing for Compensation

Income Issues

During the background interview, it is important to get a clear idea of the extent of the taxpayer's employment in the entertainment industry during the taxable year in issue. Use Forms W-2 and 1099, as well as information from the taxpayer (diaries, travel logs, etc.) and third party sources when necessary.

Trade or Business vs. Hobby

Not everyone who wants to be employed in the entertainment industry is able to support him or herself by doing so. If the taxpayer had a source of income outside the entertainment industry during the year, or claimed expenses disproportionate to his or her entertainment income, any loss from the entertainment activity may be an I.R.C. §183 (hobby loss) issue. See *Dreicer v. Commissioner*, 78 T.C. 642 (1982).

Facts and Circumstances Test

Can the taxpayer show that his or her entertainment activities were really profit motivated? For example, devotion of sufficient time, money, energy? Businesslike approach? Good recordkeeping?

I.R.C. § 183 Limits Deductions

Where I.R.C. § 183 applies, all of the income is recognizable, but the deductions are limited to that income.

Case Law Intensely Factual.

For example, *Grommers v. Commissioner*, T.C. Memo 1992-343 (taxpayer's "dabbling" in art and antiques was not a profit-motivated activity, where she had substantial other income, maintained a luxurious lifestyle traveling, visiting European auction houses, etc., and consistently operated the "business" at a loss); Cf. *Krebs v. Commissioner*, T.C. Memo. 1992-

154 (wife of theatrical promoter was entitled to deduct expenses of pursuing her singing career, where she had musical expertise, hired professional help, devoted substantial time, effort, money, etc.); see also *Leshner v. Commissioner*, T.C. Memo 1991-162 (Court rejected taxpayer's claims to be a travel writer, where she was employed full-time as a computer programmer and never submitted anything for publication); *Rodgers v. Commissioner*, T.C. Memo. 1979-128 (Spouses' only source of income was husband's sheet metal trade, but both spouses employed in other occupations claimed to be entertainers; Court found only the husband was actually in the trade or business of being an entertainer.)

It should be noted that there is substantial case law addressing hobby/business: Many of the cases cite Treas. Reg. § 1.183-2(b) and often reference *Dreicer*.

Employee vs. Independent Contractor

This appears to be a major problem in the entertainment industry. Please check with the local procedures before initiating any employment tax issue.

Significance of the Issue

Worker classification is highly contested for a number of reasons.

For the employer

Treating a worker as an independent contractor means:

- There need be no withholding, payment, or reporting of state/Federal income, FICA/FUTA, unemployment taxes, etc. Fringe benefits (for example, pension plan, and health insurance) need not be provided.
- On the other hand, the consequences of misclassification can be huge: assessment of back withholding on any open year (considering classification settlement program), employee plan adjustments, massive penalties, etc. along with non-IRS issues such as tort liabilities.

For the worker

Independent contractor status means:

- The taxpayer can report on a Schedule C, thereby increasing available deductions (for example, can fully deduct agent's 10 percent), etc.
- The taxpayer also must file and pay estimated tax, self-employment tax.
- Independent contractor status means no employee benefits, unemployment, etc.

For the employer-employee

It should also be noted that the determination of an employer-employee relationship may affect other areas of the Federal law. For example, the Supreme Court held in *Nationwide Mutual Insurance Co. v. Darden*, 112 S. Ct. 1344 (1992), that the term "employee," as used in the

Employee Retirement Income Security Act (ERISA), similarly considers the factor of the "right to control".

Determination of the Correct Classification

Despite the wide variety of work relationships that exist in real life, the tax law requires that all workers be classified as one or the other: independent contractor or employee.

Statutory Classification

The Internal Revenue Code provides clear rules for some occupations, for example, corporate officers are invariably employees, I.R.C. §§ 3121(d)(1), 3306(i), and 3401(c); "direct sellers" are always independent contractors, I.R.C. § 3508.

I.R.C. § 3121 defines employees for FICA as: corporate officers, common law employees, and "statutory employees" (agent drivers, full-time insurance salesmen, home workers, and traveling salesmen).

I.R.C. § 3306(i) applies the same rules for FUTA by referencing 3121(d) but excludes the insurance salesmen and home workers. I.R.C. § 3401(c) covers withholding. I.R.C. § 3508 covers direct sellers and qualified real estate agents.

Common Law Analysis

Generally, the determination of worker status depends on common law.

Categories used to determine worker classification (based on facts and circumstances of each particular case).

- Behavioral Control - The right to direct or control the details and means by which the worker performs the required services.
- Financial Control - The right to direct or control the economic aspects of the worker's activities.
- Relationship of the Parties - Intent concerning control. The facts and circumstances under which a worker performs services are determinative of a worker's status.

Employee Status is the Norm

Major studios and many other employers in the entertainment field, preferring not to risk the disastrous consequences of misclassification, treat almost everyone on the payroll as employees.

In Office Audit - Use Forms W-2 in analysis, matching income sources and amounts with any non-reimbursed employee expenses claimed. Be sure all non-union employers have complied with payroll rules.

- **Where Schedule C Is Not Allowed** - Some performers simply use a Schedule C even though their income was Form W-2; this must be corrected.
- **Mixed Income Sources** - Where the taxpayer has both Form W-2 and Form 1099 income, there should be an allocation between Schedule C and Schedule A on how the expenses are deducted - depending on how they match up with the jobs.
- **"Qualified Performing Artist"** - Certain low-income entertainers are permitted to deduct their expenses "above the line," that is, for purposes of arriving at AGI. I.R.C. § 62(a)(2)(B).

Application of Facts and Law

Every individual case turns on its own facts. For example:

Barnaba Photographs Corp. v. United States, United States District Court for the Southern District of New York, entered June 28, 1949, *aff'd per curiam*, 178 F.2d 402 (2d Cir. 1949); Rev. Rul. 71-144, 1971-1 C.B. 285. Photographers' models who worked through booking agents, had no continuing relationship with any particular photographer, charged hourly rates, typically furnished their own make-up and wardrobe, and "used their own initiative, ability, and experience in interpreting the roles assigned to them," were not employees of the photographers, despite taking directions, etc., from them.

Rev. Rul. 74-332, 1974-2 C.B. 327. Models that performed services under the agency's name, were not permitted to do free-lance modeling, were graduates of the agency's modeling school, and in general functioned only through the agency, were employees of the agency. Rev. Rul. 68-107, 1968-1 C.B. 427. As circumstances varied, orchestra members could be considered either employees of the nightclub operator, employees of the orchestral leader, or "partners" on a "cooperative" basis.

Rev. Rul. 57-155, 1955-2 C.B. 333. An actor or actress who provided his or her own costume, delivered a few lines from a script, and took technical instructions from the producer was considered an employee; a narrator who took technical instruction from the producer and advice from the client was also an employee. An artist, who took only suggestions, who supplied his or her own materials and performed his or her work at home, etc., was independent.

Rev. Rul. 68-644, 1968-2 C.B. 468. Newspaper correspondents, over whose work hours the newspaper had no control, and who furnished weekly news items to the paper which the paper could accept and pay for or reject, were not employees of the paper.

Rev. Rul. 74-412, 1974-2 C.B. 332. A professional architect, working on a project-by-project basis for an architectural firm, on the firm's premises, furnished with office, desk, secretary, etc., paid according to time and difficulty of assignment, subject to the firm's supervision, was an employee of the firm.

Personal Service ("Loan Out") Corporations (PSC)

Those in the entertainment industry will often form corporations to conduct their business. These corporations are usually solely owned by the person who is providing the services generating the majority of the gross receipts. There are many benefits to forming these corporations including the availability of deductions that are limited to the self-employed taxpayer such as medical insurance, pension deductions, etc. There have been cases among entertainers and others in the industry toward unjustified use of the corporate device to obtain the benefits of deductions and shelters that would otherwise not be available.

Background

There is a large body of case law on this subject, motivated by evolving tax principles over the years. See e.g., *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1963) cert denied 395 U.S. 933 (1969); *Keller v. United States*, 77 T.C. 1014 (1981), *aff'd*, 723 F. 2d 58 (10th Cir. 1983); *Foglesong v. United States*, 691 F. 2d 848 (7th Cir. 1982).

Current applicable law

At the present time, some of the controlling law to consider in this area may be found in the following authorities.

I.R.C. § 482 - This statute authorizes the Government to re-allocate gross income in order to clearly reflect income among commonly-controlled taxpayers (See Foglesong).

I.R.C. § 269A - If a PSC was formed principally to avoid or evade tax, and if the corporation performed services for only one other entity, the IRS is authorized to reallocate income to the artist/shareholder.

Rev. Rul. 74-330, 1974-2 C.B. 278, Rev. Rul. 74-331, 1974-2 C.B. 281 - The "lend-a-star" rulings deal with off shore personal service corporations owned by non-U.S. performers.

Common law factors - The employee versus independent contractor factual analysis is appropriate for personal service corporations in order to determine whether the performer was an employee of his or her corporation or of the producer directly.

Sargent v. Commissioner, 929 F. 2d 1252 (8th Cir. 1991); *Nonacq.*, A.O.D., 1991-022 (October 22, 1991) - The Tax Court held that the hockey teams had paid the players directly and the players' PSCs thus should be ignored, based on assignment of income doctrine and I.R.C. § 482. *T Sargent v. Commissioner*, 93 T.C. 572 (1989). The Eighth Circuit reversed in *Sargent v. Commissioner*, 929 F.2d 1252 (8th Cir. 1991), holding the players were employees of their PSCs. IRS has announced non-acquiescence in the appellate decision; A.O.D. 1991-022. Outside the Eighth Circuit we will follow the Tax Court.

Statutory requirements - The PSC must comply with all withholding, reporting, and payment rules with respect to the wages it pays the performer.

Residuals, Royalties, Other Income

Income may be received by entertainers in many different forms.

Residuals

Periodic payments received by actors and actresses and others for reruns of commercials, episodic television, etc.

- Payor may be a film studio, or one of a few payroll services who do that work.
- Agents' 10 percent commission is usually charged only where the amount of the residuals is above union scale.
- Payors typically withhold, file Forms W-2. IRS should therefore have adequate records for cross reference.

Royalties, license fees

Periodic payments received by copyright owners such as songwriters, recording artists, authors, paid by those who perform, exhibit, run, or otherwise distribute copyrighted works for a prescribed time period or purpose.

Sources of information - "Mechanicals" (royalties on music) are tracked by BMI, ASCAP, and SESAC for the publishing copyright and SoundExchange for the recording copyright.

Other sources of information - Such as motion picture studios, television, book publishers, are publicly available on-line.

Fringe benefits, goods for services

The frequency and variety of advertising and promotion deals in the entertainment industry create many opportunities to pay employees in something other than cash. These items may not always appear on the recipients' Forms 1040, but they should. I.R.C. § 83 (fair market value of property received for services is includable in gross income).

Perks - Performers sometimes receive wardrobe and other perquisites from producers; for example, they might get to keep their costumes after a film, or they might get a case of the sponsor's product after doing a commercial; an established spokesperson for an automobile usually drives a new one each year.

Merchandise deals - Compensation in the broadcasting industry is frequently in the form of merchandise, barter, etc.

Passes - Employees of TV, movie studios, record companies, etc., may get free passes to concerts, shows, and screenings.

Excessive per diem

If an employer reimburses employee expenses, there must be an "arrangement" requiring the employee to substantiate the expenses and/or return the unsubstantiated portion; I.R.C. § 274(d). Where there is no such arrangement in effect, the unsubstantiated portion will be considered income to the employee. I.R.C. § 62(c); Treas. Reg. § 1.62-2(c)(5).

Miscellaneous

Participations, endorsements, product tie-ins, prizes (for example, tractor-pulling, rodeo), foreign source, etc. are all includible in gross receipts.

Unemployment insurance

Entertainers are often eligible for unemployment compensation between jobs. These payments are included in gross income. I.R.C. § 85.

Buy-outs, releases

Creative individuals sometimes have agreements that pay them when their ideas are not used - "pay-or-play" contracts; also, past performances re-used in excerpts, clips and "bloopers" may generate new fees, talent releases, etc.

Business Expenses

This is one of the areas most subject to both abuse and genuine misunderstanding and/or differences of opinion. Even case law can be contradictory.

Fact: Most Expenses Are Reimbursed/Reimbursable by the Employer

It's likely that a union contract requires the producer to pay expenses directly or reimburse workers for all expenses connected with the job.

No deduction without proof

Actors who claim they had to buy their own costume, pay their own travel, etc., for a production, should be able to show an employment contract or other confirmation of this requirement.

May not be deductible, even with proof - Even if a "costume" was required to be provided by the taxpayer, it is not deductible as wardrobe unless it's unsuitable for general use.

Analyze the year's job history - Compare the taxpayer's notes of jobs worked with expenses claimed; get dates worked, job requirements; question thoroughly to make sure it all makes logical sense. See *Kisicki v. Commissioner*, T.C. Memo. 1987-245 (taxpayer's calendars contained discrepancies, alterations); *Wilson v. Commissioner*, T.C. Memo. 1973-92, reversed on other grounds, 500 F. 2d 645 (2d Cir. 1974). (Taxpayers' expense log didn't correspond to their known activities during the year.)

Union/non-union - Where taxpayers claim they incurred unusual expenses because they worked on non-union jobs, they must be able to prove it. Insist on seeing contracts; if necessary, contact employers or unions to confirm.

Reimbursement - No deduction is allowed for an expense if the taxpayer could have received reimbursement but did not choose to claim it. *Campbell v. Commissioner*, T.C. Memo. 1987-480.

Travel

There is a deduction allowed for expenses incurred away from home, in pursuit of a trade or business. I.R.C. § 162(a)(2). However, as stated above, a production company typically pays all travel expenses for cast and crew, either to or from a local location or out of town. Consult the union or the guild contract.

Deduction controlled by I.R.C. § 274

Even where a deduction for meals, lodgings, etc., is proper, it is allowed only to the extent the taxpayer presents thorough documentation, which means records (preferably contemporaneous) or other corroboration of his or her statements. Treas. Reg. § 1.274-5T. Elements to be substantiated:

- Amount of each separate category of expenditure;
- Dates of departure and return;
- Destination(s);
- Business purpose, including business benefit expected.

Note: A contemporaneous log is not required, but the closer in time to the event the record was created, the more probative value it has; conversely, if a taxpayer has no log or diary, the need for independent corroborative evidence is greater. Treas. Reg. § 1.274-5T(c).

Away from home

Taxpayers in the entertainment industry may regularly work in more than one city (for example, Los Angeles and New York City). Several issues may arise as a result.

Tax home - A taxpayer's home is normally the (one) city where his or her job is performed. Rev. Ruls. 60-189, 1960-1 C.B. 60; Rev. Rul. 73-529, 1973-2 C.B. 37. Revenue Ruling 93-86 covers temporary v. indefinite abode. Rev. Rul. 93-86, 1993-40 I.R.B. 4.

Only one tax home - As a rule, a taxpayer can have only one tax home, even when he or she has two widely separated ongoing places of business. Duplicated expenses would therefore be deductible. *Andrews v. Commissioner*, 931 F.2d 132 (1st Cir. 1991).

- Limitations - However, there are limits; for example, frequent, short trips home during the duration of the job would be a personal expense.

- Profit motive - Also, where the transportation costs are greater than the income from the job, it raises doubts about profit motive.

Several jobs during year - If the taxpayer works in two or more locations in one tax year, the determination of which is his or her tax home is based on:

- Total time spent in each city;
- Degree of business activity in each area;
- Relative amount of income per area.

See Markey v. Commissioner, 490 F.2d 1249, 1256, (6th Cir. 1974).

No principal place of business - Where taxpayers' work is of such a nature that they have no principal place of business their "regular place of abode" may be deemed to be their tax home, provided:

- The taxpayer performs a portion of his or her work in the same area as the abode, and lives there while doing so; and
- Living expenses in that abode continue while the taxpayer is necessarily away on business; and
- The taxpayer has either:
 - Not abandoned that abode, or
 - Has family members living there, or
 - Uses that abode frequently himself or herself.

See Rev. Rul. 73-529, 1973-2 C.B. 37.

Itinerant; no tax home - If the taxpayer cannot meet at least two of the above three criteria, he or she has no tax home and may not deduct travel expenses. *Rosenspan v. United States*, 438 F.2d 905 (2d Cir. 1971).

Travel may be multi-purpose - Where travel is for both business and pleasure deductibility depends on which was primary. Treas. Reg. § 1.162-2(b). For dual purpose foreign travel, expenses may be allocated. Treas. Reg. § 1.274-4(f).

Local Travel

Just as in any other line of work, commuting is not a deductible expense, although there are several exceptions to this rule.

General rule: commuting not deductible - The expense of commuting, though absolutely necessary and ordinary to earning a living is not deductible. Treas. Reg. § 1.162-2(e); *Fausner v. Commissioner*, 413 U.S. 838 (1973).

More than one commute per day - Even where the taxpayer goes back and forth from home more than once a day (as an actor might have to do), the expense of the commute does not become

deductible. See, e.g., *O'Hare v. Commissioner*, 54 T.C. 874 (1970); *Sheldon v. Commissioner*, 50 T.C. 24 (1968).

Exception: traveling between locations during the work day - Expenditures for traveling between work sites within the work day are deductible. See Rev. Rul. 55-109, 1955-1 C.B. 261.

Exception: home office - Where the taxpayer's home is his or her principal place of business, travel to and from home would no longer be "commuting," and could thus be deductible. See *Curphey v. Commissioner*, 73 T.C. 766, 777-78 (1980).

Exception: commuting outside the metropolitan area – A free-lance worker who normally works within the metropolitan area may deduct the commuting expenses of going outside that area for a temporary job. Rev. Rul. 190, 1953-2 C.B. 303. See *Harris v. Commissioner*, T.C. Memo. 1980-56, *aff'd* and remanded in an unpublished opinion 697 F.2d 898, 9th Cir. 1982.

Where taxpayer had a choice - Producers often provide a bus for cast and crew to nearby locations, but some may prefer to drive themselves. Where an employer has made a benefit available to the taxpayer but the taxpayer prefers to use his or her own, there is no deduction. *Kessler v. Commissioner*, T.C. Memo. 1985-254 (FBI agent could not deduct cost of ammunition for required target practice, where his employer had offered ammunition for that purpose).

Wardrobe, Make-Up, Etc.

In most kinds of productions, a performer's costumes, wigs, make-up, and other needs are supplied and paid for by the employer. (One possible exception might be TV announcers or news reporters who wear their own wardrobe.)

Substantiation

If a taxpayer has deducted wardrobe, make-up, or any such personal items used during performance, he or she should be able to prove the item was actually required (that is, a copy of the employment contract), and that the amount was actually spent (sales receipt).

Business versus personal

The rule is that personal expenses are not deductible, even when they are required as a condition of employment. I.R.C. § 262.

Clothing; other personal items - Clothes are ordinarily a personal expense. *Kennedy v. Commissioner*, T.C. Memo. 1970-58, *aff'd*, 451 F. 2d 1023 (7th Cir. 1971). Haircuts and other grooming expenses are also personal, and thus not deductible as a business expense, even if required by an employer. *Drake v. Commissioner*, 52 T.C. 842, 844, (1969) (Haircuts are not deductible, though required by job.) *Hynes v. Commissioner*, 74 T.C. 1266, 1291-1292 (1980) (Grooming is an inherently personal expense and the cost is not deductible).

Taxpayer must prove his or her primary motive – Taxpayers may not simply allege their motives in making a questionable expenditure were business and not personal, they must prove it by a showing of objective circumstances. *Wrightsmen v. United States*, 428 F.2d 1316 (Cl. Ct. 1970) (an art "investor" could not prove his primary motive was not personal enjoyment of art).

Gratuities, Gifts, Etc.

These items are no more (or less) deductible by taxpayers in the entertainment industry than anyone else. The \$25 limit on business gifts must be observed. .I.R.C § 274(b).

Education, Coaching, Special Training

If the taxpayer can establish that he or she needed special training for a particular job, it may be deductible. For example, a C&W singer got a role in a commercial and needed to learn to ride a horse. (Although it would be more likely for the producer to pay for special coaching.) If this issue comes up, get specific details. The courts tend to consider if there is also a personal reason for the lesson. The courts take into consideration as to how much they will advance the taxpayer's business. For example, flight lessons are a common one, and were disallowed for a CPA with a love of flying in *Katz v. Commissioner*, T.C. Memo. 1968-16, but were allowed for a news photographer in *Aaronson v. Commissioner*, T.C. Memo. 1970-178. Examiners should address if the lessons qualified the taxpayer for new field, which would not be deductible. Treas. Reg. § 1.162-5(b) and (c). *See, e.g., Roussel v. Commissioner*, T.C. Memo. 1979-125. For example if the singer was starting a side business doing something with horses, the lessons would not necessarily be for her singing business.

Agents' and Managers' Fees

Agents typically take 10 percent of gross receipts. Managers may take more; ask to see contract, if available. (Further discussion below.)

Searching for Work

As stated earlier, those who work in the entertainment industry spend a lot of time looking for their next job.

Promotional Materials, Resumes, Photographs, Etc.

Actors and other entertainers need to advertise by means of ads, flyers, and other printed materials distributed to potential employers.

I.R.C. § 162 Deduction Is Probably Okay

It is usually clear that these items fall within I.R.C. § 162 definition of "ordinary and necessary." E.g., *Kisicki v. Commissioner*, T.C. Memo. 1987-245 (actor could deduct cost of photography, printing, demo tapes.)

Get Substantiation

However, be sure to see bill, invoice from printer, statement from photographer, canceled checks, etc. Match dates, item, amounts, postage costs, etc. (to eliminate duplication and tendency to toss in personal expenditures).

Auditions, Screen Tests

A large part of a performer's job-hunting expenses are deductible, but review the documents for any personal expenses deducted.

Travel Between Auditions Is Deductible

In other lines of work, the cost of traveling between job sites during the work day is deductible; thus so is the cost of traveling between auditions.

I.R.C. § 274(d) Limits

There is no I.R.C. § 162 travel deduction allowed unless the taxpayer provides substantiation.

Substantiation

Get details, as shown in the taxpayer's own "adequate records," or by "sufficient evidence" to corroborate the taxpayer's statement, for example, parking lot receipts, travel log, etc.

Travel

It is rare that an entertainer will have to travel out of town for a mere audition. (An out-of-town producer who is casting a role will come to town or send a casting director to conduct a series of auditions; if they want to interview that actor specifically, they'll pay his or her travel expenses.) An actor who claimed this unusual expense should have substantiation.

Telephone

Telephone is probably a valid expense, at least in part; also an answering machine, answering service, cell phone, beeper, call forwarding, etc. But insist on substantiation; allocate where appropriate (using month sampling). *Int'l Artists, Ltd. v. Commissioner*, 55 T.C. 94, 105 (1970).

Unique Expenditures

Once in a while, an actor or actress will have to incur an unusual cost, just for one particular audition; for example, a lesson from a dialect coach to help him or her prepare to try out for a certain part, some kind of special hairpiece (or hair cut or color) or make-up for a screen test, not otherwise of any use to the taxpayer. Request confirmation, details, and substantiation.

Entertainment, Gifts, etc., Claimed in Connection with Looking for Work

Actors or actresses rarely get jobs on the basis of gifts they've given to casting directors. (If actors or actresses insist this practice is going on, audit of the casting directors' returns should be initiated.)

- Request documentation in complete compliance with I.R.C. § 274(d), and then analyze the correlation between the gift, the recipient, and the expected benefit to be derived.
- Observe the \$25 limit on business gifts, and the 50 percent limit on meal deductions. (See further discussion below.)

Union and Guild Dues

Dues are almost certainly a legitimate deduction, assuming there is adequate substantiation. Union and guild rules, standard contracts, phone numbers, etc., are available on the internet; do not hesitate to use them to double check taxpayer's statements. Below are some of the links that specify the dues. Be aware that they can vary because a percentage is often involved. Refer to the following websites for more information:

- Screen Actors Guild–American Federation of Television and Radio Artists ([SAG-AFTRA](#))
- Writers Guild of America, West ([WGAW](#))
- American Federation of Musicians ([AFM](#)) , search the page for the local union

Maintaining Skills, Image, Position, Etc.

According to Hollywood myth, it's even harder to stay on top than to get there in the first place. Thus established performers may be entitled to certain deductions for this purpose.

Public Relations, Promotion, Publicity

The line between business and personal motives regarding these expenditures is frequently unclear; insist on specificity.

Publicity Manager, PR Firm, etc.

Often valid, assuming there is good documentation. Review statements received from service provider; inquire about value of services performed; ask to examples (newspaper clippings, press coverage, magazine articles) of what the expenditure bought and the results obtained therefrom (for example, a job); otherwise, publicity just to maintain a public image is a personal choice and is not deductible.

Deduction Controlled by I.R.C. § 274(d)

Even when a deduction for promotion, gifts, entertainment, etc. is proper, it is allowed only to the extent the taxpayer presents thorough documentation; this means records (preferably kept at or near time of expenditure) or other corroboration of his or her statements. See Treas. Reg. § 1.274-5T(b). The taxpayer must show:

- Amount of each expenditure.
- Time and place of the entertainment, or date and description of the gift.
- Business purpose, including benefit expected.
- Identity of recipient of the entertainment or gift, and business relationship between recipient and taxpayer.

Note: Specificity is required. *Dowell v. United States*, 522 F. 2d 708 (5th Cir. 1975); *Smith v. Commissioner*, 80 T.C. 1165, 1172 (1983).

Compensation Paid to Managers and Others

Successful entertainers frequently have an entourage; some of these individuals perform "ordinary and necessary" functions, but others may just be hangers-on, family members, etc.

Agent, Personal Manager, Other Professionals

Big stars often need business managers, accountants, lawyers, secretaries, and more. Analyze documentation for personal deductions.

Request Details - Ask for a description of services performed; get copies of contracts, detailed statements from lawyers, etc., proof of employment taxes and wages paid out, etc.

Analyze Services – I.R.C. § 162(a): Were the services performed by these individuals ordinary and necessary to the taxpayer's trade/business? Was the cost reasonable? Be alert for:

- Whether the service-provider was perhaps a friend or relative? ("Comensation" may have been a disguised gift.)
- Whether any part of the services was of a personal nature? (Business managers often look after the personal finances of their clients as well, pay household bills, etc.)

Legal Expenses, Settlements - Deductibility of legal services and costs depends on the origin of the claim or conflict. See, e.g., *Harden v. Commissioner*, T.C. Memo. 1991-454 (football player's payments of hush money to ex-girlfriend, to keep her from filing criminal charges was not a business deduction just because he knew his team would have traded or released him if she had filed the complaint).

Coach, Personal Trainer, Guru

The general rule is that personal expenses are just not deductible. I.R.C. § 262. A personal, living or family expense is not deductible unless specified by the Code. Treas. Reg. § 1.262-1.

I.R.C. § 262 Take Precedence over I.R.C. § 162

I.R.C. § 262 takes precedence over I.R.C. § 162 and thus carves out exceptions to what might otherwise be deductible expenses under I.R.C. § 162. *Sharon v. Commissioner*, 66 T.C. 515, 522-23 (1976), *aff'd per curiam* 509 F.2d (9th Cir. 1978), *citing Commissioner v. Idaho Power*

Co., 418 U.S. 1, 17 (1974). I.R.C. § 262; *Bodzin v. Commissioner*, 60 T.C. 820 (1973), *rev'd* 509 F.2d 679 (4th Cir. 1975), *cert denied* 423 U.S. 825 (1975). This means the taxpayer has the burden to prove that the expenditure was not personal.

Taxpayers Have the Burden of Proof.

In *Welch v. Helvering*, 290 U.S. 111, 115 (U.S. 1933) the burden of proof is on the taxpayer. The statement is that "his [commissioner] ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong." Many cases start by establishing that, citing Welch, and then proceed to determine if the taxpayer has done that. This concept is also in Rules of Practice and Procedure of the United States Tax Court, Rule 142(a).

Taxpayers Rarely Can Carry Their Burden

Amend v. Commissioner, 55 T.C. 320, 325-26 (1970), *aff'd*, 454 F. 2d 399 (7th Cir. 1971) (some expenses - in that case a Christian Science counselor on staff - are so "inherently personal" they simply cannot qualify for I.R.C. § 162 treatment irrespective of the role they play in the taxpayer's trade or business); *Sieber v. Commissioner*, T.C. Memo. 1979-15 (taxpayer, who was in the construction business, played polo in order to meet potential clients; costs not deductible, since he could not prove the activity was primarily business and not social, nor could he show proximate connection between polo and his business). *Hamper v. Commissioner*, T.C. Summary Opinion 2011-17 disallowed clothing, hair, makeup, gym membership, etc. for a news anchor on the premise that they are inherently personal.

Bodyguards, Security Services

Physical security is also too personal an item to be deducted, unless there is a clear business-related purpose to the service, for example, to control fans, paparazzi during a star's personal appearance (but for such occasions, the producer of the event would probably bear those costs, since the security of all would be the producer's responsibility).

Bodyguard

See *Holmes v. Commissioner*, T.C. Memo. 1983-442 (no deduction for bodyguard expenses for protection of diplomat's household while posted in Quito, Ecuador). Generally, bodyguard services are personal; however, there could be circumstances that would allow this deduction on occasional bases. For example, attendance at award ceremonies when nominated or performing at a concert (for which the producer does not provide security) may result in allowable deductions.

Home Security

Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. Treas. Reg. § 1.212-1(h). See *Contini v. Commissioner*, 76 T.C. 447, 453 (1981)

(expenses disallowed because taxpayers could not prove home was held for investment purposes).

Specific Items May Be Business-related

In *Holmes v. Commissioner*, T.C. Memo. 1983-442, a business deduction may be proper for certain security items installed in the home for business reasons, such as a fire-proof safe in which to keep office documents. But see *Semp v. Commissioner*, T.C. Memo. 1981-706 (handguns were clearly an "extraordinary" expense, in spite of taxpayer's contentions that as an insurance salesman he was obliged to travel in dangerous neighborhoods).

Keeping Up Skills, Status, Image, etc.

Entertainers may believe that, because they have to make certain expenditures in order to "stay on top," these items should be deductible as business expenses; nevertheless, most of these items typically overlap too much with personal expenses to constitute valid business deductions.

TV, Movies, Theatre, Cable TV Expenses

I.R.C. § 274 places strict limits on deductions for items "generally considered to constitute amusement, entertainment, or recreation." Such items are thus deductible only where there is a clear tie to particular work.

Everyday Items

Generally, there is no deduction for the things everybody buys, such as concert tickets or cable fees. In *Noland v. Commissioner*, 269 F.2d 108 (4th Cir. 1959), the Court held that a businessman could deduct the Wall St. Journal, but not Time Magazine; by that standard, an actor can deduct the Hollywood Reporter but not TV Guide.

Specific Occasions

I.R.C. § 274 requires a "direct relation" to active conduct of taxpayers' trade or business: *Walliser v. Commissioner*, 72 T.C. 433, 441-42 (1979). The taxpayer must supply names, dates, etc., I.R.C. § 274(d).

Limits

Even where a deduction for a particular event is allowed, such as theatre ticket to a certain play in order to research an upcoming film role, only one ticket would be deductible; taking a guest would be a purely personal cost.

Screenings

Writers Guild, Directors Guild, and various professional groups offer regular screenings of new releases to members; thus membership fees paid by the taxpayer may already cover at least some of these "necessary" expenses.

Ongoing Training to Keep Up Skills

This may be an ordinary and necessary business expense, similar to CPE for lawyers and accountants. *Elliot v. United States*, 250 F. Supp. 322 (DCNY, 1966) (Concert harpist could deduct cost of lessons to maintain proficiency.)

Who Is Eligible

The taxpayer must already be employed or self-employed in a trade, business, or profession. See Treas. § Reg. 1.162-5(b).

What is Eligible

Education expenditures are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if falls under one of two categories:

Maintains or improves skills required by the individual in his employment or other trade or business. Treas. Reg. § 1.162-5(a)(1). The taxpayer must demonstrate a connection between the course of the study and his particular job skills. *Takahashi v. Commissioner*, 87 TC 126-130-31 (1986), OR

Meets the express requirements of the individual's employer. Treas. Reg. § 1.162-5(a)(2).

AND, Meets the Two-Prong Test - There is a double hurdle regarding the type of education or training which may be deducted, even if the expenses fall under the two categories, above.

- Not for basic skills already in use - The expense may not be to learn the skills that qualified the taxpayer for the job already held. Treas. Reg. § 1.162-5(b)(2). AND
- Not to qualify for new trade or business – The expense not be one that qualifies the taxpayer for a new trade or business. Treas. Reg. § 1.162-5(b)(3); *Callender v. Commissioner*, 75 T.C. 334 (1980); *Kroyt v. Commissioner*, T.C. Memo. 1961-322 (concert artists could not deduct the cost of learning to play a new instrument).

c. Unique Situations May Arise in the Entertainment Field

The above test probably means a sports announcer cannot deduct the cost of tap dancing lessons, a mime cannot deduct the cost of elocution lessons.

Cost of Owning and Maintaining Airplane, Motorcycle, Horses

The equipment used by actors or actresses, stunt persons, and many others in movies and television is often what others would see as "toys." Taxpayers' claims that their expenditures on

these items are business-related may arguably have some truth; but these items also present so great an opportunity for abuse that they merit careful scrutiny of the particular facts and circumstances of each case.

Background

Court cases have addressed the deductibility of airplane expenses in many different settings; the outcome has typically turned on the issue of just how ordinary and necessary the plane was to the operation of the taxpayer's trade or business.

As Transportation - One clear business connection is where the plane is needed for transport. *Palo Alto Town & Country Village, Inc. v. Commissioner*, 565 F. 2d 1388 (9th Cir. 1977) (taxpayer convinced the court of the business value of having the plane standing by at all times); *Sartor v. Commissioner*, T.C. Memo. 1984-274 (taxpayer proved the plane expenses were necessary and ordinary to his business as a salesman); *Ballard v. Commissioner*, T.C. Memo. 1984-662 (deduction denied in part, where commercial flights would have done just as well, and would have cost less).

Education to keep up flying skills - Another line of cases analyzed the issue in light of the taxpayers' alleged need to "maintain or improve" their flying skills for purposes of their trade or business. See, e.g., *Boser v. Commissioner*, 77 T.C. 1124 (1981).

- "Ordinary and necessary" - When flying expenses are deducted as I.R.C. § 162 educational expenses, the taxpayer must show they were "ordinary," which means "normal, usual, or customary" in the taxpayer's trade or business. *Perfetti v. Commissioner*, T.C. Memo. 1983549, *aff'd* on this issue, 762 F. 2d 638 (8th Cir. 1985); *Stoddard v. Commissioner*, T.C. Memo. 1982-720.
- "Reasonable" - Inherent in the concept of "necessary" is the requirement that the amount of the expenditure be reasonable in relation to its purpose; where expenditure is excessive, only the portion which is reasonable may be deducted. *United States v. Haskell Engineering & Supply Co.*, 380 F.2d 786, 788-89 (9th Cir. 1967).
- Relationship to trade/business - The burden of proof is on the taxpayer to show "a direct and proximate relationship" between the use of his or her own plane and the performance of his or her duties in his or her trade or business. *Carroll v. Commissioner*, 51 T.C. 213, 218 (1968), *aff'd*, 418 F.2d 91 (7th Cir. 1969).
 - Income-producing Property, I.R.C. § 212 - Instead of I.R.C. § 162, the taxpayer may invoke I.R.C. § 212, contending that the plane, car or horse was "income producing property," the upkeep of which is deductible under I.R.C. § 212. Ask for history of the income earned by this property (presumably rentals). The taxpayer's argument that the property was held for the production of income is subject to an I.R.C. § 1.83-type analysis, to make sure the ownership was, in fact, profit-motivated.

Listed Property

I.R.C. § 280F - Under I.R.C. § 280F(d)(4)(A), passenger cars, computers, other transportation property, and any property generally used for entertainment, recreation, and amusement, are "listed property." (No reason to think this doesn't include horses.) Tax benefits claimed in connection with this kind of property are strictly limited.

Where the taxpayer is an employee - Under I.R.C. § 280F(d)(3), an employee can get the tax benefits of "listed property" only to the extent it can be shown that:

- The property was used for the convenience of the employer, and
- The property was required as a condition of his employment.

Computers - Computers and peripherals are fully deductible (and eligible for I.R.C. § 179 expensing) only if used exclusively at the taxpayer's regular business establishment (including a home office, if I.R.C. § 280A requirements are met). I.R.C. § 280F(d)(4)(B). Otherwise, they are "listed property" and tax benefits are subject to strict recordkeeping (showing business versus personal use).

MACRS depreciation: only on "Qualified Business Use" Property - Unless the "qualified business use" (which means actual use in the taxpayer's trade or business) of the property is more than 50 percent, the taxpayer may only use "alternative depreciation system" (I.R.C. § 168(g): straight line) and may not claim I.R.C. § 179 expensing elections. The percentage of business use is gauged by time spent in actual use. Treas. Reg. § 1.280F-6.

Identify the taxpayer's exact trade/business

In order to analyze the degree to which the taxpayer might be entitled to the deduction for his or her plane, horse, motorcycle, etc., the first step is obviously to identify his or her trade or business.

Employee (Form 2106 for unreimbursed expenses)

If income was W-2, determine what he or she was employed as (for example, stunt person, actor or actress, pilot, animal trainer, wrangler).

- The taxpayer can have more than one occupation;
- Review appropriate job contract(s), union contract(s); contact the union, the producer, other third parties, if necessary;
- Which employer(s) does the taxpayer contend required him or her to provide the property in question? For which job(s)? Was it truly for the employer's convenience, rather than simply that the taxpayer preferred to use his or her own (horse, motorcycle, etc.)? What part of the claimed expenses were attributable to that job? Allocate as appropriate.

Note: "Requirement of employment," "employer's convenience" depends on facts and circumstances. A mere statement from the employer is not sufficient. Treas. Reg. § 1.280F-6.

No intermingling - Don't mix employee deductions with independent contractor deductions; I.R.C. § 280F requires separate treatment. Furthermore, assume expenses were reimbursed by employer unless the taxpayer proves otherwise.

Schedule C Deductions

Where the taxpayer has reported income and deductions on Schedule C(s), it is equally necessary to clearly identify (each) trade or business (for example, independent stunt coordinator, animal trainer, flight instructor).

Income/deduction should agree - The source of the income should be consistent with the deduction claimed; that is, if he or she is reporting income for staging stunts, the services contract should not be for horse rentals. Specifically match up each trade or business, each job, and each kind of deduction claimed.

"Qualified business use" limitation on depreciation

As stated above, in order for MACRS depreciation to be allowed, at least 50 percent of the use of the property in question must have been in a trade or business of the taxpayer.

Break out each trade/business – There should be a separate Schedule C for each trade or business: for example, horse expenses cannot offset auto racing income.

Analyze - Ask lots of questions and use common sense on personal use: for example, if there were kids in the family, they may have ridden the taxpayer's horses; a local traffic reporter with a faraway vacation home may have used his or her plane to get there.

Interaction with I.R.C. § 183 - Facts such as unbusinesslike operation and consistent losses may suggest lack of a profit motive. Each Schedule C must stand on its own with respect to I.R.C. § 183.

No loose ends - In analyzing and matching income and deductions from various sources verify that the taxpayer has reported all income properly and not omitted reimbursements; for example, if he or she was required to bring his or her horse to a job, was he or she reimbursed for the cost of horse trailer, feed?

Personal Services Corporation

I.R.C. § 280F applies only to taxpayers who are individuals and S-Corporations. Where the taxpayer functions through a C-Corporation, these strict provisions do not come into play.

Actual connection not enough - As stated above, an actual connection between the property and the taxpayer's trade or business is not enough: use of that property must be ordinary and necessary within that taxpayer's profession. For example, how many stunt persons specialize in flying stunts? How many of those own their own planes? How many flying stunts has this taxpayer worked on? How much of total income was derived from stunt flying?

Entertainment/recreation/amusement property - When the property in question was used not on camera or for the taxpayer's technical skills but for actual recreation, for example, to entertain a network vice-president or a prospective investor, the special substantiation rules of I.R.C. § 274(d) must be satisfied.

Physical Fitness

Expenses for physical fitness are deductible only to the extent they are linked to the specific requirements of the taxpayer's work - a particular job, or type of job. It is up to the taxpayer to prove this linkage.

Health Club, Gym, Equipment, etc. - All such expenses are considered personal, and thus not deductible, even if they do provide an overall benefit to the taxpayer's trade or business. Rev. Rul. 78-128, 1978-1 C.B. 197 (law enforcement officer could not deduct health club costs).

Athletic, Sporting Club Dues - Moreover, dues paid to athletic, sporting (and social) clubs are treated the same as entertainment and recreation expenses (I.R.C. § 274(a)(2)), and are thus subject to the special substantiation rules of I.R.C. § 274(d).

Possible Allowance of Deduction - Fitness expenses might be deductible in certain situations, where there is a specific connection with the taxpayer's trade or business.

- Particular job - For example, an actor or actress gets a role in a martial arts movie and has to learn Karate. (I.R.C. § 274(d) substantiation requirements would have to be satisfied, of course.)
- Specialty associated with the taxpayer's success - In certain instances, a special skill is so associated with an entertainer's or athlete's success that its maintenance is akin to keeping up professional skills; for instance, a Mr. Universe-turned-actor might be required by the nature of his employment (type of roles) to keep up his body building and weightlifting skills. Another example might be an Olympic ice skater who becomes a professional ice skating star.

Wardrobe

General rule

It is well-accepted that clothing is deductible as a business expense only where:

- It is required by the employer or essential to the taxpayer's employment;
- It is not suitable for general wear or use away from work; and
- It was not, in fact, worn while away from work.

Hynes v. Commissioner, 74 T.C. 1266, 1290 (1980); *Yeomans v. Commissioner*, 30 T.C. 757, 767 (1958).

Lenient Policy

Formerly, courts were more lenient. A line of cases from several decades ago established a lenient policy with respect to wardrobe deductions:

Deductions by entertainers - E.g., *Nelson v. Commissioner*, T.C. Memo. 1966-224 (Ozzie & Harriet were permitted to deduct the clothes they wore on their TV show even though they were suitable for general use;); See also *Denny v. Commissioner*, 33 B.T.A. 738 (1935) (clothes were "theatrical costumes"); *Fisher v. Commissioner*, 23 T.C. 218 (1954), *aff'd* 230 F.2d 79 (7th Cir. 1956) (night club pianist could deduct cost of tuxedos).

Deductions by taxpayers in other lines of work - Leading cases typically involved specialized occupations. E.g., *Meier v. Commissioner*, 2 T.C. 458 (1943) (nurse could deduct uniforms, due to extra "sanitary" requirements of job); *Harsaghy v. Commissioner*, 2 T.C. 484 (1943) (taxpayer not allowed to wear uniform off the job, thus could deduct costs).

Current Standards

Today's standards are different. Perhaps because a wider variety of clothes are in fact suitable for general wear today, denial of a clothing deduction has become the norm. E.g., *Pevsner v. Commissioner*, 628 F. 2d 467 (5th Cir. 1980) *rev'g* T.C. Memo. 1979-311 (boutique saleswoman could not deduct expensive clothes even though they were required for the job and never worn in personal life, because they were, in fact, suitable for general use); *Mella v. Commissioner*, T.C. Memo. 1986-594 (professional tennis player was not permitted to deduct cost of tennis togs, since objectively they were suited for general use).

Working conditions hard on clothes; need more frequent replacement

A taxpayer may think because his or her particular occupation is exceptionally hard on his or her clothes that he or she is entitled to a deduction, but this is not so.

Protective wear is deductible - Equipment or special clothing required by certain jobs, which does not take the place of other clothing is deductible, for example, makeup artist's smock, asbestos underwear worn by stunt person for fire scene. *Kozera v. Commissioner*, T.C. Memo. 1986-604 (special electrician's "bunny boots" deductible); *Jeffers v. Commissioner*, T.C. Memo. 1986-285 (for taxpayer who was a pipefitter, steel-toed boots were deductible but jeans were not).

Unusual wear and tear - There is no deduction, however, simply because a taxpayer's job causes unusual wear and tear on regular clothes. *Drill v. Commissioner*, 8 T.C. 902 (1947); *Henry v. Commissioner*, T.C. Memo. 1971-50. *Hawbaker v. Commissioner*, T.C. Memo. 1983-665 (no deduction for auto salesman's suits which he was required to wear and which got unusually dirty and greasy on the job).

Care of wardrobe

Generally, where the cost of the work clothes is deductible, so is the cost of their cleaning. *Mortrud v. Commissioner*, 44 T.C. 208 (1965).

Adequate proof: substantiation and documentation

The requirements are not as strict regarding I.R.C. §162 expenses as they are with respect to I.R.C. § 274. While original bills and cancelled checks are always preferable, they are not an absolute necessity. Consider all the surrounding circumstances. See *Campbell v. Commissioner*, T.C. Memo. 1992-66. (A deduction was allowed where the taxpayer, a plastics technician, "testified credibly" that he wore out two pairs of protective work boots in a year.)

Grooming and Other Personal Items

As a rule, these items are too personal; they will generate a business deduction only in the presence of very special circumstances.

Make-up, Haircuts

There may be a possible deduction for stage make-up (with substantiation that taxpayer was required to purchase it, did purchase it, and never wore it offstage), but it's a narrow exception. E.g., *Drake v. Commissioner*, 52 T.C. 842 (1969) *supra*.

Toupee

Probably too personal to yield a business deduction; possible exception where the taxpayer presents abundant evidence that he wore the toupee exclusively while working.

False Teeth, Hearing Aids, etc.

False teeth, hearing aids, etc. are considered extremely personal, and thus usually not deductible.

Courts divided; a fact intensive issue - Some courts have been lenient on deductions for the various needs of actors or actresses, for example, *Denny v. Commissioner*, 33 BTA 738 (Court allowed deduction for replacement dental work, also wigs, costumes, etc.). Others have not: *Sparkman v. Commissioner*, 112 F.2d 774 (9th Cir. 1940). (No deduction for actor's dentures, even though he needed them for enunciation; "taxpayer did not prove the teeth were used for business purposes only.")

Generally, few personal deductions are allowed, even where arguably business related - See, e.g., *Bakewell v. Commissioner*, 23 T.C. 803 (1955). (No deduction for hearing aid needed by courtroom lawyer.)

Business-related Medical Expenses

The I.R.C. § 213(a) limit is now 10% with a caveat for 2013-2016 allowing 7.5% for those more than 65 years old before the end of the year. This is all the more reason why taxpayers now might want to argue that certain medical expenditures were business-related. (Since medical deductions were readily available until recently, there is little judicial guidance in this area.)

Cosmetic Surgery – I.R.C. § 213(d)(9) now prohibits a medical deduction for face lifts, hair transplants, and any other procedure directed merely at "improving the patient's appearance," thereby providing still further motivation for on-camera performers to claim such items under I.R.C. § 162, unless, as in *Hess v. Commissioner* (T.C. Summary Opinion 1994-79) the cosmetic surgery is considered detrimental to the taxpayer outside of their career.

I.R.C. § 213(d)(9) does allow an exception for expenses to "ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease".

Medical Treatment - Rarely allowed as business expense; for example, Rev. Rul. 71-45, 1971-1 C.B. 51 (singer's costs of throat treatments allowed as medical, not business, expense).

Insurance - Note that health coverage for Hollywood union and guild members is very good; it is unlikely that a member of, say, SAG-AFTRA, had any uncompensated medicals sufficient to generate a Schedule A deduction.

Extravagance, in General

Not Limited to Lowest Price

Show business folks sometimes like to splurge. The reasonableness of the price a taxpayer chooses to pay for goods and services is determined by fact and circumstances: what is lavish and extravagant to one taxpayer, maybe normal to another taxpayer.

Compensation for Services

A deduction for salaries or fees for personal services is limited to a "reasonable allowance" for "services actually rendered." I.R.C. § 162(a)(1). The test of reasonableness depends on facts and circumstances. However, as discussed under Personal Service and Personal Holding Companies (Loan Outs), wages to shareholder/artist are not subject to limitations.

Exception: Lavish Food and Drink

I.R.C. § 274(k) provides that food and beverages are not deductible if they were "lavish or extravagant under the circumstances" or if the taxpayer was not present. See I.R.C. § 162(a)(2).

Amount May Indicate Motives

The amount spent may be relevant to determining whether the expenditure was primarily for business or personal motives; for instance, if it looks as if that audition in New York may be an excuse to deduct the cost of a luxury trip. Consider reasonableness" in relation to the purported business purpose of the item. *United States v. Haskel Eng. & Supply Co.*, 380 F. 2d 786, 788-789 (9th Cir. 1967); *Harbor Medical Corp. v. Commissioner*, T.C. Memo. 1979-291.

Use of Home for Business Purposes

This issue often arises in the entertainment industry, where business and personal lives intermingle to so great an extent.

Home Office Deduction

I.R.C. § 280A severely restricts the deduction for office in the home. To claim a deduction for business use of a taxpayer's personal residence under I.R.C. § 280A(c)(1), the taxpayer must establish that a portion of his dwelling unit is (1) exclusively used, (2) on a regular basis, (3) qualified business purposes under I.R.C. § 280A(c)(1) (either principal place of business, place to meet with patients, etc., separate structure, or designated storage space for inventory), and (4) if the taxpayer is an employee, the office is maintained for the convenience of the employer. *Hamacher v. Commissioner*, 94 T.C. 348, 353-354 (1990).

Principal Place of Business - The most frequent of the above issues in the entertainment industry, is the principal place of business. In *Commissioner v. Soliman*, 506 168, 175-177, (1993), the Supreme Court laid out a two-part test to determine whether a taxpayer's residence qualifies as a principal place of business: (1) the relative importance of the activities undertaken at each business location; and (2) the time spent at each location. However, after the Supreme Court's decision in *Soliman*, Congress added language following I.R.C. § 280A(c)(1)(C), to define "principal place of business" for tax years after 1998, as including "a place of business which is used by the taxpayer for the administrative or management of any trade or business of the taxpayer if there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business." The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 932(a), 111 Stat. at 881; *Thunstedt v. Commissioner*, T.C. Memo 2013-280; *Beale v. Commissioner*, T.C. Memo 2000-158.

Result May Depend on Status of Taxpayer

An independent contractor may deduct a portion of his or her home only if it is his or her principal place of business, used by clients, patients, or customers, or is a separate structure. I.R.C. § 280A(c). An employee may deduct the expense of a home office only where it's for the convenience of the employer.

Corporate Taxpayer

Individuals who have formed a personal service C- corporation may still deduct business use of their home, but the creation of the corporate entity would give rise to separate issues, for example, it would have to rent the premises from the entertainer. See, e.g., *Int'l Artists, Ltd. v. Commissioner*, 55 T.C. 94 (1970). (Liberace's corporation deducted expenses of a screening room, wardrobe, theatrical lighting, concert stage, etc., in the stars Harold Way home; but the corporation paid him rent for it.)

There is a PAL issue regarding rent of an individual to his corporation. Per Treas. Reg. § 1.469-2(f)(6), income from rental to an entity in which the taxpayer materially participates is deemed to be non-passive. Losses are still passive.

"Listed Property" I.R.C. § 280F

Note that personal computers and property generally used for recreation, amusement, and entertainment are all among the I.R.C. § 280F listed property categories. All business deductions and credits arising from "listed property" are subject to the I.R.C. § 274(d) special substantiation rules.

Miscellaneous

Uniform Capitalization Rules

Exception – I.R.C. § 263A(h) - Beginning after 1986, "creative individuals" may depreciate "qualified creative expenses." Notice 8862, 1988-1 C.B. 548.

Special Treatment

Taxpayers who qualify under this provision are exempt from the uniform capitalization requirement. They may deduct "qualified creative expenses," instead of having to capitalize them.

Who Is Eligible

This provision applies to freelance authors, photographers, artists, and other creative individuals. They must either be self-employed or work through a personal service corporation.

"Qualified Creative Expenses"

These are the expenditures incurred by a creative individual in producing a creative property through his or her own efforts. They encompass:

- Expenses paid or incurred in the taxpayer's trade or business (other than as an employee);
- Which would otherwise be deductible, were it not for the uniform capitalization rule.
- "Qualified creative expenses" do not include expenses related to printing, motion picture films, disks, etc., because these are reproduction and distribution expenses.

"UNICAP"

For years before 1987, or for taxpayers who are not "creative individuals," the costs of producing creative properties may not be amortized until the project is placed in service. In other words, costs are capitalized and there is no current deduction for the costs of producing or acquiring property prior to the year in which it can begin generating income. I.R.C. § 263A. Cost recovery is then based on the income forecast method. *Siegel v. Commissioner*, 78 T.C. 659 (1982).