"I Can Deduct The Making Of My CD... Right?"

by Alan M. Friedman, CPA

Alan Friedman is a CPA and Senior Partner with the accounting firm of Friedman, Kannenberg & Company, located in West Hartford, Connecticut. He holds a Bachelor and Masters degree in Professional Accounting, and has been employed by United Technologies and the international accounting firm of Ernst & Young. Alan and his firm have extensive experience in providing accounting, tax and consulting services to the music industry, servicing professional musicians and bands, music stores, instrument and product manufacturers, recording studios, music schools and other music industry professionals. Alan resides in West Hartford, Connecticut with his wife and three children. In his spare time, he records music in his basement studio (www.alhomeboy.com) and plays lead guitar in the all-CPA rock band "The Accounting Crows" (www.accountingcrows.com) and the print music industry band "Printz." E mail Alan at money@drumheadmag.com.

Every March and April, as we prepare scores of tax returns for our musician clients, the question of deducting CD production costs is inevitably raised.

Even before I did my first CD of bad 80's rock tunes, I wondered if all of my CD production expenses were deductible. After all, our tax laws are built on the premise that any expense incurred in the production of income is generally deductible. But my right brain started to cross over to my left brain with questions like "What if I incur big recording expenses but don't have CD sales income right away?" or "Can I immediately deduct money spent on recording equipment?", leading up to the big question "Can I deduct all of the expenses I incur in the making of my CD and, if so, when?" Frankly, these questions didn't matter much to me while I was recording my CD, as all I wanted to do was produce a body of musical work I was proud of. But these issues began to matter more once I sat down to do my own tax return in light of the thousands of dollars I spent in CD production. Knowing how important this issue is to most, if not all, musicians, I thought I'd shed some light on this somewhat complicated topic.

The Fine Line Between Art & Business

Most musicians have a passion to capture a lasting memory of their musical artistry and creativity. That passion has fueled an explosion of sound recordings made not only for the musician's listening pleasure but also to help promote, achieve and sustain a successful career in music. This partly explains why musicians sometimes wonder whether they can get a tax break for making a CD. But the variety, magnitude and timing of CD production costs is usually what causes your typical musician to find themselves confused over the deductibility of CD production and replication costs – and for good reason. The answers are not straightforward, often confusing and have been changed over time by our friends at the Internal Revenue Service. I'll explain a little later in this article, but first let's talk about the myriad of costs typically incurred in producing one's CD.

"Can I deduct all of **the expenses I incur in the making of my CD** and, if so, when?"

Endless Love, Endless Costs

I used to think CD production costs would be somewhat minimal, once I made my "one-time" investment into recording gear. This notion made me either stupid or very naïve (or arguably both) for a couple of reasons.

A long time ago I thought my investment in recording equipment would remain at the couple of thousand of dollars for my Tascam mixer and 8-track tape-based recorder. But somehow that evolved into spending tens of thousands (or hundreds of thousands of dollars if you ask my wife) for constant equipment upgrades over the years. The Tascam recorder got replaced by ADATs, which later got replaced by a modular digital 24-track recorder, which was further replaced by ProTools hardware and software, and finally (for the moment) replaced by more software and hardware upgrades. Four-rack-space analog effects got replaced by single rack-space digital effects, only to disappear by the advent of software plug-ins. My microphone collection expanded hand-in-hand with my guitar & amp collection, coupled with money spent for an assortment of cables, accessories and studio furniture. Accordingly, there's a lot to be said for simply paying the hourly or daily rate for an "up-to-date" recording studio to do your tracking.

Furthermore, while CD tracking may be the most time consuming task, it's only one of the critical stages in the production of a quality sound recording. After your investment of time, effort and money in writing and tracking songs, you're obviously going to want those tunes "mixed" by someone who knows how to create a soundscape of appropriate instrument and effect levels that enhance the listening experience, not muddy it. After that, the entire compilation should be "mastered" to bring a uniform clarity and volume to each song relative to the entire CD as a whole. Lastly the CD master needs to be reproduced, along with an artistically pleasing CD jacket. Add the cost of photography and graphic design, and you've undoubtedly got thousands (if not tens of thousands) in CD production costs...and that's before you've spent the money to duplicate the CD for public consumption.

It's no wonder that any musician doing his/her own CD would want to get a tax deduction for these production costs. Unfortunately, the IRS has some different thoughts about allowing you a "current year" deduction for these costs, resulting in less tax paid to Uncle Sam.

The "Unicap" Rules Of 1986

In 1986, a new tax act created Section 263A of the internal revenue code which governed the tax treatment of costs incurred in the production of tangible personal property, like sound recordings. This new section of law (also referred to as the "Uniform Capitalization Rules", or "UNICAP") was enacted, in part, to prevent taxpayers from inappropriately mismatching income and expenses which, in turn, create a "current deduction" of production costs that have future value.

Under Section 263a(b), our internal revenue code requires the artist/songwriter to "capitalize" (not immediately deduct) the costs to create, research, write, prepare and record the body of work. The costs also include any travel, rent, equipment depreciation and repairs, office overhead, interest and any other costs relating to the production of tangible personal property, including labor costs for any persons involved in the production activity.

In compliance with the UNICAP rules, the taxpayer must "amortize" (ratably write-off) the production costs under the "income forecast method." This method requires the taxpayer to estimate the future expected income to be received from (in this example) the sound recordings, in addition to only allowing the deduction for tax periods that report income from the sound recordings.

You've Got To Be Joking

Shortly after the IRS enacted Section 263A UNICAP rules, they started to receive numerous inquiries and complaints from authors, recording artists, photographers and other persons expressing concern regarding the application and administrative complexities of these new rules... what a surprise. In response to this concern, Congress granted the Treasury Department authority to "adopt other simplifying methods and assumptions, where the costs and other burdens of compliance with the Code may outweigh the benefits". In other words, Congress was strongly suggesting the Treasury find a simpler way for taxpayers to comply with the spirit of the new tax law.

A Kinder, Gentler IRS

Based on these numerous complaints and concerns, the IRS provided an elective three-year "safe harbor" for certain authors, artists and taxpayers who were now required to comply with the new Sections 263A rules. Under the three-year safe harbor, taxpayers could aggregate and capitalize all of their "qualified creative costs" incurred during each tax year, and then amortize (deduct) 50% of the aggregated costs in the year they're incurred, 25% of the costs the following year, and the remaining 25% in year three.

This safe harbor election greatly reduces the administrative complexities of complying with the UNICAP rules by eliminating the necessity to amortize these costs using the subjective income forecast method, as well as eliminating the need to figure out which costs should be capitalized versus expensed.

Although the safe harbor generally applies to individuals only, a corporation or partnership may use the three-year safe harbor election if the corporation or partnership is substantially owned by a "qualified employee owner." A "qualified employee owner" is an individual who owns at least 95% of the corporation's stock or at least a 95% partnership interest.

How Do I Make This Election?

Qualified taxpayers may automatically elect to use the three-year safe harbor by timely filing their federal income tax return and noting the election by typing or legibly printing '*Three-Year Safe Harbor Adopted Under The Provisions of Notice 88-62*" at the top of Form 1040, Schedule C, Page 1 (for a sole proprietorship or single-member LLC), or Form 1065, Schedule A (for partnerships), or Form 1120 / 1120S, Schedule A (for corporations).

Deducting CD Duplication Costs

Now that you've incurred the cost to create the CD master and artwork layout, you have the final task and cost of duplicating and packaging the CD for public consumption. Here's where things get a little tricky as far as taking a tax deduction for these duplication costs.

> "there's a lot to be said for **simply paying the hourly or daily rate for an 'up-to-date' recording studio studio"**

Let's say you just spent $2,000 for a 1,000 piece run of your new CD; the cost per CD is $2. You start selling your CD online and at your shows for $10 each. At the end of this year you determine you've sold 600 of the 1,000 CDs you bought, with 400 CDs still sitting in "inventory". Can you deduct the full $2,000 you spent on the CDs? No. But you can deduct $1,200 ($2 cost x 600 sold) against the $6,000 ($10 selling price x 600 sold) of CD sales income you've earned, netting $4,800 ($6,000 in sales - $1,200 of cost) in gross profit from CD sales.

Why can't you immediately take a deduction for the $2,000 of CD duplication costs? The IRS considers your CD inventory an "asset" (something having future value) until it's sold. Only upon disposition can you take a deduction for the cost of the CDs sold or disposed of. The good news is if you give away 100 CDs as part of the promotion of your CD you can take an immediate $200 ($2 cost x 100 CDs) deduction for those CDs.

Some Final Thoughts

The IRS has recently announced some other tax benefits, including a special deduction for certain domestic production activities (that includes sound recordings) as well as capital gains treatment for the sale or exchange of musical compositions or copyrights in musical works. By the same token, there are some stringent IRS guidelines that determine whether your musical endeavors are truly part of a "business" or are part of your "hobby". Although the IRS generally requires a "net profit" (as opposed to recurring losses) to be shown 3 of the last 5 years from any musical endeavor treated as a business, there are other factors the IRS considers, going both ways, in determining the tax status of those endeavors.

Just like most of us wouldn't do our own plumbing, I suggest you consult with a CPA or other tax advisor familiar with these somewhat complex rules. But just like your investment in a music editing software upgrade or CD mastering services, the benefits from using a good tax preparer will most likely far outweigh the cost. So keep track of your CD production cost receipts and invoices, as they save you money by reducing tax liabilities and minimize headaches if or when Uncle Sam comes knocking at your studio door.