Taxes and the working musician

by Alan M. Friedman, CPA

Taxes are probably the last thing a musician wants to think about while pursuing their passion to make music. But in our world of rags to riches, taxes can be the knock-out punch for the artist who didn't bother to plan for Uncle Sam's left jab. A musician's tax return can be somewhat complicated because most artists are self-employed and, accordingly, get paid with "before-tax" dollars. This requires them to be disciplined enough to save for the April 15th tax bill. And let's face it: a musician with a savings account is like an accountant with a personality.

Death from taxes

Our federal government is empowered to tax the income earned by its citizens, which it does via the Internal Revenue Service. Additionally, each state government may impose a tax on income earned while doing business in their state (a.k.a. "State Income Tax"), as well as tax its residents for buying and owning goods in their state (a.k.a. "Sales and Use Tax" and "Property Tax" respectively). Counties and cities may also tax those who are residing and/or doing business within their jurisdiction. It's each taxpayer's responsibility to determine which state and local tax laws apply. Because state and local tax law varies so much, this discussion is limited to issues regarding federal income taxes only.

iStockPhoto

The price paid for money made

Don't worry about opening up Swiss bank accounts; as a U.S. citizen, your "world-wide" income from all sources is considered taxable income. We frequently read about famous musicians who "forgot" to report taxable income and ended up having to pay big money to (or do big time for) Uncle Sam for their forgetfulness. Income you receive, whether from club dates, wedding gigs, music lessons, session work, drum-loop programming, royalties or any other music-related work, is taxable income. One way the federal government makes sure you're not receiving income "under the table" is to require the entities paying you (record labels, publishing companies, night clubs and venues, etc.) to report to both you and the IRS how much money they paid you during the year. This is done via Federal Form 1099-MISC, which you would generally receive by January 31st following the end of each tax year.

Tax myths

A common fallacy is that every dollar a musician spends is a tax deduction (more commonly known as the "write-off"). Many people are under the assumption that the more money you lose at your musical business, the better off you are, because those losses can offset other income on your tax return. This is not true. If you lose money at your business for too many years in a row, the IRS doesn't consider it a business anymore; it is now merely a hobby. After all, who in their right mind would continue to operate a losing business? The costs involved in pursuing a hobby are deemed personal, and are not deductible no matter how promising your album project is. By the way, is the term "album" still acceptable?

The right way to write off

Let's assume your music career is truly a business. You can ben-

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 has written for International Musician, Music Inc. and Music & Sound Retailer magazines. Alan's firm is a member of the National Association of Music Merchants (NAMM), the Retail Print Music Dealers Association (RPMDA), the National Association of School Music Dealers (NASMD), the American Music Conference (AMC) and the National Association of Certified Valuation Analysts (NACVA). Alan is the host of NAMM's interactive "Financial Management" CD-Rom and many of NAMM University's new online courses.

He 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.

efit from a variety of deductions, by writing off certain expenses directly against your music business income. The general rule is you can take deductions for any expense that is an ordinary and necessary expense incurred in connection with running your business. If a deduction looks out of the ordinary or unnecessary, it may come under IRS scrutiny and trigger an audit. The following are some of the more common allowable expenses encountered by most musicians, which are deductible on their income tax return.

Rent for Studio/Rehearsal/Office Space. Rent is commonly considered to be reasonable business expense. Of late, however, the IRS has been scrutinizing write-offs that involve rent paid for "home office / studio" space. Although tax rules have been recently relaxed, many home space deductions are denied because the space was not used exclusively on a regular basis for the taxpayer's music business. When planning your home recording or teaching studio, make sure it'll be used only for business purposes and will not double as a living area. The size of the deduction is usually based on the percentage of the work area space compared to the total space of the premises. For example, if your studio takes up 15% of your apartment, your deduction is equivalent to 15% of your annual rent and utility costs.

Equipment Purchases/Leasing. Musicians, bands, studio owners and other gear-heads go crazy over this potential write-off. There's good news and bad news when it comes to equipment purchases. Yes, you can write off your equipment purchases all in one year instead of having to "depreciate" the equipment cost over several years. However, you must make an election to do so on your tax return, and there is a dollar limit on how much you can write off in a given year. Many taxpayers don't know that the immediate write-off (a.k.a. Sec. 179) cannot create a taxable loss for the business. Leasing gear may be a viable option, as it gives the flexibility to update equipment at the end of the lease while allowing the full deduction of the lease payments. So before you run out and buy a $50,000 fully-loaded Pro Tools rig and mixing console, be sure to speak to your tax advisor about how much you can deduct.

Recording and Studio Costs. Many expenses incurred in recording projects are potential deductions. This includes studio rental, tape costs, engineer/producer costs, editing/mixing/mastering service fees and other related expenses. This assumes, of course, there is or will be income from the sale of the recorded material.

Professional Services. Fees paid to accountants, lawyers, studio-design consultants and session players are all potential write-offs. Because these professionals are working for you, you should provide them each with an IRS Form 1099-MISC at the end of the year, as previously mentioned. This is required if you paid $600 or more to any unincorporated independent contractor during the course of the year. You're also required to submit a copy of the 1099 form to the IRS, as well. It's a good idea to have these independent contractors furnish you with an invoice, which clearly states their business name, address and federal tax ID (or social security) number to support your deduction of payments made to these individuals.

Meals, Travel and Entertainment. Given the potential for abuse, you can understand why the limits of ordinary and necessary travel expenses are being tested by the IRS on a daily basis. Hotel and truck-rental costs incurred by your band for touring the regional club circuit are probably allowable. Your bar tab at the Viper Room with some music industry big-shot is probably not allowable, unless you can prove that it was in furtherance of your business purpose (perhaps that big-shot is now your booking agent). A trip to Jamaica to "learn to play reggae" is questionable, whereas a trip to L.A. for a music trade show is probably allowable. And remember, only a portion (50%) of your business meals can be written off, so don't be so anxious to pick up the check at your local restaurant just for the sake of getting the write-off.

Supplies. Many musicians neglect to write-off their supplies. Cables, strings, drum heads, sheet music, office stationery, blank CDs and DVDs (or cassette and video tape for the "analog" musician) add up to a substantial amount of both money and potential tax deductions.

IF YOU LIVE IN MASSACHUSETTS, PLAY OUT IN CONNECTICUT AND DO SESSION WORK IN NEW YORK, BE PREPARED TO FILE AN INCOME TAX RETURN FOR EACH STATE.

Education and Conferences. From taking a MIDI course at your local junior college to attending a major recording industry seminar, anything you do to further your skill and knowledge in connection with your career is a potential write-off. This includes educational materials like reference books and subscriptions to trade magazines.

Advertising and Communication Costs. Don't overlook deductions for costs associated with advertising and promotional efforts. Photography, photocopying, faxing charges, postage and overnight mail fees, telephone bills, internet access and web hosting add up to a substantial amount of money and are possible write-offs for your business.

There's More. The list of potential deductions goes on and on, depending on how creative you and your tax advisor wish to be (within the limits of what is ordinary and necessary, of course). Other deductions include union dues, voice lessons, auto expenses, equipment-insurance costs, per diem travel costs for the touring musician, and so on. Who knows best what you're able to deduct? A CPA who prepares income tax returns is great place to start.

Playing jailhouse rock

The IRS conducts audits, sometimes randomly and sometimes based on specific questions raised by a tax return. Those audits are on the rise as the IRS has recently been appropriated more funds to hire a slew of new auditors. But don't hit the panic button and start crying. An audit is simply a meeting with an IRS agent to determine whether you have indeed paid the correct amount of tax. If you're prepared by having your documents in order, including the receipts that support the deductions on your return, you will survive an audit.

If your case is complicated, you may wish to enlist the aid of a professional, such as a tax accountant or lawyer. They'll also advise you whether you should even attend the audit. You should be prepared to spend some money for these professional services, as IRS audits can sometimes be time consuming. If some of your expenses are disallowed, you may be liable for additional taxes, penalties and interest based on the audit adjustments. You're best insurance is to have your return professionally prepared by a tax return preparer who understands your profession and the music industry.

A taxing state of mind

The IRS is now auditing more returns by examining certain deductions, instead of every line item on fewer returns. They're also reporting their audit findings to state governments, who have been taxing more aggressively than ever. For traveling musicians, particular attention must be given to state tax laws, as certain states have gone after and collected back taxes from musicians who have earned money in their states. If you live in Massachusetts, play out in Connecticut and do session work in New York, be prepared to file an income tax return for each state.

Pay your fair share (but not more)

The key to keeping your tax liability down is impeccable record keeping and a qualified tax preparer. A number of software programs are available that can help you keep good records (Quicken and QuickBooks by Intuit are two of my favorites). Federal and State tax laws are changing daily, so be sure to enlist the aid of a competent tax advisor to assist you. It's important to choose a tax professional you're comfortable with and who is familiar with the music industry; get referrals from fellow musicians. If you treat your financial matters with the same attention you give your audio mixes and loop samples, that new Pro Tools rig may be just a tax refund away.