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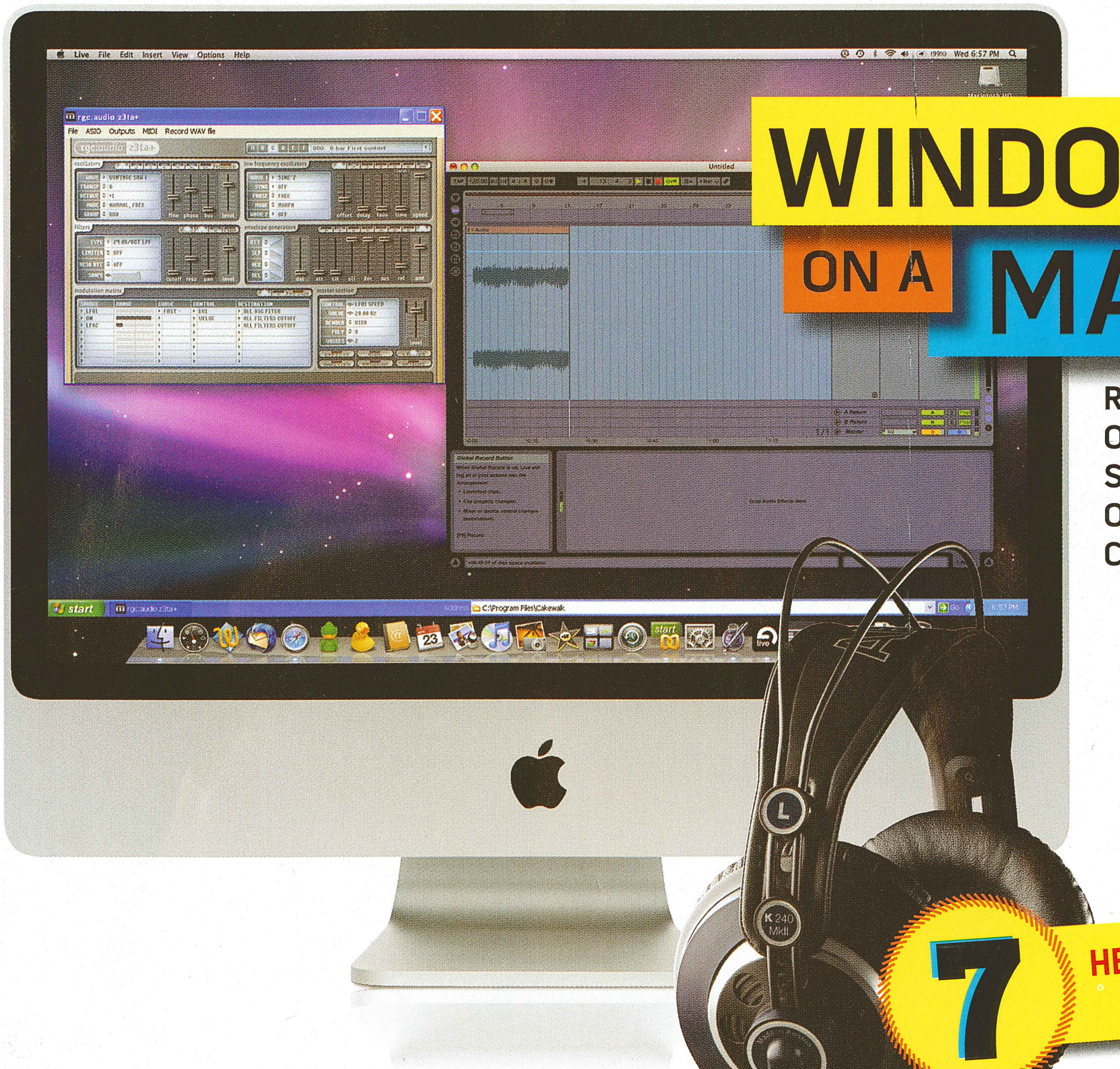

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Q&A: Alan Friedman

A CPA's advice for self-employed musicians.

You may not think of yourself as a business owner, but if you're earning income as a self-employed musician, composer, producer, programmer, and so on, that's essentially what you are. Having a business not only gives you certain tax obligations, but it also opens you up to greater potential liabilities (that is, you're more likely to get sued). One of the best ways to help protect your personal assets is to set up a business legal structure beyond just filing a Schedule C on your tax return. The options for doing so have changed since I set up my company ten years ago. Back then I was advised to incorporate, but today there are other options.

By Ravi

FIG. 1: CPA Alan Friedman specializes in serving music-industry clients.

To find out how musicians can structure their businesses in the most advantageous manner, I turned to certified public accountant Alan Friedman (see **Fig. 1**) of Friedman, Kannenberg & Company. For more than 25 years, Friedman has provided accounting, tax, and consulting services for clients in the music industry including retailers, manufacturers, musicians, bands, and studios. He is also a faculty member of NAMM University (along with yours truly) and a financial consultant for Yamaha's Band and Orchestra Division and Customer Financial Services.

Why should the owner of a home-based business consider anything beyond filing a Schedule C on his individual tax return?

If your business has high exposure to potential lawsuits, as most do, you can limit exposure by purchasing adequate business insurance if you're a sole proprietorship. Alternatively, consider a different business form that provides greater liability protection. For not much money or effort, you can form a structure such as an LLC, or limited liability company.

What are the advantages of an LLC?

We live in a very litigious world where anybody can get sued for a variety of reasons. If you're writing music or doing projects for others, the best thing to do is to incorporate or form an LLC. If somebody sues you, the entity will put a wall between personal assets—like your home, car, or bank account—and business assets. By funneling all contracts and payments through the business, someone could only sue the business and therefore only attach the business assets. And if you're like most musicians, there are no real business assets—money earned is taken out the same day in the form of withdrawal or salary.

What are some of the other business legal structures?

You mostly find sole proprietorships. In general, there are no documents needed to organize the business. It can even operate under a different name from the owner as long as specific documents are filed with your local government informing them and the public that you are operating under a d/b/a ["doing business as"] name. Sole proprietorships are easy to set up and take down, but the problem is that you have unlimited liability. So the more popular vehicle will be the LLC because every state in the country now allows a single-member LLC. You operate just like a sole proprietorship and report all income and expenses like a sole proprietorship on a Schedule C tax return. Yet you have limited liability protection. Then there is the corporation, either a "C corporation" (conventional) or "S corporation" (subchapter S). Whether you are a C or an S is merely a tax distinction. Unless one makes a tax election to become an S, corporations are considered C. C corporations pay tax at the corporate level, but in an S corporation, corporate income flows through to its shareholders and taxable income flows onto the individual's tax return. Tax is paid individually.

How else do C and S corporations differ?

A corporation is separate legal entity like the LLC; however, much more administration goes on. You must have bylaws, annual meetings, records of corporate minutes, and a separate tax return. C corporations are subject to double taxation. If you have $20,000 of net annual income after expenses, the corporation is taxed on that income. Since the only way to take profits out of a corporation is either as a salary or dividend, C corporation shareholders will get taxed again when they take a salary or dividend. Also, some C corporations are considered "personal service corporations." This may apply to those providing services in certain fields including the performing arts, and they are subject to the highest tax bracket of 35 percent from dollar one. On the other hand, a C corporation is generally the only structure that can have a fiscal year other than the calendar year. That could be advantageous by structuring your fiscal year from February to January so that income earned could be pulled out in January and taxed the following year—that allows a one-year deferral of tax payments. Also, you may need your fiscal year to coincide with other events. For example, many music stores and schools have a June 30th year-end because that's when the school year ends. They have earned out all of their revenue for the school year by then and inventory is probably at its lowest and easy to count.

By comparison, you don't have the problem of double taxation in an S corporation. All previously taxed profits can be pulled out as a shareholder dividend [without additional taxation]. While all income is taxed at a potentially higher rate individually, S corporation distributions are free of payroll related taxes. However, S corporations do have some limitations in their structure, including calendar year-ends, shareholders cannot be partnerships or other corporations, and one class of stock, to name a few.

> [The entity will put a wall between personal assets—like your home, car, or bank account—and business assets.]

What kinds of structures are there for bands, cowriters, or co–studio owners?

Partnerships are the simplest entities to create for multiowner businesses. They require a little more effort to operate than sole proprietorships but aren't nearly as involved as corporations. Virtually anyone can be partners—individuals, partnerships, limited liability companies, corporations, or trusts. Additionally, partnerships allow profit sharing, loss sharing, and ownership percentages to vary by partner, making them far more flexible in their financial structure than most other entities. However, just like sole proprietorships, all partner/owners are deemed "jointly and severally liable" for the obligations of the partnership. So again, the LLC is a hybrid entity that combines the ease and favorable tax aspects of a partnership with the liability protection of a corporation or limited partnership.

What are the advantages of corporations compared with LLCs?

Hardly any. There may be more case law on the books of a corporation defending its liability status, since LLCs are newer. But for most, an LLC makes the best sense. It's my favorite entity. It was born because everyone was looking for an easy way to account for and tax their business activities while having the liability protection that one could only get from a corporation. LLCs are easy to set up, easy to dissolve, flexible in their financial structure, and there's no double taxation to worry about. Even health-care expenses now flow through onto the individual returns of the owners of S corporations or LLCs and are 100 percent deductible—that level of deduction used to only be possible with C corporations.

Does one need a lawyer to set up these structures?

You want one to file the Articles of Incorporation with the state in which the company is doing business, generate the bylaws, etc. In an LLC, one can theoretically do it by oneself, especially as a single-member LLC. But I recommend hiring a lawyer regardless because if you get sued, you want to make sure that it was set up properly and you are in good corporate standing to protect you from extended liability. Otherwise, the other party's attorney has the ability to "pierce the corporate veil," which means that you didn't really operate as a separate legal entity, but rather as an extension of yourself. So factor in the one-time up-front cost of an attorney. A change in entity form can usually be made at any time, but there are often adverse tax effects and unexpected costs that can be avoided with a little forethought.

How about trademarks, business bank accounts, and separate credit cards?

You don't have to establish a trademark, but it's a good idea since the business name is only protected in the state in which you organize. However, you must have separate accounts since you are doing this primarily to limit liability. You ultimately want anyone doing business with you to think that they are dealing with a company, not you personally. You don't want to commingle personal and business funds. I would insist that any owner of any of these entities have separate accounts for business. em

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Ravi (heyravi.com), former guitarist of three-time Grammy nominee Hanson, tours the country performing, lecturing, and conducting guitar clinics. He writes for several magazines, and Simon & Schuster published his tour journal.