WORKING MUSICIAN

I Can Deduct CD Production, Right?

by Alan M. Friedman, CPA

Recently, there has been an explosion in independent CD recordings, often made at a musician's own expense on digital home recording equipment we could have only dreamed of 20 or 30 years ago. Consequently, every March and April, as my firm prepares scores of tax returns for musician clients, the question of deducting CD production costs is inevitably raised.

The variety, magnitude, and timing of production costs is usually what causes a musician to become confused over the deductibility of CD production and replication—and for good reason. The answers are not straightforward, and they have been changed over time by the Internal Revenue Service (IRS).

Deducing Deductions

I used to think CD production costs were somewhat minimal, essentially a one-time investment in recording gear. But production gear is constantly evolving, and naturally that eight-track tape recorder gets replaced by a digital recorder/mixer. Then there's ProTools hardware and software to buy, higher and higher fidelity microphones, digital effects, cables, racks, and so on. A professional musician can end up spending tens of thousands of dollars.

And that's only one stage in recording. Those tunes have to be mixed by a professional, and after that, the entire CD needs to be mastered for uniform clarity and volume. Lastly the CD master needs to be reproduced and a CD jacket needs to be designed. The cost of photography and graphic design adds more dollars to CD production, and that's before it is duplicated for public consumption.

It's no wonder that any musician producing his or her own CD will inquire about a tax deduction. Unfortunately, the IRS has some different thoughts about you simply taking a "current year" deduction for all of these costs and letting you reduce your taxable income.

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UNICAP Rules

In 1986, a new tax act created Section 263A of the Internal Revenue Code, which governs the tax treatment of costs incurred in the production of tangible personal property, such as sound recordings. This new section (referred to as the Uniform Capitalization Rules, or UNICAP rules) 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. These 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.

Shortly after the IRS enacted 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.

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.

Safe Harbor

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 UNICAP 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 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," an individual who owns at least 95% of the corporation's stock or at least a 95% partnership interest.

Qualified taxpayers may automatically elect to use the three-year safe harbor by filing their federal income tax return in a timely fashion 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).

Taking Inventory

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. Here's where the deductions get a little tricky!

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 CDs, with 400 CDs 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 list x 600 sold) of CD sales income you've earned—netting $4,800 ($6,000 less $1,200) in gross profit.

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) deduction.

In Conclusion

The IRS has recently announced some other tax benefits, including a special deduction for certain domestic production activities (including 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 three of the last five years from any musical endeavor treated as a business, there are other factors the IRS considers in determining the tax status of musical endeavors.

Just as 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.

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