Increase Your Cut: Top Ten Tax Tips for Musicians

By Peter Irvine
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Musicians deserve a living wage for their work. With a little planning, you can boost your percentage of the door by reducing the cut due to Uncle Sam. Even if you abhor the thought of filing a tax return, or have trouble organizing your finances, take a few minutes to ponder the following money-saving tips.

Whether a solo artist or a member of a band, most musicians operate as sole proprietors and should file a Schedule C as part of their annual tax return. Anyone in business who has not organized as an entity (such as a corporation or limited liability company) is by default taxed as a sole proprietor. For example, a singer-songwriter who performs solo, a session drummer, or a touring soundperson could each file as sole proprietors.

Any group of people, such as a band, who operate a business with the intent to make a profit are by default considered a general partnership. Bands should have basic written partnership agreements that govern this relationship, and file partnership tax returns. If your band is not quite organized enough to do this, you should make it a priority. One alternative is to treat the situation as one person owning the band business who hires the rest of the band as independent contractors. That owner can file as a sole proprietor, reporting the band income and expenses, while the rest of the band members also file as sole proprietors, but only claiming the amounts paid directly to them, and expenses directly related to that income.

Schedule C is where a sole proprietor claims business expenses. Any legitimate expense of pursuing your music career can be deducted from the income you earn doing music. For example, the costs of instruments, copying fliers, mailing tour announcements, driving to performances, and even music magazine subscriptions can all be deductible. By claiming deductions on Schedule C, you reduce your net taxable music income, and thus the amount of your income tax.

To file a Schedule C, your music must rise above being a hobby to being a business. If music is merely a hobby you can still deduct your losses (i.e. expenses) up to the amount of the income you receive doing music but you can't deduct a net loss. As a business, however, you can deduct the *net* loss of your music business from income you generate through a "straight" job. For example, suppose in 2002 you earned $12,000 wearing a blue apron and running a copy machine. Meanwhile, playing music part-time you had income of $2000 and expenses of $3000. Your net music business loss of $1000 can be deducted from your other income of $12,000, reducing the overall income to $11,000.

To be in "business" you must show a profit motive. Basically, there is a "looks like a duck, quacks like a duck" test. The IRS wants to know if you do the things that an average businessperson does, such as keep records, advertise, attend conferences, have some expertise, put time into the activity, and at least occasional success. Of course, these are all things you want to do anyway. You do not ever need to actually make a profit, but failing to do so for three out of five years may increase your chance of being audited.

Now for the tips. This is not a comprehensive list, just some of the major things to consider. Note that the following discussion is applicable to musicians paying tax in the United States in 2002. Canada has its own system. Some of the principles are the same, but the details are different. Of course rates are subject to change every year on both countries. If you have any questions, or your business is complex, consult an accountant or lawyer who specializes in entertainment tax.

(1) Keep a journal

You can deduct business expenses on your Schedule C, but you need proof. Keep a journal of all your income, expenses and travels. This need not be complicated, simply note down what you do each day and what it cost, whether driving to a gig, making photocopies, or buying a guitar. If you're organized, on a regular basis you can enter this data into an accounting program such as Quicken. If you're not, at least keep some paper record of your activities. Keep receipts for any items over $75. For lesser amounts, a receipt is helpful, but not absolutely necessary if you note the amount in your journal.

(2) Keep a mileage log

Every time you drive somewhere for a business purpose, you can deduct either a portion of the actual expense of driving, or a standard rate of $0.365 per mile. Most musicians will likely use the standard rate rather than figuring actual expenses, but if you have an expensive vehicle, add up both and choose the most favorable. The best way to track mileage is a log in your car where you note the odometer reading and purpose of the trip whenever you turn the key. At a minimum, record your odometer reading on January 1 every year. Knowing the total annual mileage, you can add up your trips to figure out the percentage of business use of your car. If you don't have exact figures, calculate your business miles by looking up (in an atlas or online at MapQuest.com) the distance from, for example, your home to the gig. Of course, you remember where all the gigs were because you wrote them down in your journal (see #1).

(3) Eat well

If you keep the receipts, or have a credit card bill, you can deduct 50% of business meals. Remember that on tour, all of your meals are business meals. The IRS also provides a potential bonus for those who eat lightly. Instead of the actual cost, you can legitimately deduct a standard meal and incidentals allowance of $30 per day. This "per diem" rate is even higher in major cities: Nashville, for example, is $42. You do not necessarily need receipts to claim the per diem amount, but you will need proof that you were actually engaged in business, so receipts or a thorough journal are helpful. Note that as a sole proprietor you can claim the per diem for meals but, unlike corporations, not for hotels. For lodging, you can only deduct the actual cost, so keep track of hotel bills.

(4) Have a home

To deduct business travel expenses, you need to leave home. If you have no home, for tax purposes, then you haven't left it, you aren't traveling, and your expenses are not deductible. Your tax home is usually where you would expect it to be: the place where you sleep, vote, get your mail, and so on. Some states, however, have different rules. So if you travel frequently and most of your income is earned on the road, check with a tax specialist to make sure you are not liable for tax in other states. If you earn any significant income in another state, you are supposed to file a return in that state, even if you don't think you owe any tax. Also, many localities have their own taxes, sometimes in the form of a requirement that businesses located in a city that earn above a specified amount must pay an annual license fee.

(5) Work from home

Thanks to recent changes in the law, musicians who do administrative tasks from home, for example making phone calls, then travel elsewhere to perform can now claim a home office deduction. You calculate your deduction by determining the percentage of your home, in square feet, that is exclusively dedicated to your "office." An office can include practice space, inventory storage, or desk space. This deduction applies to apartment-dwellers as well as homeowners. The former can deduct a portion of rent and utilities, while the latter deduct a portion of mortgage payments and utilities. If, on the other hand, you rent office or rehearsal space outside of your home, that rental cost is deductible.

If you own a home and are planning to sell it, consult with a tax specialist about the home office deduction. Gain on the sale of your principal residence is typically not taxed, but if you currently claim the home office deduction a portion of the gain may be taxable as business income.

(6) Depreciate your gear

When you buy equipment, such as an instrument, that has a useful life longer than one year, you must "depreciate" it over several years. This means your deduction gets spread out over the tax life, usually seven years, of the item. Alternatively, for equipment that is mainly used in business, you may elect to deduct the entire expense in the year of purchase, under Section 179 of the Internal Revenue Code. The benefit is that you have an immediate large deduction to offset income for that year. The risk is that if you do not actually continue to use the item for its entire tax life, you may have to "recapture" part of your initial deduction, paying tax on the excess depreciation when you sell the item.

Usually, people want to reduce their tax burden as soon as possible, so they claim the maximum deductions. Some musicians, however, may want to delay deductions. If you are just starting out you may have more expenses than income. Or if you own a home, you may already have a significant home mortgage interest deduction that reduces your tax liability to a manageable level. Once you have reduced your taxable income below the level where you owe tax, consider delaying additional deductions into a future year to offset increased earnings as your career picks up. For example, suppose you spend $1400 on a new guitar. You could elect a Section 179 deduction to reduce this year's taxable income by $1400, or, if you already had a lot of expenses, you could depreciate the guitar over seven years, taking a $200 deduction each year. This could save you a little tax each year, rather than wasting an excess deduction.

(7) Report payments to other musicians

If you hire other musicians or lead a band, you need to be aware of Form 1099. You must send a 1099 to any independent contractor, such as the extra guitarist you hire for the tour, to whom you pay $600 or more. You must also file with the IRS a report of all these 1099s. In turn, for any venue that paid you $600 or more, you should receive a 1099. Keep in mind when you receive a 1099 that it is also reported to the IRS, so if you do not in turn report that income, you may receive an unpleasant phone call. Note that payments, even if less than $600 and not reported on a 1099, to independent contractors are deductible on Schedule C as "commissions and fees." So if you tip the soundperson $20 at the end of the night, deduct it. Legal fees are also deductible.

(8) Remember the self-employment tax

This is the self-employed person's equivalent to social security and Medicare tax. It is separate from income tax, so you may owe self-employment tax even when you don't owe income tax. If you earn more than $400, you need to calculate your self-employment income on Schedule SE, and face the15.3% tax. You can then deduct half of this amount from your gross income, reducing any income tax you owe. The upside of paying self-employment tax is that you earn credits for social security purposes, potentially increasing your benefits upon retirement. To receive social security, you must earn a certain number of credits that you accumulate by earning and reporting self-employment income.

(9) Track your inventory

Most musicians use the "cash method" of accounting, in which you record income and expenses when they actually occur. Under this method, if you order CDs from your record company or a manufacturer, you deduct the expense when you in fact pay it, not when you place the order. If your record company doesn't charge you for product until it issues a statement a year later, then you deduct the actual amount you pay in the later year. The timing rules leave room for shifting income or expenses from one year to the next by planning your inventory. If you've made a lot of money one year, consider ordering and paying for merchandise in December to offset that income.

If you sell CDs or other merchandise, count it every New Year's day. On Schedule C, you enter the value of your starting and ending annual inventory then deduct the cost of any goods purchased during the year. The remainder is taxable profit.

The alternative to the cash method is the more complex "accrual method," but most small businesses are allowed to use the cash method. Technically, if you manufacture your own CDs (this includes ordering and paying for a company such as Oasis to make them) then you must capitalize the cost. This involves estimating how many copies you will sell, figuring the cost of production into each unit, and deducting the cost only when you actually sell the CD. Generally, if you get into the accrual method or capitalization of inventory, it is wise to consult a tax professional.

(10) Save for the future

Self-employed musicians have several options for retirement savings. The simplest is an Individual Retirement Account (IRA). For 2002, you can contribute $3000 to your savings plan ($3500 if you are over 50). Using a standard IRA, the amount of your contribution is deducted from your current taxable income, and instead is taxed when you withdraw the money in retirement. The newer alternative Roth IRA reverses the plan: contributions are not currently deductible, but future withdrawals are tax-free. If your current tax burden is low, contributions to a Roth IRA can give you a tax-free nest egg for those over 65 years, when touring is less fun. Self-employed people have additional options to set up through their business plans with higher contribution levels. If you have children, new laws have broadened the number of educational savings plans available, so check out those tax-saving options.

For more help

Free information, including a free CD, The Small Business Resource Guide, is available online at www.irs.gov or by calling 1-800-829-3676. The CD is compatible with both Macintosh and Windows systems. In particular, you might refer to The Small Business Resource Guide (IRS Publication number 3207); Travel, Entertainment, Gift and Car Expenses (463); Per Diem Rates (1542); Depreciation (946); Business Expenses (535); and Self-Employment Tax (533). Another source of inexpensive information is www.nolo.com, a publisher of plain-English small business legal guides.