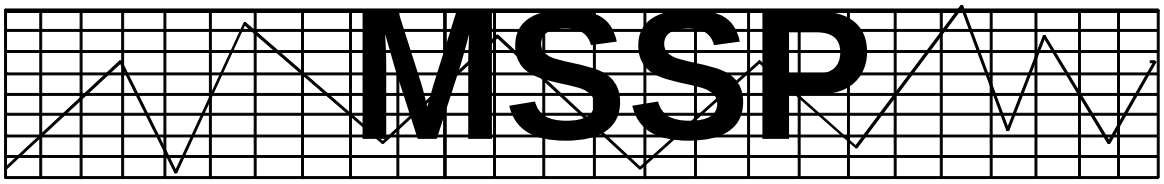

Market Segment Specialization Program

ENTERTAINMENT

Important 1040 Issues

The taxpayer names and addresses shown in this publication are hypothetical. They were chosen at random from a list of names of American colleges and universities as shown in *Webster's Dictionary* or from a list of names of counties in the United States as listed in the *United States Government Printing Office Style Manual.*

This material was designed specifically for training purposes only. Under no circumstances should the contents be used or cited as authority for setting or sustaining a technical position.

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Internal Revenue Service

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INTRODUCTION

The purpose of this Market Segment Specialization Program (MSSP) Guide is:

1. To provide an overview of the activities encountered in audits of individuals in the entertainment industry.

2. To familiarize auditors with issues and terminology pertinent to individuals in the entertainment industry.

3. To assist auditors with their examinations by providing audit techniques.

This MSSP guide should help reduce the time needed to examine returns of individuals in the entertainment industry, by providing some background on the industry and the applicable tax law. While this guide covers a variety of situations and issues, it is not all-inclusive.

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Chapter 1

BACKGROUND

PROFESSIONS

This MSSP guide is designed to provide assistance in auditing individuals in various aspects of the entertainment industry. The issues need to be developed in relation to the taxpayer's trade or business. Sometimes it is a challenge to determine exactly what the taxpayer's profession is. It is, therefore, necessary to look beyond the job title and determine the actual duties and responsibilities of the taxpayer.

At one time, an individual's job title clearly denoted the duties associated. Now, there is a great deal of cross over between job titles. In the early years of film making, the Director was under the control of the Producer and had complete control of the actors, editors, etc. Now, many actors have creative control. Directors may have creative control. Editors may work directly under the control of the producer and independent of the director.

Individuals can function in different job titles on different projects. A taxpayer may be a property master on one project and a "prop man," assistant property master, or a set dresser on another. Many actors are also directors or producers; sometimes on the same project. It is, therefore, critical to determine the duties of a taxpayer in regard to each project. This will be important in determining which expenses are ordinary and necessary.

In the film industry, employees are categorized as "above" or "below the line." Above the line employees are thought of as creative talent; while, below the line generally refers to technicians and support services (although it includes set designers and artists). The "line" is an accounting demarcation used in developing the budget for production. Some above the line costs are incurred even before a film goes into the production stage. Above the line costs include the story rights, the screen play, the producer, the director, and the principal cast. Generally, during the "pre-production" period, the expense for the principal cast is negotiated, but the cost of the story rights is actually paid.

This MSSP guide covers performers, producers, directors, technicians, and other workers in the film industry, the recording industry, and live performances. The same general rules apply and the same issues are found on most of these returns.

Taxpayers in the entertainment industry are involved in three activities when engaged

in their business for profit:

1. Performing for compensation

2. Searching for work through auditions or any other reasonable means of attaining employment

3. Maintaining their position (skills, image, etc.) through reasonable expenditures for education, training, public relations, etc.

Traditionally the industry has interpreted these activities liberally. Our goal is to bring the allowable deductions back within the confines of the Code. The distinction between ordinary/necessary and extravagant must be more clearly drawn.

UNIONS AND GUILDS

The entertainment industry has numerous unions and guilds. Each of these organizations has entered a collective bargaining agreement on behalf of its members. These agreements or contracts address rates of compensation, reimbursements, allowances, hours required to be worked, materials to be provided, etc.

Prominent performers and creative talents may negotiate additional terms for each project on which they work to supplement the union or guild contract. Issues not addressed in these individual contracts are determined on the basis of the underlying union or guild contract.

When an individual is a member of a guild or union (pays dues), we can generally assume that individual is entitled to the benefits of the current union/guild contract. In the absence of any verification to the contrary, all reimbursements and benefits provided for in the contract will be deemed available to the taxpayer.

REIMBURSEMENTS

When entertainment industry taxpayers work on union productions, their respective contracts typically require reimbursement compensation. Taxpayers claiming otherwise should prove they were not entitled to reimbursements or compensation under their applicable contract. The major contracts (SAG, DGA, etc.) provide for extensive reimbursement and compensation for the more common expenses such as travel and meals. Many other expenses commonly seen are covered by the contracts as well. Taxpayers who claim a production was non-union must provide a copy of their contract with the producer or other proof.

Frequently, taxpayers claim that although expenses were reimbursable under the contract, they did not claim reimbursement because they feared they might not be hired for future projects. The IRS position, nevertheless, holds that if the taxpayer could have received reimbursement, the expense is not deductible even if the reimbursement is not claimed.

If the expense exceeds the potential reimbursement, the excess expense may be allowable if it is necessary.

The most common example is auto expense. If the taxpayer claims actual expenses, the expense can be reduced by the mileage reimbursement available (whether or not claimed from the employer) and the remainder may still be allowed as a deduction.

When the taxpayer is entitled to stay in a hotel paid for by the employer but chooses to stay at another hotel at his own expense, the expense is not considered necessary. Personal preference is not a valid business reason to incur an otherwise unnecessary expense.

See Chapter 3, the section titled "Residuals, Royalties, and Other Income," for information on IRC section 62(c) when reimbursement can create taxable income.

COPYRIGHTS

An implied copyright is automatically created as soon as a copyrightable item is created. This protects the creative talent from having his or her work stolen. This applies to screenplays, scripts, compositions, etc. Additionally, finished works are generally protected by a formal copyright. The following materials may be copyrighted:

1. Literary works
2. Musical works, including any accompanying words
3. Dramatic works, including any accompanying music
4. Pictorial and graphic works
5. Motion pictures and other audiovisual works
6. Sound recordings

An idea or concept cannot be copyrighted. The copyright covers the artistic interpretation or specific treatment of the concept.

Period Covered

Any copyright, the first term of which was in existence prior to January 1, 1978, endures for 28 years from the date it was originally secured. Copyrights registered for

renewal before January 1, 1978, endure for 75 years from the date the copyright was originally secured. In general, a copyright on a work created on or after January 1, 1978, lasts for the life of the author and 50 years after the author's death (with no renewal).

Copyright Infringement

For anyone to use copyrighted material without permission is an infringement of the owner's copyright. This exclusive right covers copying, reproducing, printing, reprinting, and publishing copyrighted works. It also prohibits the use of copyrighted material in audiovisuals. Moreover, the use of material from a copyrighted work that infringed on an earlier copyright (even with permission) is itself an infringement of the original copyright.

Receiving Income

When copyrighted material is used, reproduced, or adapted to another medium, permission must be obtained. This generally results in royalties being paid to the copyright holder, fees being paid for the granting of a license, or the selling of an option. This income to the copyright holder is taxable. When received by the creator of the copyrighted material it is considered self-employment income and is subject to self-employment tax.

The payer has an expense for the purchase of the option, fees for the granting of a license, or the payment of royalties. This expense would typically be subject to capitalization as a production expense.

Chapter 2

PLANNING THE AUDIT

GENERAL APPROACH TO THE INTERVIEW

The key to a successful audit, particularly with individuals in the entertainment industry, is developing a solid background and history of the individual's activities and responsibilities. Because people in this industry slide from one job category to another it is imperative to determine what the taxpayer actually did to receive each item of compensation during the tax year. If a "singer" received all of his or her income from choreographing another performer's routines, his or her expenses should not include any "on camera" costs such as wardrobe, make-up, or hair. He or she should, likewise, not be incurring expenses for rehearsal studios or back-up musicians.

Information To Obtain

Whenever possible, secure copies of all contracts, project agreements, deal memos, and working proposals pertaining to the taxpayer's activities. This is important whether or not the income from these projects was received in the tax year. These agreements provide fundamental information on the nature of the taxpayer's income, expenses, and reimbursements. The contracts also disclose who has control and who retains any rights related to the project.

Request a copy of the taxpayer's resume. This show what type of work the taxpayer has done, what sources of income (royalties, residuals, etc.) to expect, and the taxpayer's reputation or standing in the industry. The taxpayer's standing in the industry can be helpful in determining the nature and extent of expenses that would be incurred to maintain that standing. An unknown actor would not normally need to send gifts to a prominent producer. A well known, highly sought after singer would not need to entertain a cameraman.

Allocation of Personal Expenses

Allocation of personal expenses to business purpose will depend on specific correlation between expenditure and income source. The background interview is very important for these cases. It will be the basis upon which expenses will be allowed.

Get an initial chronological background of the tax year by inspecting or researching all logs and records of travel and meals and entertainment. Try using a general month to

month format. Get a sense of the taxpayer's main activities each month.

You can also get the following information for each Form W-2, Form 1099, etc.:

1. Dates worked

2. Requirements

3. Specific activities

Recordkeeping

In the case of personal expenses used for business purposes, the taxpayer's compliance with IRC section 274 determines the deductions allowed.

Extract

IRC section 274(a)

(1) *** No deduction otherwise allowable under this chapter shall be allowed for any item -

(A) *** With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business. ***

* * * * * * *

In addition, taxpayers who do not comply with the requirements of IRC section 274(d) are not allowed very many, if any, deductions. The five criteria for IRC section 274(d) are:

1. Amount of each expenditure.

2. Date of each expenditure.

3. Name, address, or location and designation.

4. Specific business reason or benefit from expense.

5. Occupation or other information relating to the person(s) entertained, to establish business relationships.

Assign reasonable costs to each event. Reasonable cost may be based on verified records or third party knowledge. State or explain the source of any third party knowledge in your workpaper.

Workpapers must clearly show how the expenses allowed apply to the background chronology.

No deduction should be allowed if the taxpayer is merely receiving a general business benefit from personal expenses.

If a taxpayer received both a Form W-2 and a Form 1099 income, determine what the Form 1099 income is; that is, independent contractor, wages, self-employment income, or reimbursement. Allow related expenses against this income. Allocate expenses between Schedule A and Schedule C when the taxpayer has both the Form 1099 and Form W-2 income in the same line of work. If the taxpayer cannot establish which expenses directly result from which source of income, allocate based on the following formula:

		Entertainment		Sched A
W-2 Entertainment Income	X	Business	=	Misc.
Total Entertainment Income		Expenses		"EBE"

The balance of the entertainment business expenses may be allowed on a Schedule C.

Self-Employment Tax Considerations

Net profit from self-employment over $400 is subject to self-employment tax. Once expenses have been properly allocated, insure that any net profit or loss is considered in determining the taxpayer's net self-employment income. Remember to include income or losses from partnerships and other self-employed activities.

Residual payments that do not have FICA withholding should be assessed self-employment tax if a net profit is realized after related expenses, if any, are deducted.

Royalties resulting from services performed (music performed, songs written, a screenplay written, etc.) are subject to self-employment tax in the same manner as residuals. Royalties from merchandising or licensing, which did not involve any services, are not subject to self-employment tax.

EMPLOYEE VERSUS INDEPENDENT CONTRACTOR

The majority of entertainers and technicians are employees and will receive a Form W-2 with Federal income tax and FICA tax withheld. The extent of control a studio or production company has over an entertainer continues to be the determining factor in classifying an individual as either an employee or an independent contractor. Treas. Reg. section 31.3401(c)-1(b) states in part:

> Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. * * *

Audit Techniques

When a taxpayer has received a Form W-2, but claims to actually be an independent contractor, be thorough in developing the facts. Consider the following factors:

1. The taxpayer received the W-2 several years prior to the audit. Has the taxpayer taken any action to correct the situation?

2. The taxpayer received all the benefits of an employee (health benefits, pension plan, unemployment). Has the taxpayer taken any action to waive these benefits?

3. If the taxpayer is a member of a guild, does the taxpayer have an individually negotiated contract?

   If the only contract is the union or guild agreement, the taxpayer is an employee. The union/guild agreement was negotiated as a collectively bargained agreement on behalf of employees.

4. Contributions were made on behalf of the taxpayer to a union/guild pension plan indicate that the taxpayer is an employee.

With few exceptions, taxpayers issued Forms W-2 will report these wages on their Form 1040 and not on a Schedule C. No consideration should be given to performers who claim to be a statutory employee or a statutory non-employee which would allow expenses to be taken against income not subject to either the 2 percent AGI limitation or Alternative Minimum Tax. There is no such statute applicable to this industry.

One important exception, allowing an employee to claim expenses in arriving at

adjusted gross income, is IRC section 62(a)2(B). This section pertains to "performing artists" as defined in IRC section 62(b). A qualified performing artist is one who:

1. Has performed services in the performing arts for two or more employers (receiving at least $200 from each).

2. Has expenses related to performing arts services which exceed 10 percent of the income earned from the performing arts.

3. Has an adjusted gross income of $16,000 or less before deduction of expenses related to performing arts.

NON-FILERS

In the entertainment industry, income can fluctuate greatly from year to year. This creates a high potential for non-filers. There is no major difference between non-filers in the entertainment industry and those in any other industry. The same filing requirements and filing dates apply.

Some taxpayers in the entertainment industry relocate frequently in order to obtain employment. Third party letters to the unions or guilds can be helpful in locating the taxpayer. Agents and agencies can also be helpful in locating taxpayers in the entertainment and modeling professions. Musicians who perform under the name of the band are more difficult to locate, unless we can identify the band.

The same third party sources can also be helpful in reconstructing the taxpayer's income.

When working non-filer cases in the entertainment industry, keep in mind that some time delays are unavoidable. Out of town travel and location work are common for many of the professions in this industry.

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Chapter 3

INCOME ISSUES

RESIDUALS, ROYALTIES, AND OTHER INCOME

Income may be received by entertainers in many different forms. One of the most common forms is residuals. These are periodic payments received by actors and others for re-runs of commercials, episodic television, etc. The payer may be a film studio, or one of a few payroll services who do that work. The agent's 10 percent commission is usually charged only where the amount of the residuals is above union scale. Payers typically withhold and file Forms W-2. IRS should, therefore, have adequate records for cross reference.

Another common form of income received by people in the entertainment industry is royalties or license fees. These are periodic payments received by copyright owners, such as songwriters, recording artists, and authors. It is paid by those who perform, exhibit, run, or otherwise distribute copyrighted works for a prescribed time period or purpose. "Mechanicals" (royalties on music) are tracked by BMA and/or ASCAP. Records are available. Other sources, such as motion picture studios, television, writers guild, and book publishers, have information concerning royalties available in libraries.

Since advertising and promotion deals go on all the time in the entertainment industry, there are many opportunities for paying employees in something other than cash. These items may not always appear on the recipient's Form 1040, but they are taxable and should be included under IRC section 83 (fair market value of property received for services is included in gross income). They take the form of fringe benefits or goods for services.

A common form of fringe benefit is the perk. Performers sometimes receive wardrobe and other perquisites from producers. They might get to keep their costumes after the filming or get the advertisers product after a commercial shoot. An established spokesperson for an automobile typically receives a new car each year. There may be merchandise deals, where the compensation for a broadcast deal is in the form of barter. Frequently employees of TV, movie studios, and record companies receive free passes to concerts, shows, and screenings.

Beginning in 1989, if an employer reimburses employee expenses, there must be an arrangement requiring the employee to substantiate the expenses and/or return the unsubstantiated portion to the employer. Where there is no such arrangement in

effect, IRC section 62(c) requires that the unsubstantiated portion will be considered income to the employee.

For more information on fringe benefits, see Publication 535 or Document 7977.

Some performers also receive income for participation, endorsements, product tie-ins, and prizes (for example, tractor-pulling, rodeo, TV game shows). Some of these sources can be identified by relating specific expenses to the source of the income produced.

Taxpayers in the entertainment industry are often eligible for unemployment compensation between jobs. These payments must also be included in gross income. Although these amounts are generally reported by the payer on a Form 1099, it is wise during the interview to ask about periods of unemployment between jobs.

RECONSTRUCTION OF INCOME

Some taxpayers fail to report all of their income. When you are unable to use a direct method of verifying income, it may be necessary to reconstruct income. There are numerous ways to do this. Here are a few that are unique to the entertainment industry.

Using Agent Commissions

If the commissions are paid at 10 percent, then the income should be at least 10 times the commissions.

Using Union and Guild Dues

Dues for most of the guilds in the entertainment industry are comprised of an annual fee, plus an additional assessment based on the earnings of the prior year. Therefore, the SAG statement advising the taxpayer of his or her dues for 1995 will provide a statement of earnings for 1994.

Chapter 4

CAPITALIZATION AND COST RECOVERY ISSUES

GENERAL

When a taxpayer produces or creates a product (video, film, recording, etc.), the taxpayer will generally incur a great portion of the expenses before the product is ready to produce income. When this happens, the taxpayer is usually required to capitalize those expenses and recover (deduct) them over the period of time that the product is producing income. Several different provisions apply depending on whether the taxpayer is already in the business and the specific business the taxpayer is in.

INTERNAL REVENUE CODE SECTION 195

Expenses for investigating, creating, or acquiring a new business are nondeductible capital expenses. This applies to all expenses before the day the active trade or business begins. These provisions apply to someone starting out in the industry -- before offering a completed product for sale, production, or distribution.

Start-up expenses are expenditures which would normally be deductible under IRC section 162, if they were incurred in connection with an operating business. These expenses, however, do not include amounts deductible under other Code sections such as interest (IRC section 163), taxes (IRC section 164), and research expenses of a scientific nature (IRC section 174).

IRC section 195 allows a taxpayer to elect to deduct these capitalized expenses over a period of not less than 60 months. This is called "amortization of startup costs" and is computed using a straight-line computation. This election must be made by the due date of the return (including extensions) for the year in which the business begins. If the taxpayer does not make a timely election to amortize these expenses, they are carried on the books as a capitalized item until the taxpayer disposes of the business.

INTERNAL REVENUE CODE SECTION 280

IRC section 280 was repealed after 1986. Under this section, expenses incurred in the production of a film, videotape, sound recording, book, or similar property were required to be capitalized. These are expenses that would otherwise have been deductible under IRC section 162. The capitalized costs could then be recovered using the Income Forecast Method, beginning in the year income is first received from

the production or property.

INTERNAL REVENUE CODE SECTION 263A

Beginning with 1987, uniform capitalization rules under IRC section 263A apply to those taxpayers previously under IRC section 280. These rules apply to people who are already in the trade or business. This code section again requires the capitalization of expenses to produce a creative work. This includes cost of researching, preparing, producing, recording, etc. It also includes an allocation of indirect costs such as utilities, tools, clerical, rental of equipment, etc.

Exemption From Internal Revenue Code Section 263A

Qualified creative expenses of writers, photographers, artists, and composers are exempt from the Uniform Capitalization Rules (see IRC section 263A(h)). Qualified creative expenses include ordinary and necessary expenses incurred in the activity of being a writer, composer, etc, other than as an employee. This does not mean that these people never have to capitalize any expenses. Being a writer does not mean that a taxpayer may not incur expenses that relate to publishing or production of the finished (or unfinished) work. A composer may incur expenses that relate to the production of a recording. Expenses that are not directly tied to the creative activity of being a writer, composer, etc., may still require capitalization.

Cost Recovery

Expenses which represent the basis of an asset used in or produced in a trade or business may be recovered using one of several possible methods. The appropriate recovery system or period may depend upon the terms of sale or exploitation of the asset. If all rights to a completed project (film, movie, etc.) are sold as a package, the recovery of the capitalized costs will be allowed as part of adjusted basis reducing the amount realized (or cost of goods reducing gross receipts).

If, as is true in most productions, the project is exploited over a period of years (released in theaters, TV, video, etc.). The most appropriate means of recovering costs is through the income forecast method (RR 60-358, RR 64-273, and RR 71-29).

This method requires an estimate of total income to be derived from the film over its expected life. The term "income" as used here refers to the gross receipts less the distribution expenses. This estimate will include not only anticipated revenue from theatrical releases, but also TV, cable, and video, if the arrangements are entered into prior to depreciating the film down to its salvage value.

The "cost of the film" includes the projected residuals and participations which will be

received. (Transamerica Corp. v. United States, 999 F. 2d 1362 (9th Cir. 1993).)

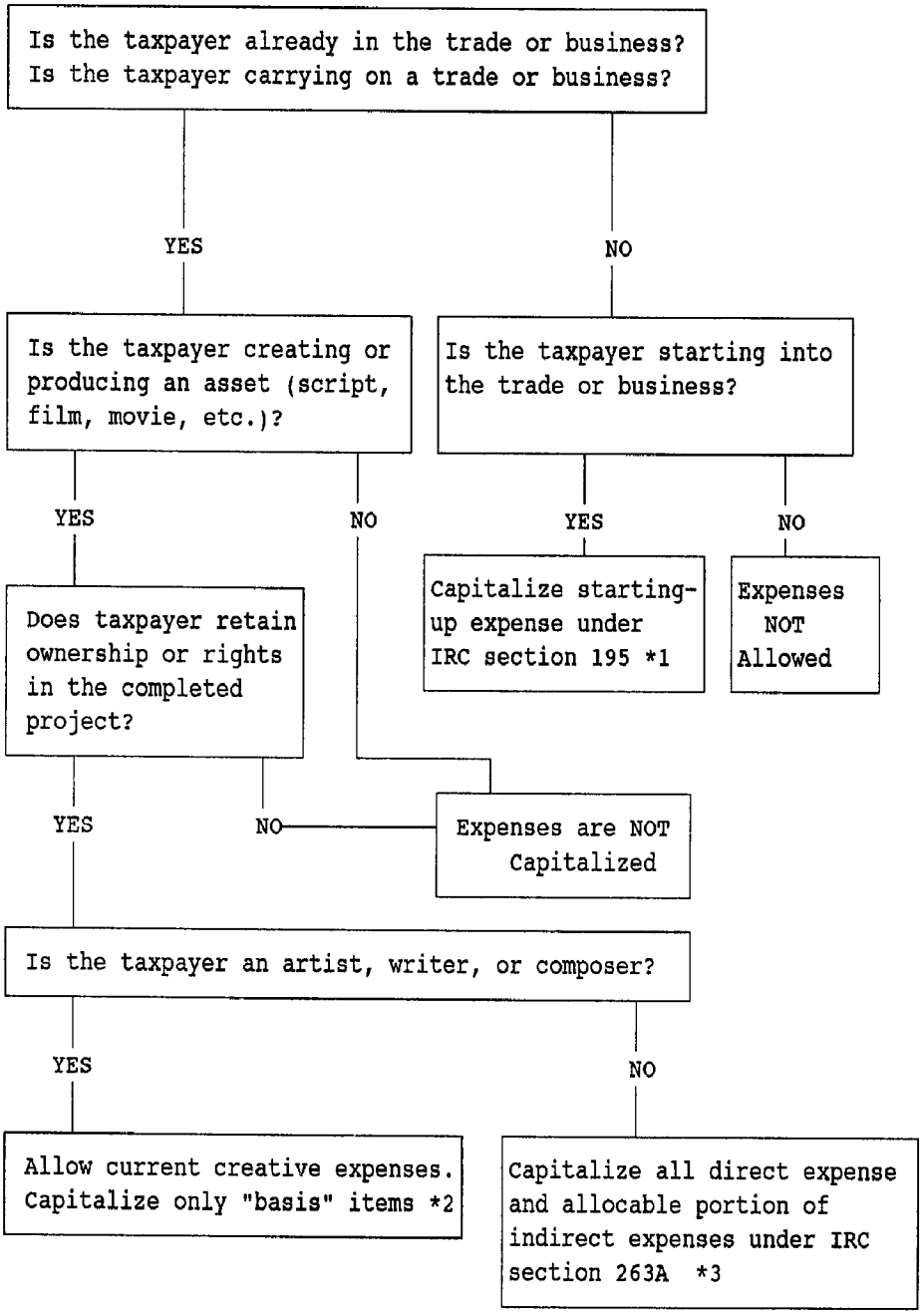
A forecast of income can be revised at the end of each taxable period, based on additional information. For this computation, merchandising receipts are not included. The basic computation for this method is:

$$\frac{\text{Revenue Received for Taxable Year}}{\text{Forecasted Total Income to be Received}} \times \text{Cost of the Film}$$

Abandonment

As with any other business venture, if a project is abandoned, the taxpayer can claim a deduction for the unrecovered basis. Abandonment requires that the taxpayer show an intent to abandon and makes an affirmative act of abandonment in such a manner that the asset is not retrievable. Putting a script on the shelf for a while, with the possibility of selling it at a later date, is not abandoning it. Merely not attempting to exhibit a film is not abandoning it, since it may still be exploited in the future.

SIMPLIFIED FLOW CHART FOR CAPITALIZATION



NOTES:

*1 Include all expenses that would have been allowed if the taxpayer were in a trade or business except for interest (IRC section 163) and taxes (IRC section 164).

The taxpayer may elect to recover these costs over a 60 month period beginning in the first year in which the taxpayer is actually in the business. This election must be made by the due date (including extensions) of the return for the first year in the business.

*2 Qualified creative expenses include trade or business expenses (IRC section 162) incurred in the activity of being a writer, artist, photographer, or composer. These expenses do NOT include expenses incurred to produce motion pictures, video tapes, sound recordings, or similar items. Therefore, a "writer" may have some expenses allowable and others capitalized if the writer is also involved in pre-production (budgeting, casting, etc.), for the production of a movie from the screenplay being written. A composer may have qualified creative expense and also incur production expenses for preparing to record (or for recording) the music as it is composed.

*3 Do Not Capitalize:

-- marketing and selling expenses such as copying, distribution contract negotiation, promotion expense, and advertising.

-- bidding expenses for contracts not obtained (job search).

-- administrative or general expenses not related to a particular production activity.

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Chapter 5

PASSIVE ACTIVITY ISSUES

INTERNAL REVENUE CODE SECTION 469

The passive loss rules of IRC section 469 impact on entertainment industry cases in several ways:

1. Rentals of equipment to studios, production teams, etc.

2. Characterizing royalties as passive income so that they are offset by otherwise non-deductible passive losses.

3. Claiming losses from entertainment or other activities in which the taxpayer does not materially participate.

Under IRC section 469, a taxpayer is not allowed to offset any personal service or portfolio income with losses from passive activities. A passive activity is any rental activity and any activity in which the taxpayer does not materially participate. To materially participate, the taxpayer must be involved in the day-to-day operations of the activity on a regular, continuous, and substantial manner. Under the regulations for IRC section 469, the taxpayer usually must participate in the activity for more than 500 hours. If his or her participation is less than 500 hours, he or she must either participate for more than 100 hours and either do substantially all the work in the activity or do more than any other person. (See Treas. Reg. section 469-5T(a) for the specific tests in determining material participation. Also see Exhibit 5-1, "Material Participation Flowchart.")

RENTALS OF EQUIPMENT

Identifying the Issue

In the entertainment industry, often we see many persons (stunt persons, lighting specialists, props persons, etc.) involved in productions who own and use their own equipment as part of their job. Along with their services, the studios contract with these persons to rent this equipment for periods of time as short as one day or as long as the duration of the production. The lessors of the equipment then mix the income and expenses of this rental activity with the income and expenses of their personal service activity on a Schedule C. In other instances, the rental activity is reflected on the Schedule E as a rental, but the taxpayer claims the losses as part of the $25,000

rental real estate allowance.

Law

Under IRC section 469, any rental activity is automatically defined as a passive activity, regardless of the taxpayer's participation. To be considered a rental under this section, the average period of customer use must be greater than 7 days. If the average period of customer use is 7 days or less, the activity is not considered a rental, and regular material participation rules must be used to determine if the activity is a passive one to the taxpayer.

In addition, the gross rents received from the activity must be more than 20 percent of the total gross income, from both the personal service portion and the rental portion of the contract. If the gross rents received is less than 20 percent, the entire activity is considered a personal service activity. Alternatively, if the gross rents received from the activity exceed 80 percent, the entire activity will be considered a rental activity.

Audit Techniques

1. Inspect the contract(s) with the lessee (studio, production crew, etc.). Determine the average period of rental use for the equipment. Look to the intent of the contract. For example, if a studio rents a prop for the duration of filming a movie, but the payment is computed and paid on a weekly basis, the period of use is the length of filming, not one week. If the equipment is typically rented out for only a day or two, the activity is not a rental and should be considered a regular trade or business activity. If the equipment is typically rented out for more than 7 days, the activity is a rental, and must be separately considered.

2. Compare the gross rents received to the compensation for personal services on the same contract. If the gross rents received is greater than 20 percent of the total of the two amounts, the activities must be divided into a rental portion and a personal service portion.

3. Separate the income and expenses into two activities -- rental versus personal service. Remember to allocate those expenses properly associated with the rental (depreciation, repairs, transportation, etc.) to the rental and those properly associated with the personal service activity to that activity. Audit the income and expenses as you normally would using IRC sections 61 and 162.

4. Compute any passive loss limitation on the rental activity. Remember that the

taxpayer is generally renting equipment (personal property) rather than real estate (real property), any losses incurred from this activity are not eligible for the $25,000 real estate rental allowance.

ROYALTY INCOME

Identifying the Issue

Artists and performers often receive current payments for services rendered in past years. These are commonly referred to as royalties or residuals. Sometimes these amounts are reported on the Schedule E as "royalties," and at other times they appear on theSchedule C, with expenses written off against the income. If on the Schedule E, the taxpayers will tend to net this income with rental losses, or with other partnership or S-Corporation losses.

Alternatively, some persons in the entertainment industry (such as executive producers or others) may receive residual payments from use of productions in which they were only an investor. These payments should be reported on the Schedule E.

Law

Taxpayers are only allowed to offset passive income with passive losses. They cannot use passive losses to offset other types of income (active or portfolio). Under IRC section 469, any compensation received for personal services (even for personal services rendered in past years) is not passive income.

Compensation received from an activity in which the taxpayer did not materially participate, however, is passive and can be offset by other passive losses.

Audit Techniques

1. Determine the nature and source of the payments received. If the payments are for activities in which the taxpayer was a material participant, then they are not allowed to be offset by passive losses. If the source of the payment is an activity in which the taxpayer was a passive investor, the income (and any related expenses) are passive items.

2. Recompute the passive loss limitation.

OTHER ACTIVITIES

Identifying the Issues

Successful entertainers, producers, editors, etc., often invest their disposable income in other, unrelated business activities. Sometimes these "business activities" closely approximate a hobby such as race horses, cattle ranches, etc. (These should be questioned under the provisions of IRC section 183.) At other times, the investments are in those activities which are intended to be used to decrease taxes paid by the taxpayer, without incurring significant risks. The entertainment professional is usually very involved in the entertainment industry. He or she may be away from home for long periods of time filming and/or performing, and is generally not able to participate in the other investments. In addition, the entertainment professional often has a business manager who makes all business decisions for him or her, including whether or not to make additional investments. Because of the unique time requirements of a profession in the entertainment industry, often these other business activities (partnerships, S-Corporations, Schedule C's, or Schedule F's) are likely to be passive activities for the taxpayer; and, any overall losses should be appropriately limited.

Other persons may be investors in the various business activities of the entertainment industry and may be classifying these activities as nonpassive. A minority producer or silent investor, for example, may have invested significant amounts of capital in a production, but may have little to do with the day-to-day decisions necessary to complete the activity. These persons may be experienced with financing transactions but have no real experience or knowledge in the entertainment field. Even if knowledgable, they may be fully engaged in other professions from which they earn the funds to invest in the entertainment industry.

Law

IRC section 469(a) disallows (suspends) any overall losses from passive activities of the taxpayer. A passive activity is a trade or business activity (not a hobby) in which the taxpayer materially participates. (See the above and Exhibit 5-1 for tests of material participation.) The rules apply regardless of how the taxpayer owns the business (whether as a Schedule C or F activity, a partnership, or S-Corporation).

Audit Techniques

1. Determine what the activity does and how the taxpayer/entertainment professional is participating.

2. If the activity appears to be in the nature of a hobby, pursue the IRC section 183 issue first. If we can establish that the activity is a hobby rather than a true trade

or business, the losses are disallowed permanently. If the taxpayer meets enough of the requirements in the regulations to call the activity a true trade or business, consider IRC section 469 next.

3. Determine if the taxpayer is materially participating in the activity. (See Treas. Reg. section 1.469-5T(a) for the criteria), Treas. Reg, section 1.469-5T(d) allows the taxpayer to use any reasonable means to substantiate his or her participation, including diaries, log books, or narrative summaries. The narrative summary must be substantiated using some reasonable means, however, not just some unsupported statements.

   When considering these facts, use all the data you have already determined about the taxpayer's travel, life-style, schedule, personal interests, etc. Ask additional questions about their statements concerning their participation. For example:

   a. If the taxpayer was busy making two or three movies or performing during the year at distant or foreign locations, how can they be materially participating in an unrelated partnership near their home?

   b. If the taxpayer's life-style typically involves many late nights or other activities which take up long hours each day (such as filming a weekly or daily television show), what time is there left over to devote to other business activities?

   c. If the taxpayer hires many specialists to make all the decisions concerning the activity (such as breeders and trainers for horse racing activities), what is the taxpayer doing?

   d. What personal knowledge do they have about the prudent operation of the activity? (For example, if they own a cattle ranch, what do they know about ranching? What experience do they have in this business?)

   e. How can they be putting in 500 hours in many different activities, including their primary profession? Remember, full-time employment during a year is generally 2080 hours.

   f. What role does the business manager play in the operations of the other activity? The participation of the taxpayer's spouse will be counted as his or her participation, but not the participation of any other family member or his or her business manager.

Often the taxpayer's representative will not be able to fully answer your questions about how the taxpayer spends time. If the representative cannot fully and clearly respond to these questions, an interview with the taxpayer may be necessary.

4. If the taxpayer cannot establish that he or she has materially participated in the other trade or business, the activity should be classified as passive. If there are losses flowing from this passive activity to the return, the allowable passive loss, if any, must be recomputed.

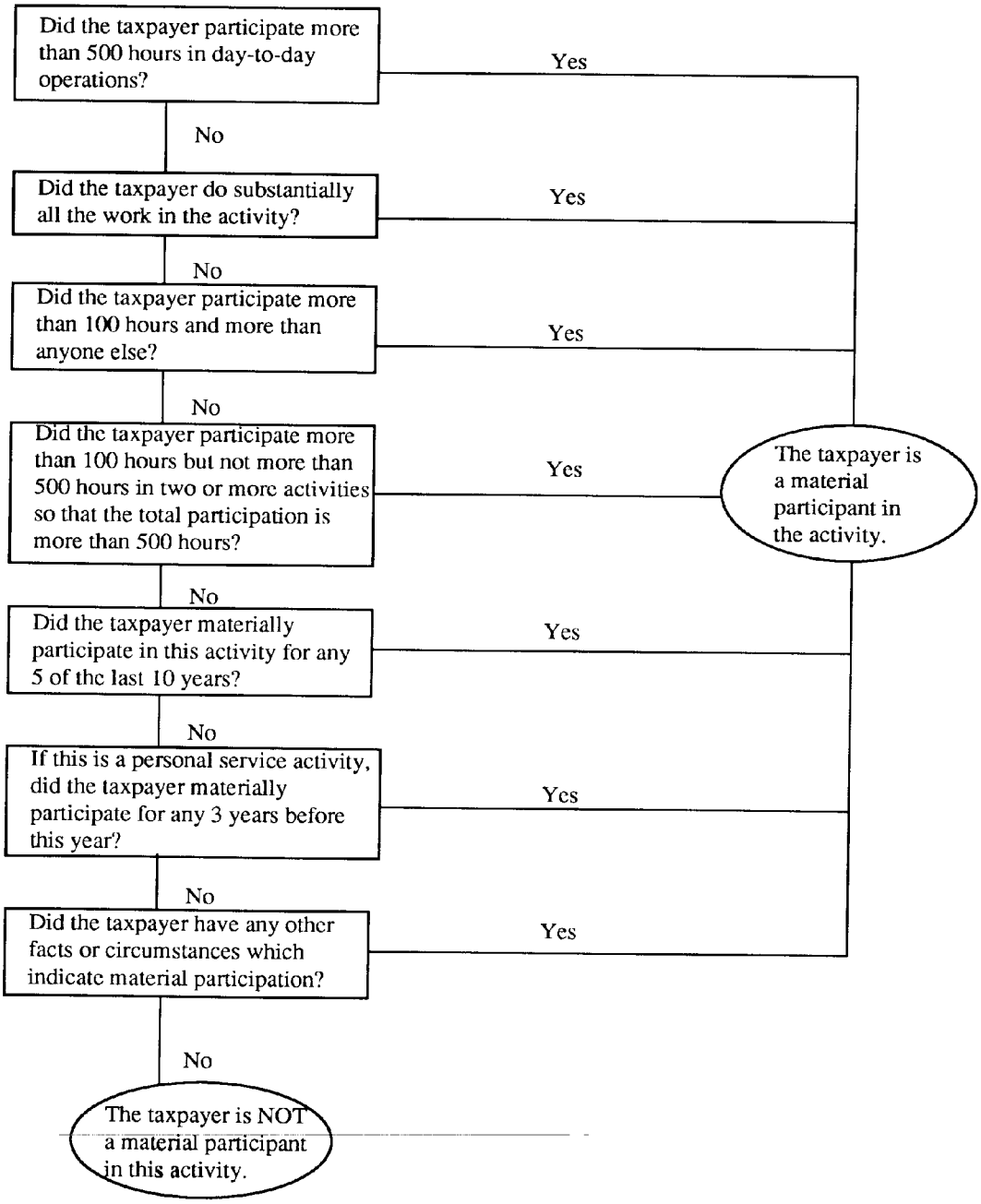
5. For taxpayers who are investors in entertainment businesses (minority producers, silent investors, etc.), is the taxpayer materially participating in the business, or simply investing capital. When participation for these persons is considered, remember that they should be in activities that involve day-to-day operations of the business. Merely visiting the set to "see how things are going" does not constitute participation. In addition, merely reviewing financial reports or statements, or compiling financial data about operations for one's own use is an investor activity and will not count as participation. The participation must be "substantial" and bona fide, not merely as an interested investor.

CONCLUSION

The rules of IRC section 469 can be encountered in entertainment cases in a variety of ways. The ones stated here are most common, but are, by no means, all inclusive. If a question concerning passive loss limitations is encountered, and the answer is not clear, research the issue further or seek other technical advice. Also see the Passive Activity Loss Audit Techniques Guide - Training

Exhibit 5-1

Materials Participation Flowchart



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Chapter 6

TRAVEL AND TRANSPORTATION ISSUES

GENERAL

Travel and transportation expenses can be incurred in all of the profit generating activities for taxpayers in the entertainment industry. In determining the allowable deduction, it is necessary to distinguish between travel and transportation expenses. Travel expense generally includes expenses while away from home overnight. Transportation is generally the expense of locomotion within the general vicinity of the taxpayer's regular place of business.

TRAVEL

Travel and mileage can be incurred in all three of the profit generating activities for taxpayers in the entertainment industry (performing, job search, and maintaining skills). Because of the nature of the industry, often the first step necessary to establish travel expense is to establish the taxpayer's tax home.

Tax Home

Generally, an individual's tax home is the general area or entire city in which the business is located. The location of the taxpayer's family home does not matter. In some instances, a taxpayer may be considered as traveling away from home even while working in the city in which that individual and his or her family live.

Revenue Rulings 60-189 and 73-529 provides that, generally, a taxpayer's "home," for purposes of IRC section 162(a), is the taxpayer's regular or principal place of business, without regard to the location of the taxpayer's residence.

A taxpayer's principal place of business encompasses the entire city, or general area, in which the TAXPAYER most frequently works.

If the TAXPAYER works in two or more locations in the tax year, the guidelines for determining which location is the taxpayer's tax home are:

1. Total time spent in each area.

2. Degree of business activity in each area.

3. Relative amount of income per area.

The fact that a taxpayer's business is of such a nature that he or she has no principal place of business will not preclude TAXPAYER from having a tax home at the taxpayer's regular "place of abode." There are three objective factors, set forth in Revenue Ruling 73-529, used to determine (with respect to the tax year) whether the claimed abode is "his regular place of abode in a real and substantial sense." These factors are:

1. The taxpayer performs a portion of his or her business in the vicinity of the claimed abode and at the same time uses the claimed abode for lodging.

2. The taxpayer's living expenses at the claimed abode are duplicated because of business necessitated absence.

3. The taxpayer either

    a. has not abandoned the vicinity on which both his or her historical place of lodging and claimed abode are located.

    b. has family members currently residing at the claimed abode.

    c. uses the claimed abode frequently for lodging.

If all three objective factors are satisfied, the service will recognize the taxpayer's "tax home" to be at the claimed abode.

If two of the three objective factors are satisfied, all the facts and circumstances must be "subjected to close scrutiny" to determine whether the TAXPAYER has a tax home or is an itinerant.

If a TAXPAYER fails to satisfy at least two of the three objective factors he or she will be regarded as an itinerant who has his "home" wherever he or she happens to work, and thus, cannot be "away from home" for purposes of IRC section 162(a).

Employment Related Travel

Travel incurred while the taxpayer is gainfully employed may or may not be reimbursed. It is up to the taxpayer to prove the job involved a non-union and possibly a non-reimbursement employment situation. (See Chapter 1, the Reimbursement section.) If there is no reimbursement available and it was necessary to travel or incur mileage to a location that was not the principal work site, the taxpayer is probably entitled to a travel or car expense.

If the taxpayer is a member of a guild or union, he or she is probably entitled to reimbursement, per most union contracts. The terms of reimbursement may be researched to determine the amount of reimbursement available. In general however, it is up to the taxpayer to prove that reimbursement was not available for each job.

Domestic Travel

When a taxpayer incurs travel within the United States, after verifying that the travel will qualify under IRC section 162 as business related, it is necessary to determine the amount of the expense that is allowable. For domestic travel, the cost of traveling to and from the business location will be allowed in full, if the primary purpose of the travel is business. Lodging and meals will be allowed for business related days. If the taxpayer makes additional stops at other locations, it is necessary to determine which of the locations and days are business and which are personal.

Foreign Travel

Travel outside the United States must also be shown to meet the business relationship requirements of IRC section 162. However, once shown to be allowable under IRC section 162, additional restrictions apply. The primary purpose test applied to domestic travel does not generally apply to foreign travel. Not only must the lodging and meals be limited to business days, but the basic cost of traveling to and from the foreign location must be allocated based on the number of bona fide business days, and the total number of days in foreign travel status.

TRANSPORTATION

As with any other business, some taxpayers may incur deductible transportation expenses in the course of their business. The same substantiation rules apply to people in the entertainment industry as to any other taxpayers.

Commuting expense is not deductible even though it is ordinary and necessary. Even where the taxpayer goes back and forth from home more than once a day (as an actor might have to do), the expense of the commute does not become deductible. O'Hare v. Commissioner, 54 T. C. 874 (1970); Sheldon v. Commissioner, 50 T.C. 24 (1968).

The exception to this rule is where the taxpayer's home is her or his principal place of business; in that case travel to and from home would no longer be "commuting" and could thus be deductible. See Curpher v. Commissioner, 73 T.C. 766,777-78 (1980). (But see office in the home to determine if the taxpayer qualifies.)

Many taxpayers in the entertainment industry have many short term jobs. The usual claim is that these are all temporary jobs; and therefore, "temporary job sites." When

the taxpayer has no "regular business location" the entire local commuting area is his or her regular business location and transportation to any place in that area is commuting.

Taxpayers who must travel from one business location to another are entitled to the expense of going between job sites. Producers often provide a bus for cast and crew to nearby locations but some may prefer to drive themselves. Where an employer has made a benefit available to the taxpayer, but the taxpayer prefers to use his or her own, there is no deduction. Kessler v. Commissioner, T.C. Memo 1985-254.

Taxpayers in the entertainment industry are entitled to a deduction for mileage incurred while searching for employment. They must comply with the rules of IRC section 274(d) in order to qualify for the deduction. This is especially true for travel incurred while trying to promote one's self. The use of historical success will also be of importance when considering the allowance of such travel. The taxpayer must prove that in the past there has been a measure of success while travelling to promote himself or herself. A narrative may be a good start.

Auditions are a common reason taxpayers who perform in the entertainment industry incur travel and mileage. These expenses should be timely documented. Sign-in sheets are commonly used at auditions. This should be requested if there is some doubt as to the legitimacy of the documentation presented. Usually if this expense is well documented, the taxpayer is entitled to the deduction.

Continuing education is common in the entertainment industry. Taxpayers are usually allowed applicable car expenses for qualified education expenses. See Chapter 7, the Educational and Research Expense section.

Chapter 7

RECORDKEEPING ISSUES

MEALS, ENTERTAINMENT, AND GIFTS

Generally, taxpayers in the entertainment industry may be entitled to deduct expenses for business meals, entertainment, and gifts. Once the expense has been shown to be ordinary and necessary, in the taxpayer's business, the specific recordkeeping requirements must be met.

Meals and Entertainment

To deduct meals and entertainment expenses, the taxpayer must first establish that the expenses are ordinary and necessary to his or her business or profession. The taxpayer must also meet the requirements of the substantiation rules of IRC section 274. Taxpayers can only deduct 80 percent of the allowed expense (50 percent for tax years beginning after 1993). If the expense is for job hunting, it is subject to 2 percent of adjusted gross income. An entertainment expense will qualify for deduction if it is incurred with the intent to obtain specific business benefit, and it is customary in the taxpayer's trade or business and not lavish or extravagant.

Gifts

Taxpayers must show that the gift was ordinary and necessary to their profession. Taxpayers must further show the following elements:

1. Cost of the gift

2. Date of the gift

3. Description of the gift

4. Business purpose or reason for the gift, or nature of business benefit expected to be derived as a result of the gift.

5. Occupation or other information relating to the recipient of the gift, including name, title, or other description sufficient to establish a business relationship to the taxpayer. In addition to the elements to be proved, the law limits the deduction to $25 per person per year. This limit does not apply to any item for general distribution which costs less than $4 and has the giver's name imprinted on it.

EDUCATIONAL AND RESEARCH EXPENSES

Continuing education may be deductible by taxpayers in the entertainment industry. Qualifying expenses include books, supplies, tuition, and applicable car expense. The course must directly relate to the taxpayer's trade or business and must not qualify the taxpayer for a higher or different position.

It is in this area that taxpayers often attempt to justify viewing movies and videos without meeting the requirement of IRC section 274. (For more on "viewing" see Chapter 8, "Keeping Current.")

In an effort to maintain or improve skills, stunt-persons claim a number of unusual expenses. Some of the larger items claimed include the cost of owning and maintaining airplanes, motorcycles, and horses. Taxpayers' claims that their expenditures on these items are business-related may arguably have a germ of truth; but, these items also present so great an opportunity for abuse that they merit careful scrutiny of the particular facts and circumstances of each case.

Not only must these expenses be shown as IRC section 162 expenses, they generally fall under the requirements of IRC section 280F as listed property and, consequently, IRC section 274. Under IRC section 280F(d)(3), an employee can get the tax benefits of "listed property" only to the extent it can be shown that the property was:

1. used for the convenience of the employer, and

2. was required as a condition of his employment

Instead of IRC section 162, the taxpayer may invoke IRC section 212, contending that the plane, car, or house was "income producing property," the upkeep of which is deductible under IRC section 212. Ask for history of the income earned by this property, (presumably rentals). The taxpayer's argument that the property was held for the production of income is subject to a IRC section 183 -- type analysis, to make sure the ownership was, in fact, profit-motivated.

Research expense is incurred for a variety of reasons. If a taxpayer is incurring the expense for a specific project, there must be sufficient documentation to trace the expense to that project. If there is no reasonable expectation of income being produced on that project for the current tax year, the expense should be capitalized. If the research is in anticipation of specific employment, there should be sufficient evidence presented to show the expectation or possibility of employment. In all cases, the expense must be ordinary, necessary, and reasonable.

Some representatives attempt to avoid capitalization of "research" expenses under IRC

section 174. This is not a valid position. Treas. Reg. section 1.174-2(a) provides that the term "research or experimental expenditures," as used in IRC section 174, means expenditures incurred in connection with a taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The regulation further provides that the term does not include expenditures paid or incurred for research in connection with literary, historical, or similar projects.

TELECOMMUNICATION EXPENSE

This deduction is common among taxpayers in the entertainment industry. The expense must be ordinary and necessary to the taxpayer's trade or business. More specifically, it must be necessary, which will be the key to allowability.

To determine the allowable deduction amount, the taxpayer must show specifically how the allocation was derived. A general verbal explanation is not sufficient. Specific allocation through monthly sampling would probably be the best technique.

Answering services are usually allowable in full. Car phones should only be allowed for those trades or businesses in which the income potential depends heavily on prompt communication. Cellular telephones placed in service after 1989 are considered "listed property" under IRC section 280F. Therefore, MACRS will only be allowed if the cellular phone is used more that 50 percent for qualified business use (7-year property). If the business use is 50 percent or less, alternative MACRS must be used (straight-line over a 10-year period). As listed property, cellular phones are also subject to the recordkeeping and substantiation requirements of IRC section 274(d).

Telephone expense incurred on behalf of an employer must be required by that employer. In general, most productions do not require performers to use a phone for most of the work that a production entails.

If the expense is incurred for job search, the taxpayer must document which calls are business calls.

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Chapter 8

PERSONAL EXPENSE ISSUES

KEEPING CURRENT

Entertainers have been known to make a convincing argument about how much they have to spend to "stay on top" or keep current; nevertheless, most of these items typically overlap too much with personal expenses to constitute business deductions. Use the chart in Figure 8-1 to determine if a deduction would be allowed.

Cable TV

Taxpayers in the entertainment industry often try to deduct amounts paid for cable TV. They must be able to show how cable TV, as a whole, specifically benefits their employment. IRC section 274 places strict limits on deductions for items which are "generally considered to constitute amusement, entertainment, or recreation." Such items are thus deductible only where there is a clear tie to particular work.

Cable TV may also be deducted as an educational tool. To qualify as an educational tool, it must directly benefit the taxpayer's trade or business. This must be shown through written documentation. In addition to the recordkeeping requirements of IRC section 274(a), there should be some note-taking showing exactly what educational benefit was achieved. This may take any form that is reasonable for the particular event. The easier it is to trace the expense to a particular event or class, the better the chances of an allowable deduction.

If the taxpayer has a spouse or children in the household, their personal use of the cable TV should also be considered in determining any allowable deduction.

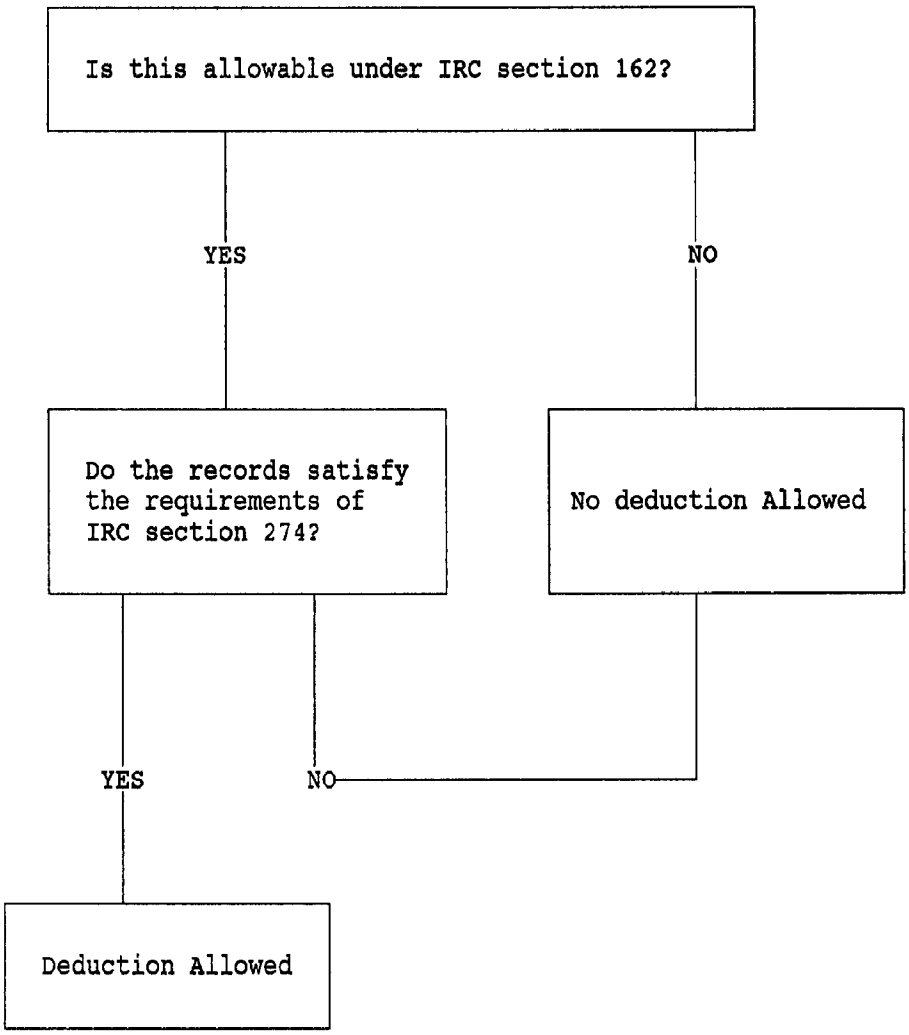
Movies and Theatre

The same situation exists for movies and theatre. Movies and theatre are deducted as entertainment or education. Either way, the same documentation requirements exist. THE TAXPAYER must specifically identify how the movie or play directly applied to his or her career at the time through the appropriate documentation. Even where a deduction for a particular event is allowed, such as a theatre ticket to a certain play to research an upcoming film role, only one ticket would generally be deductible.

Writers Guild, Directors Guild, and various professional groups offer regular screenings of new releases to members; thus, membership fees paid by the taxpayer

may already cover at least some of these "necessary" expenses. Members of the American Film Institute (AFI)and various other organizations receive free passes to the cinemas. Thus, it cannot be assumed that all tickets represent an actual cash outlay.

Figure 8-1



APPEARANCE AND IMAGE

Taxpayers in the entertainment industry sometimes incur unusually high expenses to maintain an image. These expenses are frequently related to the individual's appearance in the form of clothing, make-up, and physical fitness. Other expenses in this area include bodyguards and limousines. These are generally found to be personal expenses as the inherently personal nature of the expense and the personal benefit far outweigh any potential business benefit.

No deduction is allowed for wardrobe, general make-up, or hair styles for auditions, job interviews, or "to maintain an image."

Wardrobe

To deduct clothes as a business expense, two requirements must be met. First, the clothes must be required by the employer. Second, clothes must not be adaptable to street or general use.

Expenses for costumes and "period" clothing are generally deductible. However, most union contracts provide for compensation to be given performers who require special wear. The taxpayer must prove that his or her contract did not include such reimbursement for the expense to be allowable.

Make-up

Make-up for performances is usually provided by the studio. Stage make-up that the taxpayer buys for an audition or a live theatrical performance may be deductible, if it is not a general over-the-counter product.

Physical Fitness

Deductions for general physical fitness are not allowable. Usually, if physical fitness is required of a specific job, the studio will provide the cost. If the taxpayer was employed in a capacity that required physical conditioning, allow expenses for the duration of employment if no reimbursement or compensation was available.

Security

Physical security is also too personal an item to be deducted, unless there is a clear business-related aspect to the service; for example, to control fans or papparazzi during a star's personal appearance (but for such occasions, the producer of the event would probably bear those costs).

Bodyguards and home security are deemed to be personal expenses. The fact that the taxpayer is in a high profile profession is still a matter of personal choice and does not convert a personal security expense into a business expense. The expense does nothing to increase the income of the taxpayer and provides a personal benefit of "peace of mind."

Chapter 9

OTHER ISSUES

OFFICE IN THE HOME

In the entertainment industry the issue of home office frequently arises. Taxpayers usually claim their home office is used for keeping records, making telephone contacts, rehearsing, and a myriad of clerical chores. While this may well be true, the issue of allowability remains.

IRC section 280A severely restricts the deduction for office in the home. The office must be used on a regular basis and exclusively for business. Regular use means on a continuing basis, not just occasionally. In the entertainment industry regular use is not generally a problem.

Exclusive use means that the area that serves as an office must be a distinguishable area used only for qualified business use. Moreover, all use of the office must be qualified use. (See multiple businesses.)

Qualified business use must be one of the following:

1. As the principal place of business

2. As a place to meet with patients, clients, or customers

3. A separate structure not attached to the dwelling unit.

4. A designated storage space for inventory in the trade or business of selling products at retail or wholesale.

Principal Place of Business

The most frequently heard of the above three arguments, in the entertainment industry, is the principal place of business. In Soliman v. Commissioner, 113 S.Ct. 701 (1993), the taxpayer claimed a home office for administrative duties essential to his practice. IRS's position was that the income the taxpayer received was for services performed at another site; and, therefore, the home office was not the principal place of business. The Supreme Court held that only when the more essential aspects of the taxpayer's work are performed in the home office may the taxpayer deduct the cost of a office in the home.

For entertainers, most of whom mainly perform in clubs, theaters, etc., this effectively eliminates any home office deduction.

For designers, technicians, and others, there may still be a deduction, in certain cases; for example, freelance special effects creator whose workshop or studio is in his or her home.

For musicians, the principal place of employment is where the performance occurs, not the home practice area.

Employees

As with any industry, an employee will only be able to deduct office in the home when all requirements are met and the home office is required by and for the convenience of the employer.

Personal Service Corporation

Individuals who have formed a personal service (C) corporation may still deduct business use of their home, but the creation of the corporate entity would give rise to separate issues, for example, the corporation would have to rent the premises from the taxpayer. This may, in turn, give rise to passive activity loss limitations for the rental activity. (See Chapter 5, Passive Activities.)

Multiple Business Activities

When a taxpayer has multiple business activities, all of the activities for which the office is used must meet the qualifications. If any of the activities uses the home office and does not meet the requirements, the exclusive use test is not met and no deduction is allowed.

This position was upheld by the Tax Court, in *Hamacher*, 94 T.C. No. 21. The taxpayer was an actor who performed on stage, screen, and radio as an independent contractor. He was also employed at one theater as an acting instructor and administrator. His employer provided him with an office at the theater, but the taxpayer also set up an office in his home. The home office was used in connection with both his employment and his self-employed activities.

The Tax Court found that the employer did not require the taxpayer to do any work at home. The home office may have been helpful but was not for the convenience of the employer. It was not necessary for the court to determine if the home office would have qualified solely in conjunction with the taxpayer's self-employment. Since the use with regard to the taxpayer's employment was not qualified, the exclusive use test was

not met and no office in the home deduction was allowed.

In addition to the obvious expense for office in the home, this issue has impact on the allowability of business mileage for what would otherwise be commuting expense.

EMPLOYMENT TAX

Many taxpayers in the entertainment industry make payments in the course of their business for services performed by others. It is necessary to determine whether the service provider is an employee of the taxpayer or an independent contractor. The first step is to find out what service was performed. If an actor pays a publicist, there is usually no employer-employee relationship. If a producer hires a secretary or an assistant, there is a greater probability of an employer-employee relationship.

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification--independent contractor or employee--can be a valid and appropriate business choice. For an in-depth discussion, see the training materials on determining employment status. "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96) TPDS 84238I. The training materials are also available from the IRS Home Page (http://www.irs.ustreas.gov).

The first step in any case involving worker classification is to consider section 530. Section 530 of the Revenue Act of 1978 was enacted by Congress to provide relief to certain taxpayers who had acted in good faith in classifying their workers from the potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. The statute is a relief provision and provides an alternative method by which to avoid employment tax liability where a taxpayer cannot establish his workers are or were independent contractors.

In order to qualify for section 530 relief, the business must meet consistency and reasonable basis tests. The consistency test requires that the business has filed all required Forms 1099 with respect to the worker for the period, on a basis consistent with treatment of the worker as not being an employee (reporting consistency); and that the business has treated all workers in similar positions the same (substantive consistency).

Under the reasonable basis test, the business must have had some reasonable basis for not treating the worker as an employee. There are three "safe harbors" that form the basis for an objective reasonable basis standard under section 530. These safe harbors are: (1) judicial precedent, published rulings, technical advice to the taxpayer or a letter ruling to the taxpayer; (2) a past favorable IRS audit on the same issue; and (3)

long-standing, recognized practice of a significant segment of the industry in which the individual was engaged. A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee.

Before or at the beginning of any audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of section 530. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's, not the worker's employment tax liability and any interest or penalties attributable to the liability for employment taxes.

Guides for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

The regulations provide that, generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. The examiner will need to weigh the facts and circumstances of each case and determine worker status accordingly.

The training materials provide more information on the method of analysis used in determining employment status. They explain the kinds of facts to be considered, including those evidencing behavioral control, those evidencing financial control, and those evidencing the relationship of the parties.

Domestic Employees

Many taxpayers in the entertainment industry employ the services of domestic workers for either personal reasons or to maintain an image. This is a personal expense and not an allowable business deduction. Domestic service in the taxpayer's home includes for such service that equals or exceeds $50 in a calendar quarter. The Form 942 is used to to report the social security and Medicare taxes (FICA) and may also include income tax withholding. Any applicable FUTA taxes due are reported on a Form 940.

A new employer may obtain an identification number by filing a Form SS-4. If a number has not been obtained before the audit, one can be obtained by the auditor, by calling the service center.

ACTIVITIES NOT ENGAGED IN FOR PROFIT

It is common in the entertainment industry for "creative people" to be driven by strong compulsions for personal recognition and a passion for artistic expression. These are strong motivating factors which have little or no bearing on whether or not a profit is realized. IRC section 183 limits expenses related to activities which are not engaged in for profit. This provision effectively eliminates losses from these activities. If the taxpayer is showing losses in multiple tax years, this provision should be considered. Auditors are advised to be reasonable in deciding when to apply this provision.

The Nine Factors

There are nine areas to consider when making the determination as to whether an activity is engaged in for profit. The nine factors, as addressed in Treasury Regulation 1.183-2(b), are:

1. Manner in Which the Taxpayer Carries on the Activity

    a. What type of books and records are kept?
    b. What changes were made to eliminate losses?
    c. What type of promotion is being used to increase business?

2. The Expertise of the Taxpayer or His or Her Advisors

    a. Reasons for engaging in this business.
    b. Prior experience in this industry or activity.
    c. Preparation for the activity and the accepted business practices.

3. The Time and Effort Expended by the Taxpayer in Carrying on the Activity

    a. Time spent in the activity.
    b. Assistance from others.

4. Expectation That Assets Used in the Activity May Appreciate in Value

5. Success of the Taxpayer in Carrying on Other Similar or Dissimilar Activities

    a. Branching out into related activity.
    b. Making a comeback.

6. The Taxpayer"s History of Income or Losses with Respect to the Activity

    a. How many years has the taxpayer shown losses in the activity?
    b. Are the losses increasing or decreasing?

7. The Amount of Occasional Profits, if any, Which are Earned

    a. Has the taxpayer ever shown a profit from this activity?
    b. How does the amount of the profit compare to the amount of the losses?

8. The Financial Status of the Taxpayer

    a. Other sources of income
    b. Is the activity being used to shelter other income?

9. Elements of Personal Pleasure or Recreation

Audit Techniques

Even if an activity is thought to be one not engaged in for profit, it is still necessary to verify the expenses and develop other issues. To do a quality audit, alternative positions should be developed along with IRC section 183.

The number of years that a taxpayer incurs losses in a particular business is indicative of an activity not engaged in for profit but is not, in and of itself, conclusive. If this provision of the tax law applies to the situation, develop the case fully, addressing all of the relevant factors. Be sure to solicit the taxpayer's views and explanations. The workpapers should include arguments both for and against the conclusion.

JOB SEARCH

Taxpayers in the entertainment industry commonly incur expenses while searching for employment. The allowable deductions in this area are generally the same expenses allowed for any other industry. Commonly allowed expenses include photo-resume, composites, video resumes, demos, and publicity photos. There may also be some unusual self-promotion. The expense must be ordinary, necessary, and reasonable. Make sure the expense relates to the taxpayers' specific trade.

Photo and Video Resumes

Photo and video resumes are generally composites of other work the taxpayer has

done. They are used to show potential employers the taxpayers' skills and versatility. These resumes generally include a reasonable expense for taping, editing, and copying. It is generally expected that they would be reasonable expenses incurred every year.

Demos

In contrast, we have the "demo." Unlike a demo which is shopped to sell a "production" (song, video, etc.), this demo is used to promote the talents of the taxpayer to potential employers. Some of these demos are like full productions in cost and expended effort, except they are not made for sale. When a major expense is incurred to produce "demos," it must be determined if these assets have a useful life of more than one year. These tapes (video or audio) are used for job seeking or marketing the taxpayer and are, therefore, not subject to IRC section 263A. They are, however, IRC section 1231 assets; used in a trade or business, with a useful life of over one year, and of a character which is subject to depreciation under IRC section 167. It is, therefore, necessary to determine the useful life of these demos. This can be done by checking when a replacement demo was produced. By verifying that the demo was actually submitted (or shopped), it may be determined that the demo is still being submitted and has no determinable useful life. Generally audio tapes are used from 1-4 years and videos from 2-5 years. This may vary with the nature and subject matter recorded.

Showcasing

Another way performers try to obtain employment is by "showcasing." This involves staging performances without compensation, or even at a cost to the performer.

Actors, Directors, Producers

Many showcase opportunities exist for actors, directors, and producers to exhibit their skills. Frequently, a producer or other entrepreneur will arrange a production consisting of unrelated one scene performances. The individuals who wish to demonstrate their skills can pay the producer to perform one of the scenes. Depending on the location, expected attendance, and history of success, the cost to the individual actor can run from $35 to $200.

A director may pay for the entire scene and recruit his or her own actors. This generally costs the director up to $1,000. The director may recover some of his or her expenses from the actors or he or she may absorb the cost.

Many acting coaches or teachers highlight each series of workshops with a public performance. The coaches invite directors and producers to attend the performance. These performances are considered another opportunity for the actors to demonstrate

their skills.

Comedians

Similar showcasing opportunities exist in the area of stand-up comedy. Many comedy clubs offer 20 minute to one hour segments for a little or no fee. This usually runs from $50 to $500 depending on the reputation of the club.

Musicians

Showcasing opportunities for musicians can create another source of income. Commonly, musicians are provided an opportunity to perform in a club with only a moderate fee or without a fee. In exchange for performing, the musician is expected to encourage his or her fans to attend the performance. The musician is then entitled to a percentage of the door.

Agents

Some agents are now charging a fee for a performer to audition. These fees are generally around $35. If the performer is successful, the agent will then represent that performer. This is a new development in the entertainment industry and not all agents believe it to be ethical. It is, however, acceptable for the performer to pay these fees to acquire representation or employment.

Audit Techniques

Showcasing expenses can be verified by canceled checks along with contracts, letters of agreement, or other documentary evidence of the arrangement between the performer and the producer or club. In the absence of documentary evidence, a third party contact can verify the nature of the expense and any income received by the performer.

When a performer pays an exceptionally high fee to perform, the probability of the performer receiving a percentage of the door must be considered.

MOVING EXPENSES

Taxpayers can deduct their moving expenses, subject to certain dollar limits, if that move is closely related to the start of work at a new location, and the taxpayer meets the distance test and the time test.

The move will meet the distance test if the taxpayer's new main job location is at least 35 miles farther from his or her former home than the old main job location was. (The

distance increases to 50 miles for expenses incurred after 1993.)

If the taxpayer is an employee, he or she must work full-time for at least 39 weeks during the first 12 months after arriving in the general area of the new job location. The taxpayer does not have to work for the same employer for the 39 weeks. However, the taxpayer must work full-time within the same general commuting area. The 39 weeks do not have to be consecutive. Whether a taxpayer is considered to be employed full-time depends on what is usual for the type of work the taxpayer does. For example, a taxpayer who does voiceover work is considered full-time at 4 hours per day. Actors tend to not meet the 39 week test because their move deals with a short term job, or jobs, or the hope of finding a job. Time between jobs is not counted as part of the 39 weeks, unless it is part of a scheduled break in production and the taxpayer's contract includes continuous employment before and after the break. Only if a hiatus is included per contract, will it be included as part of the required 39 weeks. A move to another region that meets the distance test for greener pastures does not qualify unless the time test is met. There is no exception for actors or other entertainment related professions who were looking for work, but did not find it.

Performers who work many short-term engagements will have to prove all of the jobs within the year together, met the 39 week test. Check the contracts to verify a "hiatus" was scheduled. The performer would be considered "seasonal" per Treas. Reg. section 1.217-2(c)(4)(iv)(a).

Extract

Treas. Reg. section 1.217-2(c)(4)(iv)(a)

Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. Where employment is on a seasonal basis, weeks occurring in the off-season when no work is required or available may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off season period and such period is less than 6 months. * * *

If the taxpayer is self-employed he or she must work full time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months after arriving in the area of the new location. The taxpayer need not be employed in the same trade or business for the 78 weeks.

AGENT FEES AND COMMISSIONS

Fees paid to an agent (artist's representative) are allowable business expenses under

IRC section 162.

Agent fees are usually 10 percent of gross for any jobs secured by the agent. These fees are generally limited to 10 percent by SAG, SEG, etc. Some foreign productions or agents may receive up to 15 percent commissions.

Most performing artists have contracts with their agent or representative, but this is not mandatory. An oral agreement is sometimes used since the rate is standard. Residuals are subject to the 10 percent commission only if they are "over scale." Therefore, minor amounts will not result in fees to agents. When the residuals are subject to agent fees, the commission is paid to the agent who obtained the work, not the agent at the time of the payment. The agent generally does not issue a yearend statement to the performer. This is to avoid any appearance of being the employer. Most payments (wages or fees) which are subject to commissions are paid by the employer directly to the agent. The agent keeps his/her fee and pays the difference to the performer.

Business management fees are not standard. They may vary from 5 to 15 percent of gross or they may be a flat monthly fee. Business management fees are allowable in proportion to the percentage of business use. Many actors have their manager pay all their personal bills and handle their personal business. Facts and circumstances will determine the percentage of business use.

GLOSSARY

TERMS

Advance -- A fee paid to an artist prior to completion of a production to be recovered later out of royalties earned

Artists and Repertoire -- Department of a record company responsible for acquiring new talent

Audition -- A short performance to demonstrate a performer's talent, generally in an attempt to be hired for a production

Best Boy -- Second in command of either electrical operations or camera and lighting movement or placement

Billboard -- A leading trade industry magazine whose "charts" are used extensively in the recording industry

Birch Report -- A radio ratings service

Bootlegging -- The illegal recording of an artist without permission

Box Rent -- Also called Kit Rental. Payments made to individuals for the use of personally owned tools. This term includes make-up kits and supplies, carpenter tools, etc. These payments are generally not included in wages but are separately stated on a Form 1099

Chart -- Listing of recordings according to their relative popularity

Collective Bargaining Agreement -- A negotiated contract between representatives of organized workers and their employers, which determines wages, hours, and working conditions

Copyright -- The right to exclude others from reproducing a literary, musical, dramatic, or artistic work

Counterfeiting - Illegal practice of copying a recording (tape, record, etc.) and selling the copies as originals

Demographic -- A statistical representation of an audience segment

Director -- Supervises and guides the actors in a production

Distributor -- Involved in the marketing of a film product in any of the media including theaters and television

Editor -- Prepares a production for presentation by cutting and combining selected film shots and sound tracks

Emmy -- An achievement award given annually by the American Federation of Television and Radio Artists

Exploitation -- Marketing of a film or talent for profit

Extra -- Performer in a minor role, generally without solo speaking. Also called "atmosphere player"

Free Goods -- Recordings supplied by manufacturers at no charge as an incentive for sales

Gaffer -- Electrician with responsibility for lighting on a set

Grammy -- An achievement award given annually by the National Academy of Recording Arts and Sciences

Grand Rights -- A license issued by a copyright holder through its performing rights organization for use of the copyrighted material in musical drama

Grip -- Stagehand

Guild -- An alliance of persons of the same trade

Key Grip -- Responsible for all functions pertaining to camera movement required on a set

Kit Rental -- See Box Rental

License -- Agreement granting the right to use a copyright owned by the grantor

Location -- Site where picture is shot, other than the studio

Master -- The original finalized film, video, or audio recording, from which copies are made

Needle Drop -- Fee paid to music suppliers for using their music as background

Oscar -- An achievement award given annually by the Academy of Motion Picture Arts and Sciences (AMPAS)

Payola -- Illegal giving or receiving of any gratuity to obtain favorable radio or television airplay. Also refers to the gratuity itself

Producer -- Finances and supervises the overall production of a film, video, audio recording, or live performance

Residuals -- Payments required, to writers, directors, or actors, from rebroadcast, or exploitation in a secondary market, of a recorded production

Royalties -- Payments to an author or composer from the proceeds of a sale or performance of his/her work

Scale -- The minimum fee stated in the union contract for work done in a particular job category

Showcase -- A setting to display a performer's or a director's talent

Union -- An alliance for mutual interest or benefit.

ABBREVIATIONS

AEA Actors Equity Association

AFI American Film Institute

AFM American Federation of Musicians

AFTRA American Federation of Television and Radio Artists

AGVA American Guild of Variety Artists

AICP Association of Independent Commercial Producers, Inc.

AMPAS Academy of Motion Picture Arts and Sciences

ASCAP American Society of Composers, Authors, and Publishers

BMI Broadcast Music Inc.

CMA Country Music Association

DGA Director's Guild of America

GMA Gospel Music Association

IATSE International Alliance of Theatrical and Stage Employees

NAB National Association of Broadcasters

NARAS National Academy of Recording Arts and Sciences

NARM National Association of Record Merchandisers

PGA Producer's Guild of America

RIAA Recording Industry Association of America

SAG Screen Actor's Guild

SEG Screen Extra's Guild (now covered under SAG)

WGA Writer's Guild of America

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ENTERTAINMENT INDUSTRY

Office Audit Guidelines -- Blackletter Law Outline

For taxpayers in the entertainment industry, there are three general areas of activity that are likely to have tax consequences: performing for compensation, searching for work, and maintaining their skills, status, or image.

I. Performing for Compensation

A. Income Issues -- During the background interview, it is important to get a clear idea of the extent of the taxpayer's employment in the entertainment industry during the taxable year in issue. Use Forms W-2 and 1099, as well as information from the taxpayer (diaries, travel logs, etc.) and third party sources where necessary.

1. Trade or Business vs. Hobby -- Not everyone who wants to be employed in show business is able to support himself or herself when doing so. If the taxpayer had a source of income outside the entertainment industry during the year, or claimed expenses disproportionate to his or her entertainment income, there may be an IRC section 183 issue. Dreicer v. Commissioner, 78 T.C. 642 (1982), aff'd without publ. op., 702 F.2d 1205 (D.C. Cir. 1983).

a. Facts and Circumstances Test -- Can the taxpayer show that his or her entertainment activities were really profit motivated? For example, devotion of sufficient time, money, energy? Businesslike approach? Good recordkeeping?

b. IRC section 183 Limits Deductions -- Where IRC section 183 applies, the income is income, but the deductions are not allowable in an amount greater than the year's income from that activity.

c. Case Law Intensely Factual -- For example, Grommers v. Commissioner, T.C. Mem. 1992-343 (taxpayer's "dabbling" in art and antiques was not a profit-motivated activity, where she had substantial other income, maintained a luxurious lifestyle traveling, visiting European auction houses, etc., and consistently operated the "business" at a loss); Cf. Krebs v. Commissioner, T.C. Mem. 1992-154 (wife of theatrical promoter was entitled to deduct expenses of pursuing her singing career, where she had musical expertise, hired professional help, devoted substantial time, effort, money, etc.); See also Sexcius v.

Commissioner, T.C. Mem. 1991-162 (taxpayer's ghostwriting activities did not demonstrate profit motive); Lesher v. Commissioner, T.C. Mem. 1991-162 (Court rejected taxpayer's claims to be a travel writer, where she was employed full-time as a computer programmer and never submitted anything for publication); Rodgers v. Commissioner, T.C. Mem. 1979-128. (Both spouses employed in other occupations but claimed to be entertainers; Court found only the husband was actually in the trade or business of being an entertainer.)

2. **Employee vs. Independent Contractor** -- Everyone seems to agree that this issue is a major problem in the entertainment industry.

   a. **Significance of the Issue** -- The issue of whether a worker is classified as an employee or as an independent contractor is hotly contested for a number of reasons.

      1) **For the employer** -- Treating a worker as an independent contractor means:

         a) There need be no withholding, payment, or reporting of state/Federal income, FICA/FUTA, unemployment taxes, etc. Fringe benefits (for example, pension plan, health insurance) need not be provided.

         b) On the other hand, the consequences of misclassification can be huge: 3 years' back withholding, employee plan adjustments, massive penalties, tort liabilities, etc.

      2) **For the worker** -- Independent contractor status means:

         a) The taxpayer can report on a Schedule C, thereby increasing available deductions (for example, can fully deduct agent's 10 percent), etc.

         b) But the taxpayer also must file and pay estimated tax, self-employment tax.

         c) Also, independent contractor status means no employee benefits, unemployment, or disability coverage.

      3) **For the employer-employee** -- It should also be noted that the determination of an employer-employee relationship may affect other areas of the Federal law. For example, the Supreme Court

held in Nationwide Mutual Insurance Co. v. Darden, 112 S. Ct. 1344 (1992), that the term "employee," as used in the Employee Retirement Income Security Act, incorporates traditional agency law for identifying master-servant relationships.

b. Determination of the Correct Classification -- Despite the wide variety of work relationships that exist in real life, the tax law requires that all workers be classified as one or the other: independent contractor or employee.

1) Statutory Classification -- The Internal Revenue Code provides clear rules for some occupations, for example, corporate officers are invariably employees, IRC sections 3121(d)(1), 3306(i), and 3401(c); "direct sellers" are always independent contractors, IRC section 3508.

2) Common Law Analysis -- Generally, the determination of worker status depends on the common law.

a) Categories use to determine worker classification -- Based on facts and circumstances of each articular case.

(1) Behavioral Control - The right to direct or control the details and means by which the worker performs the required services.

(2) Financial Control - The right to direct or control the economic aspects of the worker’s activities.

(3) Relationship of the Parties - Intent concerning control. The facts and circumstances under which a worker performs services are determinative of a worker’s status.

c. Employee Status is the Norm -- Major studios and many other employers in the entertainment field, preferring not to risk the disastrous conse quences of misclassification, treat almost everyone on the payroll as employees.

1) In Office Audit -- Use Forms W-2 in analysis, matching income sources and amounts with any non-reimbursed employee expenses claimed. (Be sure all non-union employers have complied with payroll rules.)

a) **Where Schedule C Is Not Allowed** -- Some performers simply use a Schedule C even though their income was Form W-2; this must be corrected.

b) **Mixed Income Sources** -- Where the taxpayer had both, a Form W-2 and a Form 1099 income, there may be arguments for and against certain deductions, depending on how they match up with jobs.

c) **"Qualified Performing Artist"** -- Certain low-income entertainers are permitted to deduct their expenses "above the line," that is, for purposes of arriving at AGI. IRCsection 62(a)(2)(B),(b).

2) **Application of Facts and Law** -- Every individual case turns on its own facts.

Barnaba Photographs Corp. v. United States, 178 F.2d 402 (2d Cir. 1949); Rev. Rul. 71-144, 1971-1 C.B. 285. Photographers' models who worked through booking agents, had no continuing relationship with any particular photographer, charged hourly rates, typically furnished their own make-up and wardrobe, and "used their own initiative, ability, and experience in interpreting the roles assigned to them," were not employees of the photographers, despite taking directions, etc., from them.

Rev. Rul. 74-332, 1974-2 C.B. 327. Models who performed services under the agency's name, were not permitted to do free lance modeling, were graduates of the agency's modeling school, and in general functioned only through the agency, were employees of the agency.

Rev. Rul. 68-107, 1968-1 C.B. 427. As circumstances varied, orchestra members could be considered either employees of the nightclub operator, employees of the orchestra leader, or "partners" on a "cooperative" basis.

Rev. Rul. 57-155, 1955-2 C.B. 333. An actor or actress who provided his or her own costume, delivered a few lines from a script, and took technical instructions from the producer was considered an employee; an announcer who took technical instruction from the producer and advice from the client was

also an employee. An artist, who took only suggestions, who supplied his or her own materials and performed his or her work at home, etc., was independent.

Rev. Rul. 68-444, 1968-2 C.B. 468. Newspaper correspondents, over whose work hours the newspaper had no control, and who furnished weekly news items to the paper which the paper could accept and pay for or reject, were not employees of the paper.

Rev. Rul. 74-412, 1974-2 C.B. 332. A professional architect, working on a project-by-project basis for an architectural firm, on the firm's premises, furnished with office, desk, secretary, etc., paid according to time and difficulty of assignment, subject to the firm's supervision, was an employee of the firm.

d. Personal Service ("Loan Out") Corporations (PSC) -- There has been a growing trend among entertainers and others in the industry in recent years toward unjustified use of the corporate device to obtain the benefits of deductions and shelters that would otherwise not be available.

1) Background -- There is a large body of case law on this subject, motivated by evolving tax principles over the years. *Borge v. Commissioner*, 405 F.2d 673 (2d Cir. 1963) cert denied 395 U.S. 933 (1969); *Keller v. United States*, 723 F. 2d 58 (10th Cir. 1983); *Foglesong v. United States*, 691 F. 2d 848 (7th Cir. 1982).

2) Current applicable law -- At the present time, some of the controlling law toconsider in this area may be found in the following authorities.

a) IRC section 482 -- This statute authorizes the Government to re-allocate gross income in order to clearly reflect income among commonly-controlled taxpayers.

b) IRC section 269A -- If a PSC was formed principally to avoid or evade tax, and if the corporation performed services for only one other entity, the IRS is authorized to reallocate income to the artist/shareholder.

c) Rev. Rul. 74-330, 1974-2 C.B. 278, Rev. Rul. 74-331, 1974-2 C.B. 281 -- The "lend-a-star" rulings deal with off shore personal service corporations owned by non-U.S. performers.

d) Common law factors -- The employee versus independent contractor factual analysis is appropriate for personal service corporations in order to determine whether the performer was an employee of his or her corporation or of the producer directly.

e) ***Sargent v. Commissioner***, 929 F. 2d 1252 (8th Cir. 1991); *Nonacq.*, A.O.D., CC-1991-022 (October 22, 1991) -- The Tax Court had held (93 T.C. 572 (1989)) that the hockey teams had paid the players directly and the players' PSCs thus should be ignored, based on assignment of income doctrine and IRC section 482. The eighth circuit reversed, holding the players were employees of their PSCs. IRS has announced non-acquiescence in the appellate decision; we will follow the Tax Court (outside the eighth circuit).

f) Statutory requirements -- Where the performer has a PSC, the producer must file a Form 1099 for compensation paid to the PSC for the performer's services; the PSC must comply with all withholding, reporting, and payment rules with respect to the wages it pays the performer.

3. Residuals, Royalties, Other Income -- Income may be received by entertainers in many different forms.

a. Residuals - Periodic payments received by actors and actresses and others for re-runs of commercials, episodic television, etc.

1) Payor may be a film studio, or one of a few payroll services who do that work.

2) Agents' 10 percent commission is usually charged only where the amount of the residuals is above union scale.

3) Payors typically withhold, file Forms W-2. IRS should therefore have adequate records for cross reference.

b. Royalties, license fees -- Periodic payments received by copyright owners such as songwriters, recording artists, authors, paid by those who perform, exhibit, run, or otherwise distribute copyrighted works for a prescribed time period or purpose.

1) Sources of information -- "Mechanicals" (royalties on music) are tracked by BMI, ASCAP. Records available.

2) Others, such as motion picture studios, television, book publishers -- Publicly available information from library.

c. Fringe benefits, goods for services -- The frequency and variety of advertising and promotion deals in the entertainment industry create many opportunities to pay employees in something other than cash. These items may not always appear on the recipients' Forms 1040, but they should. IRC section 83 (fair market value of property received for services is included in gross income).

1) **Perks** -- Performers sometimes receive wardrobe and other perquisites from producers; for example, they might get to keep their costumes after a film, or they might get a case of the sponsor's product after doing a commercial; an established spokesperson for an automobile usually drives a new one each year.

2) **Merchandise deals** -- Compensation in the broadcasting industry is frequently in the form of merchandise, barter, etc.

3) **Passes** -- Employees of TV, movie studios, record companies, etc., may get free passes to concerts, shows, screenings.

d. Excessive per diem -- Beginning in 1989, if an employer reimburses employee expenses, there must be an "arrangement" requiring the employee to substantiate (per IRC section 274(d)) the expenses and/or return the unsubstantiated portion; where there is no such arrangement in effect, the unsubstantiated portion will be considered income to the employee. IRC section 62(c); Treas. Reg. section 1.62-2(c)(1),-2(e)(2); Rev. Proc. 93-21.

e. Miscellaneous -- Participations, endorsements, product tie-ins, prizes (for example, tractor-pulling, rodeo), foreign source, etc.

f. Unemployment insurance -- Entertainers are often eligible for unemployment compensation between jobs. These payments are included in gross income. IRC section 85.

g. Buy-outs, releases -- Creative individuals sometimes have agreements that pay them when their ideas are not used - "pay-or-play" contracts; also, past performances re-used in excepts, clips and "bloopers" may generate new fees, talent releases, etc.

B. Business Expenses -- This is one of the areas most subject to both abuse and genuine misunderstanding and/or differences of opinion. Even case law can be contradictory.

1. Fact: Most Expenses Are Reimbursed by the Employer -- It's likely that a union contract requires the producer to pay expenses directly or reimburse workers for all expenses connected with the job.

a. No deduction without proof -- Actors who claim they had to buy their own costume, pay their own travel, etc., for a production, should be able to show an employment contract or other confirmation of this requirement.

b. May not be deductible, even with proof -- Even if a "costume" was required to be provided by the taxpayer, it is not deductible as wardrobe unless it's unsuitable for general use. (See further discussion below.)

c. Analyze the year's job history -- Compare the taxpayer's notes of jobs worked with expenses claimed; get dates worked, job requirements; question thoroughly to make sure it all makes logical sense. See *Kisicki v. Commissioner*, T.C. Mem. 1987-245 (taxpayer's calendars contained discrepancies, alterations); *Wilson v. Commissioner*, T.C. Mem. 1973-92, rev'd, remanded on other issues, 500 F. 2d 645 (2d Cir. 1974). (Taxpayers' expense log didn't correspond to their known activities during the year.)

d. Union/non-union -- Where taxpayers claim they incurred unusual expenses because they worked on non-union jobs, they must be able to prove it. Insist on seeing contracts; if necessary, contact employers or unions to confirm.

e. Reimbursement -- No deduction is allowed for an expense if the taxpayer <u>could</u> have received reimbursement but did not choose to

claim it. *Campbell v. Commissioner*, T.C. Mem. 1987-480.

2. **Travel** -- There is a deduction allowed for expenses incurred away from home, in pursuit of a trade or business. IRC section 162(a)(2). (However, as stated above, a production company typically pays all travel expenses for cast and crew, either to and from location within the Los Angeles area, or out of town. Consult the union or the guild contract.)

   a. **Deduction controlled by IRC section 274** -- Even where a deduction for meals, lodgings, etc., is proper, it is allowed only to the extent the taxpayer presents thorough documentation, which means records (preferably kept at or near the time) or other corroboration of his or her statements. Treas. Reg. section 1.274-5T(c). Elements to be proved:

      1) Amount of each separate category of expenditure;

      2) Dates of departure and return;

      3) Destination(s);

      4) Business purpose, including business benefit expected.

      Note: A contemporaneous log is not required, but the closer in time to the event the record was created, the more probative value it has; conversely, if a taxpayer has no log or diary, the need for independent corroborative evidence is greater. Treas. Reg. section 1.274-5T(c).

   b. **Away from home** -- Taxpayers in the entertainment industry may regularly work in more than one city (for example, Los Angeles and New York City). Several issues may arise as a result.

      1) **Tax home** -- A taxpayer's home is normally the (one) city where his or her job is performed. Rev. Ruls. 60-189 and 73-529.

      2) **Only one tax home** -- As a rule, a taxpayer can have only one tax home, even when he or she has two widely separated ongoing places of business. Duplicated expenses would therefore be deductible. Andrews v. Commissioner, 931 F.2d 132 (1st Cir. 1991) rev'g a memo opinion of the Tax Court.

         a) **Limitations** -- However, there are limits; for example, frequent, short trips home during the duration of the job would be a personal expense.

b) Profit motive -- Also, where the transportation costs are greater than the income from the job, it raises doubts about profit motive.

3) Several jobs during year -- If the taxpayer works in two or more locations in one tax year, the determination of which is his or her tax home is based on:

a) Total time spent in each city;

b) Degree of business activity in each area;

c) Relative amount of income per area.

See *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974).

4) No principal place of business -- Where taxpayers' work is of such a nature that they have no principal place of business their "regular place of abode" may be deemed to be their tax home, provided:

a) The taxpayer performs a portion of his or her work in the same area as the abode, and lives there while doing so; and

b) Living expenses in that abode continue while the taxpayer is necessarily away on business; and

c) The taxpayer has either:

(1) not abandoned that abode, or

(2) has family members living there, or

(3) uses that abode frequently himself or herself.

5) Itinerant; no tax home -- If the taxpayer cannot meet at least two of the above three criteria, he or she has no tax home and may not deduct travel expenses. Rosenspan v. United States, 438 F.2d 905 (2d Cir. 1971).

6) Travel may be multi-purpose -- Where travel is for both business and pleasure deductibility depends on which was primary. Treas. Reg. section 1.162-2(b). For dual purpose foreign travel, expenses may be allocated. Treas. Reg. section 1.274-4(g) Ex. (7).

c. Local Travel -- Just as in any other line of work, commuting is not a deductible expense, although there are several exceptions to this rule.

1) General rule: commuting not deductible -- The expense of commuting, though absolutely necessary and ordinary to earning a living, is not deductible. Treas. Reg. section 1.162-2(e); *Fausner v. Commissioner*, 413 U.S. 838 (1973).

2) More than one commute per day -- Even where the taxpayer goes back and forth from home more than once a day (as an actor might have to do), the expense of the commute does not become deductible. *O'Hare v. Commissioner*, 54 T.C. 874 (1970); *Sheldon v. Commissioner*, 50 T.C. 24 (1968).

3) Exception: traveling between locations during the work day -- Expenditures for traveling between work sites within the work day are deductible. See Rev. Rul. 55-109, 1955-1 C.B. 261.

4) Exception: home office -- Where the taxpayer's home is his or her principal place of business, travel to and from home would no longer be "commuting," and could thus be deductible. See *Curphey v. Commissioner*, 73 T.C. 766, 777-78 (1980).

5) Exception: commuting outside the metropolitan area -- A free-lance worker who normally works within the metropolitan area may deduct the commuting expenses of going outside that area for a temporary job. Rev. Rul. 190, 1953-2 C.B. 303. See *Harris v. Commissioner*, T.C. Mem. 1980-56, aff'd and remanded, 9th Cir. 1982 (unpubl. opin.).

6) Where taxpayer had a choice -- Producers often provide a bus for cast and crew to nearby locations, but some may prefer to drive themselves. Where an employer has made a benefit available to the taxpayer but the taxpayer prefers to use his or her own, there is no deduction. *Kessler v. Commissioner*, T.C. Mem. 1985-254 (FBI agent could not deduct cost of ammunition for required target practice, where his employer had offered ammunition for that purpose).

3. Wardrobe, Make-Up, Etc. -- In most kinds of productions, a performer's costumes, wigs, make-up, and other needs are supplied and paid for by the employer. (One possible exception might be TV announcers or news reporters who wear their own wardrobe.)

a. Substantiation -- If a taxpayer has deducted wardrobe, make-up, or any such personal items used during performance, he or she should be able to prove the item was actually required (that is, a copy of the employment contract), and that the amount was actually spent (sales receipt).

b. Business versus personal -- The rule is that personal expenses are not deductible, even when they are required as a condition of employment. IRC section 262.

1) Clothing; other personal items -- Clothes are ordinarily a personal expense. *Kennedy v. Commissioner*, 451 F. 2d 1023 (7th Cir. 1971), aff'g a memo opinion of the Tax Court. Haircuts and other grooming expenses are also personal, and thus not deductible as a business expense, even if required by an employer. *Drake v. Commissioner*, 52 T.C. 842 (1969) (Haircuts not deductible, though required by job.) (Further discussion below.)

2) Taxpayer must prove his or her dominant motive -- Taxpayers may not simply allege their motives in making a questionable expenditure were business and not personal, they must prove it by a showing of objective circumstances. *Cremona v. Commissioner*, 58 T.C. 219 (1972). *Wrightsman v. United States*, 428 F.2d 1316 (Cl. Ct. 1970) (an art "investor" could not prove his dominant motive was not personal enjoyment of art).

4. Gratuities, Gifts, Etc. -- These items are no more (or less) deductible by taxpayers in the entertainment industry than anyone else. Don't overlook the $25 limit on business gifts. IRC section 274.

5. Education, Coaching, Special Training -- If the taxpayer can establish that he or she needed special training for a particular job, it may be deductible. For example, a C&W singer got a role in a commercial and needed to learn to ride a horse. (Although it would be more likely for the producer to pay for special coaching.) If this issue comes up, get specific details.

6. Agents' and Managers' Fees -- Agents typically take 10 percent of gross salary. Managers may take more; ask to see contract. (Further discussion below.)

II. Searching for Work -- As stated earlier, those who work in the entertainment industry spend a lot of time looking for their next job.

A. Promotional Materials, Resumes, Photographs, Etc. -- Actors and other entertainers need to advertise by means of ads, flyers, and other printed materials distributed to potential employers.

1. **IRC section 162 Deduction Is Probably Okay** -- It is usually clear that these items fall within IRC section 162 definition of "ordinary and necessary." *Kisicki v. Commissioner*, T.C. Mem. 1987-245 (actor could deduct cost of photography, printing, demo tapes.)

2. **Get Substantiation** -- However, be sure to see bill, invoice from printer, statement from photographer, canceled checks, etc. Match dates, item, amounts, postage costs, etc. (to eliminate duplication and tendency to toss in personal expenditures).

B. Auditions, Screen Tests -- A large part of a performer's job-hunting expenses are deductible, but watch out for overlap with other kinds of costs: namely, personal.

1. **Travel Between Auditions Is Deductible** -- In other lines of work, the cost of traveling between job sites during the work day is deductible; thus so is the cost of traveling between auditions.

   a. **IRC section 274(d) Limits** -- There is no IRC section 162 travel deduction allowed unless the taxpayer provides substantiation. (See above, under heading I.B.2.a.).

   b. **Substantiation** -- Get details, as shown in the taxpayer's own "adequate records," or by "sufficient evidence" to corroborate the taxpayer's statement, for example, parking lot receipts, sign-in sheet from place of audition. See above, I.B.2.a.

2. **Travel** -- It is rare that an entertainer will have to travel out of town for a mere audition. (An out-of-town producer who is casting a role will come to town or send a casting director to conduct a series of auditions; if they wants to interview that actor specifically, they'll pay his or her travel expenses.) An actor who claimed this unusual expense would certainly have confirmation.

C. Telephone -- Telephone is probably a valid expense, at least in part; also an answering machine, answering service, car phone, beeper, call forwarding, etc. But insist on substantiation; allocate where appropriate (using month sampling). *Int'l Artists, Ltd. v. Commissioner*, 55 T.C. 94, 105 (1970).

Note: Cellular phones are among the IRC section 280F "listed properties," therefore, any tax benefits claimed in connection with them are subject to the special substantiation rules of IRC section 274(d). See below, III.C.3.b.

D. Unique Expenditures -- Once in a while, an actor or actress will have to incur an unusual cost, just for one particular audition; for example, a lesson from a dialect coach to help him or her prepare to try out for a certain part, some kind of special hairpiece (or hair cut or color) or make-up for a screen test, not otherwise of any use to the taxpayer. Insist on confirmation, details, substantiation.

E. Entertainment, Gifts, etc., Claimed in Connection with Looking for Work -- Actors or actresses rarely get jobs on the basis of gifts they've given to casting directors. (If actors or actresses insist this practice is going on, audit of the casting directors' returns should be initiated.)

1. Demand complete compliance with IRC section 274(d), then scrutinize the alleged nexus between the gift, the recipient, and the hoped-for benefit to be derived.

2. Don't overlook the $25 limit on business gifts, and the 80 percent limit on meal deductions. (See further discussion below.)

F. Union and Guild Dues -- Dues are almost certainly a legitimate deduction, assuming there is adequate substantiation. Copies of union and guild rules, standard contracts, phone numbers, etc., are available in the office; do not hesitate to use them to double check taxpayer's statements.

III. Maintaining Skills, Image, Position, Etc. -- According to Hollywood myth, it's even harder to stay on top than to get there in the first place. Thus established performers are entitled to certain deductions for this purpose.

A. Public Relations, Promotion, Publicity -- The line between business and personal motives regarding these expenditures is frequently unclear; insist on specificity.

1. Publicity Manager, PR Firm, etc. -- Probably valid, assuming there is good documentation. Review statements received from service provider; inquire about value of services performed; ask to examples (newspaper clippings, press coverage, magazine articles) of what the expenditure bought and the results obtained therefrom (for example, a job).

2. Deduction Controlled by IRC Section 274(d) -- Even when a deduction

for promotion, gifts, entertainment, etc. is proper, it is allowed only to the extent the taxpayer presents thorough documentation; this means records (preferably kept at or near time of expenditure) or other corroboration of his or her statements. See Treas. Reg. section 1.274-5T(b). The taxpayer must show:

a. Amount of each expenditure.

b. Time and place of the entertainment, or date and description of the gift.

c. Business purpose, including benefit expected.

d. Identity of recipient of the entertainment or gift, and business relationship between recipient and taxpayer.

Note: Specificity is required. See, for example, *Dowell v. United States*, 522 F. 2d 708 (5th Cir. 1975); **Smith v. Commissioner**, 80 T.C. 1165, 1172 (1983).

B. Compensation Paid to Managers and Others -- Successful entertainers frequently have an entourage; some of these individuals perform "ordinary and necessary" functions, but others may just be hangers-on, family members, etc.

1. Agent, Personal Manager, Other Professionals -- Big stars often need business managers, accountants, lawyers, secretaries, and more. Scrutinize!

a. Demand Details -- Ask for a description of services performed; get copies of contracts, itemized statements from lawyers, etc., proof of employment taxes and wages paid out, etc.

b. Analyze Services -- IRC section 162(a): Were the services performed by these individuals ordinary and necessary to the taxpayer's trade/business? Was the cost reasonable? Be alert for:

1) Whether the service-provider was perhaps a friend or relative? ("Compensation" may have been a disguised gift.)

2) Whether any part of the services were of a personal nature? (Business managers often look after the personal finances of their clients as well, pay household bills, etc.)

c. Legal Expenses, Settlements -- Deductibility of legal services and

costs depends on the origin of the claim or conflict. *Harden v. Commissioner*, T.C. Mem. 1991-454 (football player's payments of hush money to ex-girlfriend, to keep her from filing criminal charges was not a business deduction just because he knew his team would have traded or released him if she had filed the complaint).

2. **Coach, Personal Trainer, Guru** -- The general rule is that personal expenses are just not deductible. IRC section 262; *Bodzin v. Commissioner*, 60 T.C. 820 (1973), *rev'd* 509 F.2d 679 (4th Cir. 1975), *cert denied* 423 U.S. 825 (1975).

   a. **IRC Section 262 Pre-empts IRC Section 162** -- The Supreme Court has held that the Code provisions barring deductions (for example, IRC sections 262, 263) have priority over IRC section 162. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17 (1974); *Bodzin, supra*, (cited in *Sharon v. Commissioner*, 66 T.C. 515, 522-23 (1976), *aff'd per curiam* 509 F.2d (9th Cir. 1978). This means the taxpayer has to affirmatively<u>prove</u> the expenditure was <u>not</u> personal.

   b. **Taxpayers Rarely Can Carry Their Burden** -- The Tax Court has consistently upheld the priority of IRC section 262 over IRC section 162, making it virtually impossible for taxpayers to prove that an expense which yielded a personal benefit was actually ordinary and necessary to trade/business. For example, *Amend v. Commissioner*, 55 T.C. 320, 325-26 (1970), aff'd, 454 F. 2d 399 (7th Cir. 1971) (some expenses -- in that case a Christian Science counsellor on staff -- are so "inherently personal" they simply cannot qualify for IRC section 162 treatment irrespective of the role they play in the taxpayer's trade or business); *Sieber v. Commissioner*, T.C. Mem. 1979-15 (taxpayer, who was in the construction business, played polo in order to meet potential clients; costs not deductible, since he could not prove the activity was primarily business and not social, nor could he show proximate connection between polo and his business).

3. **Bodyguards, Security Services** -- Physical security is also too personal an item to be deducted, unless there is a clear business- related aspect to the service, for example, to control fans, papparrazzi during a star's personal appearance (but for such occasions, the producer of the event would probably bear those costs, since the security of all would be the producer's responsibility).

   a. **Bodyguard** -- See *Holmes v. Commissioner*, T.C. Mem. 1983-442 (no deduction for bodyguard expenses for protection of diplomat's

household while posted in Quito, Ecuador).

b. Home Security -- See *Contini v. Commissioner*, 76 T.C. 447, 453 (1981) (family home expenses are a personal expenditure).

c. Specific Items May Be Business-related -- As the Tax Court indicated in *Holmes*, above, a business deduction may be proper for certain security items installed in the home for business reasons, such as a fire-proof safe in which to keep office documents. But see *Semp v. Commissioner*, T.C. Mem. 1981-706 (handguns were clearly an "extraordinary" expense, in spite of taxpayer's contentions that as an insurance salesman he was obliged to travel in dangerous neighborhoods).

C. Keeping Up Skills, Status, Image, etc. -- Entertainers may believe that, because they have to make certain expenditures in order to "stay on top," these items should be deductible as business expenses; nevertheless, most of these items typically overlap too much with personal expenses to constitute valid business deductions.

1. TV, Movies, Theatre, Cable TV Expenses -- IRC section 274 places strict limits on deductions for items "generally considered to constitute amusement, entertainment, or recreation." Such items are thus deductible only where there is a clear tie to particular work.

a. Everyday Items -- Generally, there is no deduction for the things everybody buys, such as concert tickets or cable fees. In *Noland v. Commissioner*, 269 F.2d 108 (4th Cir. 1959), the Court held that a businessman could deduct the Wall St. Journal, but not Time Magazine; by that standard, an actor can deduct the Hollywood Reporter but not TV Guide.

b. Specific Occasions -- IRC section 274 requires a "direct relation" to active conduct of taxpayers' trade or business: they must supply names, dates, etc., IRC section 274(d). *Walliser v. Commissioner*, 72 T.C. 433, 441-42 (1979).

c. Limits -- Even where a deduction for a particular event is allowed, such as theatre ticket to a certain play in order to research an upcoming film role, only one ticket would be deductible; taking a guest would be a purely personal cost.

d. Screenings - Writers Guild, Directors Guild, various professional

groups offer regular screenings of new releases to members; thus membership fees paid by the taxpayer may already cover at least some of these "necessary" expenses.

2. **Ongoing Training to Keep Up Skills** -- This may be an ordinary and necessary business expense, similar to CPE for lawyers and accountants. *Elliot v. United States*, 250 F. Supp. 322 (DCNY, 1966) (Concert harpist could deduct cost of lessons to maintain proficiency.)

   a. **Who Is Eligible** -- The taxpayer must already be employed or self-employed in a trade, business, or profession. Treas. Reg. section 1.162-5(b); Rev. Rul. 60-97, 1960-1 C.B. 69.

   b. **Two Prong Test** -- There is a double hurdle regarding the type of education or training which may be deducted.

      1) **Not for basic skills already in use** -- The first hurdle is that the expense may not be to learn the skills that qualified the taxpayer for the job already held. *Takahashi v. Commissioner*, 87 T.C. 126, 130-31 (1986).

      2) **Not to qualify for new trade or business** -- The second hurdle is that the expense not be one that qualifies the taxpayer for a new trade or business. *Callender v. Commissioner*, 75 T.C. 334 (1980); *Kroyt v. Commissioner*, T.C. Mem. 1961-322 (concert artists could not deduct the cost of learning to play a new instrument); Treas. Reg. section 1.162-5.

   c. **Unique Situations May Arise in the Entertainment Field** -- The above test probably means a sports announcer cannot deduct the cost of tapdancing lessons, a mime cannot deduct the cost of elocution lessons. But can an actor deduct singing lessons? Depends on whether an actor ordinarily and necessarily needs to practice singing in order to maintain acting skills.

3. **Cost of Owning and Maintaining Airplane, Motorcycle, Horses** -- The equipment used by actors or actresses, stunt persons, and many others in movies and television is often what others would see as "toys." Taxpayers' claims that their expenditures on these items are business-related may arguably have some truth; but these items also present so great an opportunity for abuse that they merit careful scrutiny of the particular facts and circumstances of each case.

a. Background -- Court cases have addressed the deductibility of airplane expenses in many different settings; the outcome has typically turned on the issue of just how ordinary and necessary the plane was to the operation of the taxpayer's trade or business.

1) As Transportation -- One clear business connection is where the plane is needed for transport. *Palo Alto Town & Country Village, Inc. v. Commissioner*, 565 F. 2d 1388 (9th Cir. 1977) (taxpayer convinced the court of the business value of having the plane standing by at all times); *Sherman v. Commissioner*, T.C. Mem. 1982-582 (salesman was denied plane expenses: he could not show he couldn't have covered his territory otherwise); *Sartor v. Commissioner*, T.C. Mem. 1984-274 (taxpayer proved the plane expenses were necessary and ordinary); *Ballard v. Commissioner*, T.C. Mem. 1984-662 (deduction denied in part, where commercial flights would have done just as well, and would have cost less).

2) Education; to keep up flying skills -- Another line of cases analyzed the issue in light of the taxpayers' alleged need to "maintain or improve" their flying skills for purposes of their trade or business. See, for example **Boser v. Commissioner**, 77 T.C. 1124 (1981).

a) "Ordinary and necessary" -- When flying expenses are deducted as IRC section 162 educational expenses, the taxpayer must show they were "ordinary," which means "normal, usual, or customary" in the taxpayer's trade or business. *Perfetti v. Commissioner*, T.C. Mem. 1983549, *aff'd* on this issue, 762 F. 2d 638 (8th Cir. 1985); *Stoddard v. Commissioner*, T.C. Mem. 1982-720. The expense need not be required by the taxpayer's employer in order to be "ordinary." *Carlucci v. Commissioner*, 37 T.C. 695 (1962).

b) "Reasonable" -- Inherent in the concept of "necessary" is the requirement that the amount of the expenditure be reasonable in relation to its purpose; where an expenditure is excessive, only the portion which is reasonable may be deducted. *United States v. Haskel Engineering & Supply Co.*, 380 F.2d 786, 788-89 (9th Cir. 1967).

c) Relationship to trade/business -- The burden of proof is on the taxpayer to show "a direct and proximate relationship" between the use of his or her own plane and the performance

of his or her duties in his or her trade or business. *Carroll v. Commissioner*, 51 T.C. 213, 218 (1968), *aff'd*, 418 F.2d 91 (7th Cir. 1969).

3) **Income-producing Property, IRC Section 212** - Instead of IRC section 162, the taxpayer may invoke IRC section 212, contending that the plane, car or horse was "income producing property," the upkeep of which is deductible under IRC section 212. Ask for history of the income earned by this property, (presumably rentals). The taxpayer's argument that the property was held for the production of income is subject to an IRC section 183-type analysis, to make sure the ownership was, in fact, profit-motivated.

b. Listed Property" - IRC section 280F -- Under IRC section 280F(d)(4)(A), passenger cars, other transportation property, and any property generally used for entertainment, recreation, and amusement, are "listed property." (No reason to think this doesn't include horses.) Tax benefits claimed in connection with this kind of property are strictly limited.

1) **Where the taxpayer is an employee** -- Under IRC section 280F(d)(3), an employee can get the tax benefits of "listed property" only to the extent it can be shown that:

a) the property was used for the convenience of the employer, and

b) the property was required as a condition of his employment.

2) **Computers** -- Computers and peripherals are fully deductible (and eligible for ITC and IRC section 179 expensing) only if used exclusively at the taxpayer's regular business establishment (including a home office, if IRC section 280A requirements are met). IRC section 280F(d)(3)(B). Otherwise, they are "listed property" and tax benefits are subject to strict recordkeeping (showing business versus personal use).

3) **ACRS depreciation: only on "Qualified Business Use" Property** -- Unless the "qualified business use" (which means actual use in the taxpayer's trade or business) of the property is more than 50 percent, the taxpayer may only use "alternative depreciation system" (IRC section 168(g): straight line) and may not claim ITC or IRC section 179 expensing elections. The

percentage of business use is gauged by time spent in actual use. Treas. Reg. section 1.280F-6T(d).

c. Identify the taxpayer's exact trade/business --In order to analyze the degree to which the taxpayer might be entitled to the deduction for his or her plane, horse, motorcycle, etc., the first step is obviously to identify his or her trade or business(es).

1) Employee (Form 2106 for unreimbursed expenses) -- If income was W-2, determine what he or she was employed as (for example, stunt person, actor or actress, pilot, animal trainer, wrangler).

a) The taxpayer can have more than one occupation;

b) Review appropriate job contract(s), union contract(s); contact the union, the producer, other third parties, if necessary;

c) Which employer(s) does the taxpayer contend required him or her to provide the property in question? For which job(s)? Was it truly for the employer's convenience, rather than simply that the taxpayer preferred to use his or her own (horse, motorcycle, etc.)? What part of the claimed expenses were attributable to that job? Allocate as appropriate.

Note: "Requirement of employment," "employer's convenience" depend on facts and circumstances. A mere statement from the employer is not sufficient. Treas. Reg. section 1.280F-6T.

d) No intermingling -- Don't mix employee deductions with independent contractor deductions; IRC section 280F requires separate treatment. Furthermore, assume expenses were reimbursed by employer unless the taxpayer proves otherwise.

2) Schedule C Deductions -- Where the taxpayer has reported income and deductions on Schedule C(s), it is equally necessary to clearly identify (each) trade or business (for example, independent stunt coordinator, animal trainer, flight instructor).

a) Income/deduction should agree -- The source of the income should be consistent with the deduction claimed; that is, if he or she is reporting income for staging stunts, the services contract should not be for horse rentals. Specifically match up each trade or business, each job, and each kind of deduction

claimed.

b) "Qualified business use" limitation on depreciation -- As stated above, in order for ACRS depreciation to be allowed, at least 50 percent of the use of the property in question must have been in a trade or business of the taxpayer.

c) Break out each trade/business -- Thereshould be a separate Schedule C for each trade or business: for example, horse expenses cannot offset auto racing income.

d) Scrutinize -- Ask lots of questions and use common sense on personal use: for example, if there were kids in the family, they may have have ridden the taxpayer's horses; a local traffic reporter with a faraway vacation home may have used his or her plane to get there.

e) Interaction with IRC section 183 -- Facts such as unbusinesslike operation and consistent losses may suggest lack of a profit motive. Each Schedule C must stand on its own with respect to IRC section 183.

f) No loose ends -- In analyzing and matching income and deductions from various sources verify that the taxpayer has reported all income properly and not omitted reimburse ments; for example, if he or she was required to bring his or her horse to a job, was he or she reimbursed for the cost of horse trailer, feed?

(3) Personal Services Corporation -- IRC section 280F applies only to taxpayers who are individuals and S-Corporations. Where the taxpayer functions through a C-Corporation, these strict provisions do not come into play.

d. Actual connection not enough -- As stated above, an actual connection between the property and the taxpayer's trade or business is not enough: use of that property must be ordinary and necessary within that taxpayer's profession. For example, how many stunt persons specialize in flying stunts? How many of those own their own planes? How many flying stunts has this taxpayer worked on? How much of total income was derived from stunt flying?

e. Entertainment/recreation/amusement property used for

entertainment/recreation/amusement -- When the property in question was used not on camera or for the taxpayer's technical skills but for actual recreation, for example, to entertain a network vice-president or a prospective investor, the special substantiation rules of IRC section 274(d) must be satisfied.

4. **Physical Fitness** -- Expenses for physical fitness are deductible only to the extent they are linked to the specific requirements of the taxpayer's work -- a particular job, or type of job. It is up to the taxpayer to prove this linkage.

   a. **Health Club, Gym, Equipment, etc.** -- All such expenses are considered personal, and thus not deductible, even if they do provide an overall benefit to the taxpayer's trade or business. Rev. Rul. 78-128, 1978-1 C.B. 197 (law enforcement officer could not deduct health club costs).

   b. **Athletic, Sporting Club Dues** -- Moreover, dues paid to athletic, sporting (and social) clubs are treated the same as entertainment and recreation expenses (IRC section 274(a)(2)), and are thus subject to the special substantiation rules of IRC section 274(d).

   c. **Possible Allowance of Deduction** -- Fitness expenses might be deductible in certain situations, where there is a concrete connection with the taxpayer's trade or business.

      1) **Particular job** -- For example, an actor or actress gets a role in a Kung Fu movie and has to learn Karate. (IRC section 274(d) substantiation requirements would have to be satisfied, of course.)

      2) **Specialty associated with the taxpayer's success** -- In certain instances, a special skill is so associated with an entertainer's or athlete's success that its maintenance is akin to keeping up professional skills; for instance, a Mr. Universe-turned-actor might be required by the nature of his employment (type of roles) to keep up his body building and weightlifting skills. Another example might be an Olympic ice skater who becomes a professional ice skating star.

5. **Wardrobe**

   a. General rule -- It is well-accepted that clothing is deductible as a business expense only where:

1) it is required by the employer or essential to the taxpayer's employment;

2) it is not suitable for general wear or use away from work; and

3) it was not, in fact, worn while away from work.

Donnelly v. Commissioner, 262 F.2d 411, 412 (2d Cir. 1959); *Yeomans v. Commissioner*, 30 T.C. 757, 767 (1958). Rev. Rul. 70-474, 1970-2 C.B. 34.

b. Formerly, courts were more lenient -- A line of cases from several decades ago established a lenient policy with respect to wardrobe deductions

1) **Deductions by entertainers** -- For example, *Nelson v. Commissioner*, T.C. Mem. 1966-224 (Ozzie & Harriet were permitted to deduct the clothes they wore on their TV show even though they were suitable for general use;) See also *Denny v. Commissioner*, 33 B.T.A. 738 (1935) (clothes were "theatrical costumes"); *Fisher v. Commissioner*, 23 T.C. 218 (1954), *aff'd* 230 F.2d 79 (7th Cir. 1956) (night club pianist could deduct cost of tuxedos);

2) **Deductions by taxpayers in other lines of work** -- Leading cases typically involved specialized occupations. For example, **Meier v. Commissioner**, 2 T.C. 458 (1943) (nurse could deduct uniforms, due to extra "sanitary" requirements of job); *Harsaghy v. Commissioner*, 2 T.C. 484 (1943) (taxpayer not allowed to wear uniform off the job, thus could deduct costs).

c. Today's standards are different -- Perhaps because a wider variety of clothes are in fact suitable for general wear today, denial of a clothing deduction has become the norm. For example, *Pevsner v. Commissioner*, 628 F. 2d 467 (5th Cir. 1980) *rev'g* T.C. Mem. 1979-311 (boutique saleswoman could not deduct expensive clothes even though they were required for the job and never worn in personal life, because they were, in fact, suitable for general use); *Mella v. Commissioner*, T.C. Mem. 1986-954 (professional tennis player was not permitted to deduct cost of tennis togs, since objectively they were suited for general use).

d. Working conditions hard on clothes; need more frequent

replacement -- A taxpayer may think because his or her particular occupation is exceptionally hard on his or her clothes that he or she is entitled to a deduction, but this is not so.

1) **Protective wear is deductible** -- Equipment or special clothing required by certain jobs, which does not take the place of other clothing is deductible, for example, makeup artist's smock, asbestos underwear worn by stunt person for fire scene. *Kozera v. Commissioner*, T.C. Mem. 1986-604 (special electrician's "bunny boots" deductible); *Jeffers v. Commissioner*, T.C. Mem. 1986-285 (for taxpayer who was a pipefitter, steel-toed boots were deductible but jeans were not).

2) **Unusual wear and tear** -- There is no deduction, however, simply because a taxpayer's job causes unusual wear and tear on regular clothes. *Drill v. Commissioner*, 8 T.C. 902 (1947); *Henry v. Commissioner*, T.C. Mem. 1971-50. *Hawbaker v. Commissioner*, T.C. Mem. 1983-665 (no deduction for auto salesman's suits which he was required to wear and which got unusually dirty and greasy on the job).

e. Care of wardrobe -- Generally, where the cost of the work clothes is deductible, so is the cost of their upkeep. *Mortrud v. Commissioner*, 44 T.C. 208 (1965).

f. Adequate proof: substantiation and documentation -- The requirements are not as strict regarding IRC section 162 expenses as they are with respect to IRC section 274. While original bills and cancelled checks are always preferable, they are not an absolute necessity. Consider all the surrounding circumstances. *Campbell v. Commissioner*, T.C. Mem. 1992-66. (A deductionwas allowed where the taxpayer, a plastics technician, "testified credibly" that he wore out two pairs of protective work boots in a year.)

6. Grooming and Other Personal Items -- As a rule, these items are too personal; they will generate a business deduction only in the presence of very special circumstances.

a. Make-up, Haircuts -- There may be a possible deduction for stage make-up (with substantiation that taxpayer was required to purchase it, did purchase it, and never wore it offstage), but it's a narrow exception. For example, *Drake v. Commissioner*, 52 T.C. 842 (1969) *supra*. The Tax Court denied a deduction for make-up to a (male) TV newscaster,

in *Hynes v. Commissioner*, 74 T.C. 1266.

b. Toupee -- Probably too personal to yield a business deduction; possible exception where the taxpayer presents abundant evidence that he wore the toupee exclusively while working.

c. False Teeth, Hearing Aids, etc. -- Considered extremely personal, and thus usually not deductible.

1) Courts divided; a fact intensive issue -- Some courts have been lenient on deductions for the various needs of actors or actresses, for example, *Denny v. Commissioner*, 33 BTA 738 (Court allowed deduction for replacement dental work, also wigs, costumes, etc.). Others have not: Sparkman v. Commissioner, 112 F.2d 774 (9th Cir. 1940). (No deduction for actor's dentures, even though he needed them for enunciation; "taxpayer did not prove the teeth were used for business purposes only.")

2) Generally, few personal deductions are allowed, even where arguably business related -- See, for example, *Bakewell v. Commissioner*, 23 T.C. 803 (1955). (No deduction for hearing aid needed by courtroom lawyer.)

d. Business-related Medical Expenses -- The deduction for medical care is now available only insofar as it exceeds 7.5 percent of adjusted gross income. IRC section 213(a). This is all the more reason why taxpayers now might want to argue that certain medical expenditures were business-related. (Since medical deductions were readily available until recently, there is little judicial guidance in this area.)

1) Cosmetic Surgery -- IRC section 213(d)(9) now prohibits a medical deduction for face lifts, hair transplants, and any other procedure directed merely at "improving the patient's appearance," thereby providing still further motivation for on-camera performers to claim such items under IRC section 162.

2) Medical Treatment -- Rarely allowed as business expense; for example, Rev. Rul. 71-43, 1971-1 C.B. 51 (singer's costs of throat treatments allowed as medical, not business, expense).

3) Insurance -- Note that health coverage for Hollywood union and guild members is very good; it is unlikely that a member of, say, SAG or AFTRA, had any uncompensated medicals sufficient to

generate a Schedule A deduction.

7. **Extravagance, in General**

   a. **Not Limited to Lowest Price** -- Show business folks sometimes like to splurge. The reasonableness of the price a taxpayer chooses to pay for goods and services is not normally in issue: He or she is entitled to purchase the highest price goods and services, travel first class, if that's his or her preference, and to deduct where otherwise deductible.

   b. **Exception: Compensation for Services** -- A deduction for salaries or fees for personal services is limited to a "reasonable allowance" for "services actually rendered." IRC section 162(a)(1). The test of reasonableness depends on facts and circumstances.

   c. **Exception: Lavish Food and Drink** -- IRC section 274(k) provides that food and beverages are not deductible if they were "lavish or extravagant under the circumstances" or if the taxpayer was not present. See IRC section 162(a)(2).

   d. **However, May Indicate Motives** -- The reasonableness of the amount spent may be relevant to determining whether the expenditure was primarily for business or personal motives; for instance, if it looks as if that audition in New York may be an excuse to deduct the cost of a luxury trip. Consider "reasonableness" in relation to the purported business purpose of the item. *United States v. Haskell Eng. & Supply Co.*, 380 F. 2d 786 (9th Cir. 1967); *Harbor Medical Corp. v. Commissioner*, T.C. Mem. 1979-291.

8. **Use of Home for Business Purposes** -- This issue often arises in the entertainment industry, where business and personal lives intermingle to so great an extent.

   a. **Home Office Deduction** -- In *Soliman v. Commissioner*, 71 A.F.T.R. 2d 93-463, the Supreme Court held that only when the more essential aspects of the taxpayer's work are performed at home may the taxpayer deduct the cost of a home office.

      1) **Bottom line still unclear** -- For entertainers, most of whom mainly perform as employees in clubs, theatres, etc., *Soliman* should effectively eliminate any home deduction. However, this result is rather harsh, where a taxpayer works at many different places and a home office is the only site used routinely and

regularly, for, say, rehearsal, management, storage of equipment, etc. See Prop. Treas. Reg. section 1.280A-2(b)(3); *Drucker v. Commissioner*, 715 F.2d 67 (2d Cir. 1983), *rev'g* 79 T.C. 605 (1962); but see *Kisicki, supra.* See *alsoHamacher v. Commissioner*, 94 T.C. 348 (1990).

2) **For designers, technicians and others, there may still be a deduction** -- For example, a free-lance special effects creator whose work shop or studio was in his or her home could probably still deduct those business expenditures, even after *Soliman*.

b. Result May Depend on Status of Taxpayer -- An independent contractor may deduct a portion of his or her home only if it is his or her principal place or business, used by clients, patients, or customers, or is a separate structure. IRC section 280A(c). An employee may deduct the expense of a home office only where it's for the convenience of the employer. Prop. Treas. Reg. section 1.280F-2(g)(2).

c. Corporate Taxpayer -- Individuals who have formed a personal service (C) corporation may still deduct business use of their home, but the creation of the corporate entity would give rise to separate issues, for example, it would have to rent the premises from the entertainer. See, for example, *Int'l Artists, Ltd. v. Commissioner*, 55 T.C. 94 (1970). (Liberace's corporation deducted expenses of a screening room, wardrobe, theatrical lighting, concert stage, etc., in the star's Harold Way home; but the corporation paid him rent for it.)

d. "Listed Property" IRC section 280F -- Note that personal computers, cellular phones, and property generally used for recreation, amusement, and entertainment are all among the IRC section 280F listed property categories. All business deductions and credits arising from "listed property" are subject to the IRC section 274(d) special substantiation rules.

IV. Miscellaneous

A. Uniform Capitalization Rules - Exception - IRC section 263A(h) -- Beginning after 1986, "creative individuals" may depreciate "qualified creative expenses." Notice 8862, 1988-1 C.B. 548.

1. Special Treatment -- Taxpayers who qualify under this provision are exempt from the uniform capitalization requirement. They may deduct "qualified creative expenses," instead of having to capitalize them.

a. Who Is Eligible -- This provision applies to freelance authors, photographers, artists, and other creative individuals. They must either be self-employed or work through a personal service corporation.

b. "Qualified Creative Expenses" -- These are the expenditures incurred by a creative individual in producing a creative property through his or her own efforts. They encompass:

1) Expenses paid or incurred in the taxpayer's trade or business (other than as an employee);

2) Which would otherwise be deductible, were it not for the uniform capitalization rule.

3) "Qualified creative expenses" do not include expenses related to printing, motion picture films, video tapes, etc., that is, reproduction and distribution expenses.

c. Prior Election of "Safe Harbor" -- With the enactment of IRC section 263(h) in 1988, Congress codified the benefits of the safe harbor election the IRS had provided in Notice 88-62, 1988-1 C.B. 548. In Notice 89-67, 1989-1 C.B. 793, the IRS advised taxpayers who had made the earlier election how to change their accounting method to comply with IRC section 263A(h).

2. "UNICAP" -- For years before 1987, or for taxpayers who are not "creative individuals," the costs of producing creative properties may not be amortized until the project is placed in service. In other words, there is no deduction for the costs of producing or acquiring property prior to the year in which it can begin generating income. IRC section 263A. Cost recovery is then based on the income forecast method. *Siegel v. Commissioner*, 78 T.C. 659 (1982).