

What Can I Deduct?

In this chapter I will take a bird's eye view of expenses and deductions. We will see how the IRS interprets the general deductibility of the more common expenses that all artists have, such as automobile use, travel, meals, entertainment, and the controversial home office. I will also look at the Qualified Performing Artists (QPA) provision, startup costs, and the also-controversial "hobby loss" rules. Following chapters will deal more specifically with the deductible expenses in the various disciplines, but for now let's get an overview.

The heart of saving money on your tax return is making sure you do not miss any deductions or expenses. As we have said, the artist has to be concerned about the type of income the deduction is associated with. This is the core of where the deduction goes on the tax return, i.e., does this expense relate to W-2 employment earnings or 1099 self-employment income?

Let's look at what the IRS says regarding expense deductions in general in its Publication 583:

You can deduct business expenses on your income tax return. These are the current operating costs of running your business. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your field of business, trade, or profession. A necessary expense is one that is helpful and appropriate for your business, trade, or profession. An expense does not have to be indispensable to be considered necessary

And from Publication 334:

You cannot deduct expenses that are lavish or extravagant under the circumstances.

So we can see the IRS has only three fairly simple criteria for deductible business expenses:

1. Must be incurred in connection with your trade, business, or profession.
2. Must be ordinary and necessary.
3. Must *not* be lavish or extravagant.

As I mentioned in the last chapter, as an artist you are treated as what the IRS calls a "cash basis taxpayer." This means that, generally speaking, your expenses and deductions are anything you expend money or value on during the calendar year. If you pay for a tax-deductible expense via check, cash, barter, or charge card (even if you don't pay off the credit card until the following year), the expense will qualify as a deduction in the current year. This all seems straightforward but, as the saying goes, "the devil is in the details."

First, let's tackle the matter of whether the deduction is related to employment (W-2) income or self-employment (Form 1099 or K-1) income. While the types of expenses that are deductible will usually not change between employment and self-employment,

the manner in which the deduction is taken and its effect on your tax return can be critical. Important point: the deductibility of specific items can be largely identical for employees and for the self-employed; it is basically a mechanical matter as to how they are treated during the preparation of the income tax return. Put another way, the “employee” artist might (and indeed, will often) have the exact same group of deductions as the “self-employed” artist. The following chart illustrates the flow of income and deductions:

Employment	Self-employment
Income from W-2 Form	Income from Form 1099-MISC/K-1
↓	↓
Expenses no longer deductible in 2018	Expenses found on Schedule C, or 2106 type form

PLEASE NOTE: the 2017 TCJA tax bill now disallows all employee business expenses on Form 2106 except for the rare performers that qualify under the QPA (Qualified Performing Artist).

While the employee is allowed no write off for employment related expenses starting in 2018, deductions against self-employment income are written off dollar for dollar directly against the self-employment income on the Schedule C.

The exception to this is the form K-1. If the artist is a member of an LLC (taxed as a partnership) or a partner in a partnership, they will be able to take allowable business deductions directly against the K-1 income through the use of a type of 2106 substitute form on schedule E (we will see an example of this in Sonny Phunky’s 1040 in Chapter 4; note that this type of deduction is not available on an S corporation).

Let’s see how this plays out with our four artists:

Ima Starr is a member of Actors’ Equity, so the bulk of her annual income is reported on the W-2 forms she received. That means that for all of her direct acting expenses she will not be allowed any deduction starting in 2018. For self-employment, Ima sings in a jazz group, did some modeling and even wrote a book! She and her accountant will be allocating expenses associated with those activities to her Schedule C. These expenses might include auto usage, publications, music equipment purchase, digital & streaming music and home office. It is not always easy to figure out this “allocation” I refer to. What if all of Ima Starr’s incomes were earned only in New York City where she lives? By which I mean all the acting jobs, music gigs, modeling assignments, etc., are in NYC. How does one allocate expenses in a situation like that? The answer is: very carefully and systematically! In cases where a clear-cut differentiation is impossible, try for a methodical and consistent approach. This might be done by allocating the expenses according to income received, days worked, or some other formula (an income-based allocation is what the Internal Revenue Service discusses in its audit guidelines). In other words, first assign the expenses you can clearly and directly associate with each type of income, then allocate general expenses via a formula. It is clear that Ima’s Actors’ Equity dues would be an expense against her employment income, and therefore not

allowed. The sound system and music downloads she purchased for her singing career would be deducted against her self-employment income. For her home office or her new MacBook Pro® notebook or iPad® it can be argued that they benefit all her activities equally, so these expenses might be allocated according to an income-based formula (the formula the IRS prefers). If 25% of her gross earnings were from her self-employment activities, she may choose to assign 25% of her home office and technology expenses to her Schedule C. While this gross income method is not perfect, it is logical, defensible and easy to explain in an IRS audit situation!

Now for our bass player, Sonny Phunky. Let's deal with just four of Sonny's expense line items for the year: the purchase of a new bass guitar, music supplies, auto mileage, and travel & meals. When Sonny arrives at his accountant's office he will have his W-2 from Butterball Kings, Inc., for his tour (Plate 2). He will also have 1099-MISC forms for some of his studio work and gigs. And he will have some unreported (to Internal Revenue Service) income from privately teaching the bass guitar to his students. So how will Sonny and his accountant differentiate the expenses for these items on the tax return? It turns out that the Butterball Kings specifically requested that he play a chartreuse colored bass to match their other stage equipment, which forced Sonny to purchase a new custom painted bass guitar for the tour. This would be grounds for Sonny's accountant to write off (*depreciate* – more on this later) the new bass against his W-2, but sadly this deduction is no longer allowed. Anything Sonny and his accountant allocate to his work with the Butterball Kings and his W-2 income will NOT be allowable deductions under 2017 TCJA tax reform.

Sonny's expenses for the rest of the year for music supplies, travel, mileage to the studio and gigs, etc., would become a deduction on his Schedule C against his self-employment income and against the K-1 he is receiving. We can see from this example that Sonny will have many of the same expense line items on both his 2106 and his Schedule C forms when we review his 1040 tax return in Chapter 4.

Let's look at our visual artist, Liz. As a college professor she may have no deductions at all because the college would probably be supplying all her teaching materials. But Liz would indeed have expenses for her work as an independent artist. Her expenses for framing, art supplies, home studio and mileage to visit the gallery in NYC and travel to the gallery in Dublin would all be deductions on her Schedule C form.

Finally, our writer, Guy. The magazine Guy works for will probably be supplying all his materials and equipment, as well as reimbursing him for his auto use on the job, so the only deduction he had against his W-2 was a trip to NYC (Swamp Life Magazine does not reimburse this type of travel) but sadly this deduction is no longer allowed after 2018. Guy would indeed have expenses for his work as an independent writer, which might include the use of a home office, purchase of books, travel, and home computer. These expenses would appear on Schedule C as deductions against his royalties and other freelance writing income.

It's time to delve into some of the larger expense line items that typically affect all artists.

The Automobile

The use of a car for business is the most common expense an artist has, and is often the single largest deduction. The IRS has two basic methods for writing off the business use of your automobile. It allows you to use either the annually adjusted IRS standard mileage rate or the actual expense of operating your car. The IRS sums it up in the following language in Publication 334:

For local transportation or overnight travel by car or truck, you generally can use one of the following methods to figure your expenses:

Standard Mileage Rate.

Standard mileage rate. You may be able to use the standard mileage rate to figure the deductible costs of operating your car, van, pickup, or panel truck for business purposes. For 2016, the standard mileage rate is 54 cents a mile for business travel (this is adjusted annually – see the TaxQuickGuide on www.artstaxinfo.com for the latest rate).

Caution: If you choose to use the standard mileage rate for a year, you cannot deduct your actual expenses for that year except for business-related parking fees and tolls.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car or truck you own, you must choose to use it in the first year the car is available for use in your business. In later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must choose to use it for the entire lease period.

Standard mileage rate not allowed. You cannot use the standard mileage rate if you:

- 1. Use the car for hire (such as Uber or a taxi),*
- 2. Operate two or more cars at the same time,*
- 3. Claimed a depreciation deduction using ACRS or MACRS in an earlier year,*
- 4. Claimed a section 179 deduction on the car,*
- 5. Claimed actual car expenses after 1997 for a car you leased, or*
- 6. Are a rural mail carrier who received a qualified reimbursement.*

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual Expenses

Actual expenses. If you do not choose to use the standard mileage rate, you may be able to deduct your actual car or truck expenses.

TIP: If you qualify to use both methods, figure your deduction both ways to see which gives you a larger deduction.

Actual car expenses include the costs of the following items:

<i>Depreciation</i>	<i>Lease payments</i>	<i>Registration fees</i>
<i>Garage rent</i>	<i>Licenses</i>	<i>Repairs</i>
<i>Gas</i>	<i>Oil</i>	<i>Tires</i>
<i>Insurance</i>	<i>Parking fees</i>	<i>Tolls</i>

If you use your vehicle for both business and personal purposes, you must divide your expenses between business and personal use. You can divide based on the miles driven for each purpose.

Example.

You are the musician. You drove your van 20,000 miles during the year. 16,000 miles were for going to gigs, including delivering equipment, and 4,000 miles were for personal use. You can claim only 80% (16,000/20,000) of the cost of operating your van as a business expense.

The easiest method for most folks is to use the generous IRS standard mileage allowance. This option does not require retention of receipts of any kind. All you need to have is a record in your diary or appointment book of business miles driven.

As a rule, personal miles (going to the grocery store, the dentist, out to dinner, etc.) and commuting mileage are not deductible. If you have a legitimate office at home it tends to make all business miles deductible; after all there can be no commute if you work at home. Otherwise, your commute would normally be the first and last trip every day. To illustrate, if our visual artist Liz left her college job at noon, drove to pick up some art supplies, stopped by to speak to a gallery owner, then drove back to school to check in before going home, all her miles from the time she left school until she arrived back to school would be deductible business miles; the balance would be non-deductible commuting miles.

By keeping an accurate calendar you should have all the info you need to estimate your business miles.

The Home Office/Studio

If you use a room (or rooms) in your home exclusively as your office AND you have no other office space available to you, you will most likely qualify for the home office or home studio deduction. To qualify as a deductible home office the space must generally be:

1. The principal place of business
2. The place where the taxpayer meets with clients, customers or colleagues

The room can be used as an office, a storage area for equipment, manuscripts and supplies, for recordkeeping for the business, marketing, etc. For the actor, dancer, filmmaker, and musician it can be a space for keeping business records, preparing correspondence, promotional activities, rehearsing and library/manuscript storage. For the writer and visual artist the home office is where you write, paint or sculpt. It can be a home darkroom for the photographer.

The home office is a fairly straightforward deduction to calculate on federal Form 8829. It simply utilizes a formula based on the square footage of the business portion (the home office) of your home vs. the total square footage of the house or apartment and then applies that percentage to all associated costs. The costs might be rent (if you do not own your home), mortgage interest, real estate taxes, condo fees, utilities, insurance, repairs, etc. If you own your own home, you can even depreciate that portion of your house for an additional write-off.

For example:

	Business use (square footage)	250
	Total square footage of home	1250
	Business use percentage (250/1250)	20%
Mortgage Interest		\$7,500
Real Estate Tax		\$2,500
Utilities		\$1,820
Water & Sewer		\$820
Insurance		\$400
Repairs		<u>\$225</u>
Total home expenses		<u>\$13,265</u>

Potential home office deduction:
 (\$13,265 × 20%) **\$2,653**

Other rules that come into play here include the “exclusive use” requirement. This rule states that the home office must be used only for the business – no “mixed use” is allowed. Put another way, the home office or studio cannot be a part of a larger room (such as the living room) unless the business part is partitioned off somehow. Be careful when allocating home office expense. The Internal Revenue Service could decide that one of the activities is really a “hobby” and not a legitimate business and then the entire home office will be blown off the return. Why? Because it would no longer be “exclusive use.”

If these rules sound kind of complicated, the Internal Revenue Service instituted a “Simplified Method” of deducting the home office in 2014 and it looks like this:

- Standard deduction of \$5 per square foot of home used for business with a maximum 300 square feet of space (this means a maximum deduction of not more than \$1,500).
- Allowable home-related itemized deductions claimed in full on Schedule A. (For example: Mortgage interest, real estate taxes).
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.
- All other rules apply regarding exclusive and regular use

You will want to discuss this with your tax professional to see if this method might benefit you. If you are doing your own taxes this is certainly an easier process, but keep in mind it will almost always yield a smaller tax deduction.

For instance, if Ima Starr's accountant felt that her book writing would not pass muster as a true business, he would do well to not allocate any home office expense to it.

If you are planning on selling your home in the near future, you are probably assuming that there will not be a tax, thanks to the \$250,000 (\$500,000 if a jointly owned residence) exclusion of gain on the sale of a principal residence. However, if you have a home office, or have taken home office deductions in the past, you may have an extra bit of planning to do in order to make sure you receive the full benefit of the exclusion.

The IRS rules no longer require taxpayers who claim the home office deduction to allocate the gain between business and personal use if the business occurred within the same dwelling unit as the residential use. Instead, only the amount of depreciation you deducted in the past as a home office expense will be subject to a recapture tax.

Equipment Purchases and Depreciation & Amortization of Recordings, Films & Books

This first section concerns the purchase of equipment used by the artist. It pertains to the purchase of any large assets such as computers, printers, tablets, smart phones, scanners, digital cameras, cell phones, software, musical instruments and audio equipment, cameras and photographic equipment, sculptor's welding equipment, presses or other devices used by visual artists, video cameras and equipment, and sound and audio devices. The purchase of a violin or computer is considered intrinsically different from paying the phone bill, in that when you purchase the violin or computer it will have a life beyond the year it is bought, unlike the phone service, which has no "life." Therefore, depreciation of equipment is a method of dividing the cost of the asset over its IRS-defined "useful life" and deducting it a little bit at a time, year by year, until the entire purchase price has been deducted.

In Publication 334 the IRS discusses depreciation this way:

If property you acquire to use in your business is expected to last more than one year, you generally cannot deduct the entire cost as a business expense in the year you acquire it. You must spread the cost over more than one tax year and deduct part of it each year on Schedule C, C-EZ or Form 2106. This method of deducting the cost of business property is called depreciation.

What can be depreciated? *You can depreciate property if it meets all the following requirements:*

It must be used in business or held to produce income.

- ✓ *It must be expected to last more than one year. In other words, it must have a useful life that extends substantially beyond the year it is placed in service.*
- ✓ *It must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.*

What cannot be depreciated? You cannot depreciate any of the following items:

- ✓ *Property placed in service and disposed of in the same year.*
- ✓ *Inventory.*

- ✓ *Land.*
- ✓ *Repairs and replacements that do not increase the value of your property, make it more useful, or lengthen its useful life. You can deduct these amounts on Schedule C, C-EZ or Form 2106.*

Depreciation method. *The method for depreciating most tangible property placed in service after 1986 is called the Modified Accelerated Cost Recovery System (MACRS). (Tangible property is property you can see or touch.) MACRS is discussed in detail in Publication 946.*

Section 179 deduction. *You can choose to deduct a limited amount (for 2018 this amount is \$1 million) of the cost of certain depreciable property in the year you buy it for use in your business. This deduction is known as the “section 179 deduction.” For more information, see Publication 946. It explains what costs you can and cannot deduct, how to figure the deduction, and when to recapture the deduction.*

Listed property. *Listed property is any of the following.*

- ✓ *Most passenger automobiles.*
- ✓ *Most other property used for transportation.*
- ✓ *Any property of a type generally used for entertainment, recreation, or amusement.*
- ✓ *Certain computer and related peripheral equipment.*
- ✓ *Any cellular telephone (or similar telecommunications equipment).*

You must follow additional rules and recordkeeping requirements when depreciating listed property. For more information about listed property, see Publication 946.

What are the typical “lives” of commonly purchased assets according to the IRS?

- ✓ Computer and technology assets = 5 years
- ✓ Automobiles and light trucks = 5 years
- ✓ Office furniture, fixtures, musical instruments and machinery = 7 years
- ✓ Commercial real estate = 39 years

Depreciation is calculated and reported on Form 4562, and is then carried either to the Schedule C if written off against self-employment income, or the Form 2106 if deducted against W-2 employment earnings.

A common depreciation/deduction question that comes up in the arts concerns the purchase of collectables and other antiques. For the actor or director, it can be the acquisition of a film or theatre prop or poster; for the musician it can be a vintage instrument; for the visual artist it could be a piece of artwork; and for the writer it may be a signed, first edition book. While these items may be related directly to your profession, the IRS generally feels such items are personal in nature and are not deductible or subject to depreciation. That is because they are often not used directly in the artist’s profession, but are decorative in nature. The other reason the IRS does not allow a deduction is because the nature of a collectable is to appreciate in value, not depreciate. The IRS has lost several court cases over a musician writing off an antique instrument. In two cases it

was critical that the musician used the instrument in actual performance and recording. By doing this, one taxpayer argued that the use of the bass viol did diminish the value of the instrument due to the perspiration from the performer's hands and through oxidation of the wood. In tax court cases, the IRS can either agree with the court or not agree. In these cases, the IRS did not acquiesce to the decisions of the tax court. So you cannot rely on these court rulings as a precedent. If you do decide to depreciate an antique or collectable, be sure that you are actually using it in your job as an artist and prepare for an argument!

The creation of film, videos, books and recordings follows a concept similar to depreciation: they are assumed to have some value beyond the year in which they are created and are written off over a period of time. In the case of film and recordings, the term used is *amortization*. The total cost of creating the film or recording is capitalized and then written off using one of two IRS-approved formulas. Unlike the purchase of a computer, the IRS does not define a pre-determined life for film and recordings. The two methods are:

1. The individual-film-forecast method (the most common method) – the creator estimates the amount and timing of the income stream from sales of the film, book or recording and expenses the costs associated with the creation or acquisition over that period of time. For instance, if the recording or film cost \$50,000 to produce and the income was expected to be earned over 3 years in the following formula: 65%-25%-10%, then the \$50,000 would be written off \$32,500-\$12,500-\$5,000.
2. Straight-line over the useful life – if the creator expects the film, book or recording to have a useful life of 5 years (probably the shortest life the Internal Revenue Service would generally allow), then he or she would divide the \$50,000 production cost by 5 and take approximately \$10K in expense each year.

An exception to the above concerns music videos. If the artist creates a music video to be used primarily for shopping the artist to record companies, then the cost of the video is immediately deductible as advertising expense, not subject to amortization.

Keep in mind that this quick outline on amortization of film costs is a very simplified overview of some very complex issues. If your artistic endeavors take you into this area be sure you seek out qualified tax professionals to help you.

Travel and Meal Expenses

After the business use of the automobile, travel can be the next most common (and thorny) issue for the artist. Before we discuss travel for the artist, let's see what the IRS says about business travel in its Publication 463, which includes an excellent chart (Table 1) of what types of items are deductible:

Deductible travel expenses include those ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

Table 1 summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.

Records. *When you travel away from home on business, you should keep records of all the expenses you have and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses.*

Travel expenses for another individual. *If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses.*

Employee. *You can deduct the travel expenses you have for an accompanying individual if that individual:*

- ✓ *Is your employee,*
- ✓ *Has a bona fide business purpose for the travel, and*
- ✓ *Would otherwise be allowed to deduct the travel expenses.*

Business associate. *If a business associate travels with you and meets the conditions in (2) and (3) above, you can claim the deductible travel expenses you have for that person. A business associate is someone with whom you could reasonably expect to actively conduct business. A business associate can be a current or prospective (likely to become) customer, client, supplier, employee, agent, partner, or professional advisor.*

Bona fide business purpose. *For a bona fide business purpose to exist, you must prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to warrant a deduction.*

Example: *Jerry drives to Chicago to audition for a play and takes his wife, Linda, with him. Linda is not Jerry's employee. Even if her presence serves a bona fide business purpose, her expenses are not deductible.*

Jerry pays \$115 a day for a double room. A single room costs \$90 a day. He can deduct the total cost of driving his car to and from Chicago, but only \$90 a day for his hotel room. If he uses public transportation, he can deduct only his fare.

Travel expenses you can deduct

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

TABLE 1:

IF you have expenses for:	THEN you can deduct the costs of:
<i>Transportation</i>	<i>Travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar</i>

	<i>program, your cost is zero. If you travel by ship, see additional rules & limits on Luxury Water Travel & Cruise Ships.</i>
<i>Taxi, commuter bus, and airport limousine</i>	<i>Fares for these and other types of transportation that take you to or from: 1) The airport or station and your hotel, and 2) The hotel and the work location of your staff, crew, band members, customers or clients, your business meeting place, or your temporary work location.</i>
<i>Baggage and shipping</i>	<i>Sending baggage, wardrobes, sets & props, sample or display material between your regular and temporary work locations.</i>
<i>Car</i>	<i>Operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate, as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.</i>
<i>Lodging and meals</i>	<i>Lodging and meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverage, taxes, and related tips.</i>
<i>Cleaning</i>	<i>Dry cleaning and laundry.</i>
<i>Telephone</i>	<i>Business calls while on your business trip. This includes business communication by fax machine, cellular phone or other communication devices.</i>
<i>Tips</i>	<i>Tips you pay for any expenses in this chart.</i>
<i>Other</i>	<i>Other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.</i>

In short, deductible travel is when you are taken away from your home for a direct, clearly identifiable business purpose. Keep in mind: meals are almost always only 50% deductible.

Examples:

On Wednesday, Liz Brushstroke drives to NYC to deliver some artwork to the gallery for a new show. The opening is taking place two days later, on Friday. Both Liz and the gallery owner know that it will be good for business if Liz is at the opening, so she stays on in NYC through Friday and drives back on Saturday. This is primarily business. Consequently, Liz will be able to deduct almost 100% of the costs of the trip. She can

use either the IRS per diem rates for meals while in NYC or keep her actual receipts (remember that meals are only 50% deductible).

Guy Focal has a chance to go to the “Printers Row Lit Fest” in Chicago to promote his new children’s book. The publisher has agreed to pay for his flight to Chicago, but he will have to cover all his expenses while there personally. Guy has a good friend in Chicago who he stays with, so his lodging expenses will be zero. What deductible travel expenses will he have? He will be able to deduct all his meals, taxi fares and other ground transportation; he has some entertainment expenses for taking his publisher out to lunch; and he purchases some other children’s books at the show for research purposes, etc.

Use of the IRS Per Diem rates

The US Government publishes and continually adjusts per diem rates for meals, incidentals and lodging worldwide (www.gsa.gov). Per diem rates for meals and incidentals work a little like the standard mileage allowance discussed earlier. If the artist decides that keeping receipts is too time consuming, he or she can choose to use these standard rates for all their meals and incidentals while traveling in a particular year. The IRS explains the standard rate in its Publication 463:

You generally can deduct a standard amount for your daily meals and incidental expenses (M&IE) while you are traveling away from home on business. In this publication, “standard meal allowance” refers to the federal rate for M&IE (which varies based on where and when you travel).

Incidental expenses. These include, but are not limited to, your costs for the following items:

- 1) Laundry, cleaning and pressing of clothing.*
- 2) Fees and tips for persons who provide services, such as porters and baggage carriers.*

Incidental expenses do not include taxicab fares, lodging taxes, or the costs of telegrams or telephone calls.

The standard meal allowance method is an alternative to the actual cost method. It allows you to deduct a set amount, depending on where and when you travel, instead of keeping records of your actual costs. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel.

Caution. There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.

Who can use the standard meal allowance? You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses. You cannot use the standard meal allowance if you are related to your employer.

Use of the standard meal allowance for other travel. You can use the standard meal allowance to prove meal expenses you have when you travel in connection with investment and other income-producing property. You can also use it to prove meal expenses you have when you travel for qualifying educational purposes. You cannot use the standard meal allowance to prove the amount of your meals when you travel for medical or charitable purposes.

Amount of standard meal allowance. The standard meal allowance is the federal M&IE rate. For travel in 2018, the rate is \$55 a day for most areas in the United States. Other locations in the United States are designated as high-cost areas, qualifying for higher standard meal allowances of up to \$76 per day (visit www.gsa.gov/perdiem for the most current information).

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest.

50% limit may apply. If you are not reimbursed or if you are reimbursed under a non-accountable plan for meal expenses, you can generally deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount.

Standard meal allowance for areas outside the continental United States. The standard meal allowance rates do not apply to travel in Alaska, Hawaii, or any other locations outside the continental United States. The federal per diem rates for these locations are published monthly in the Maximum Travel Per Diem Allowances for Foreign Areas.

The general CONUS (continental US) per diem rate for 2019 is \$149 a day. This is allocated as \$94 for lodging and \$55 for meals and incidentals. Locations deemed to be “high cost” localities, such as New York City and L.A., will have higher meals and incidental per diem rates. The US Government also publishes foreign per diem rates OCONUS (outside continental US) to be used for foreign travel. Rates vary from city to city; to get the latest per diem rates go to our website www.artstaxinfo.com for a link or visit the U.S. General Services Administration Website www.gsa.gov/perdiem. The GSA also has a killer per diem app for your smart phone.

Artists can choose to use the meals and incidentals per diem rates for all their business travel in lieu of keeping receipts. Please note: you cannot use a per diem rate for lodging; for that you must always have receipts. If your employer reimburses you using the US Government per diem rates, you may be able to deduct any amount that you spend in excess of the per diem.

A question frequently asked is whether the artist has any tax deductions if the employer covers or reimburses the artist for all expenses. The answer centers on what type of expense plan the employer operates. The IRS allows two basic plans:

1. Accountable Plan - If the employer has what is called an “accountable plan,” the artist will typically not have any tax-deductible costs. In this scenario, either the

artist is reimbursed using the US Government per diem allowances or the artist submits all receipts and details on an expense report (or similar document) and the employer reimburses the artist directly for all the costs. Sometimes the employer may pay a hotel bill and other expenses directly. In an accountable plan, if all the costs are being covered by the employer, the artist will not have any tax deductions. If your employer would have covered a particular expense but you forgot to submit it, can you deduct the expense? Absolutely not! Say our bassist, Sonny Phunky, notices when he is doing his tax returns that he forgot to submit a hotel bill to a band he was employed with during the year. If his contract clearly stated that all living expenses would be covered (the IRS will review these contracts if they audit him), he will not be able to deduct the bills, even if he is past the point of getting reimbursed by the employer. This hotel bill becomes what I call a “tax orphan” that nobody gets to deduct!

2. Non-Accountable Plan - This plan allows the employer simply to give the artist a flat amount in addition to wages on the W-2 to “cover” expenses. Using this system, the artist would be able to deduct all allowable expenses incurred.

Entertainment Expenses

Under 2017 tax reform TCJA entertainment expenses are no longer allowed

Substantiating Your Deductions for Travel and Meals

The area of travel and meals presents difficult substantiation issues for the artist. It is easy to keep records when you pay your business phone, buy a professional book or magazine, pay an agent, etc., but when you take a potential employer, buyer, agent, publisher, producer or colleague out to lunch, how do you “account” for that? What will the IRS ask for to substantiate your travel, meals & entertainment deductions?

You will need two types of records in case the IRS comes knocking:

1. A printed record of your activity (you may live in the digital world, rest assured the Internal Revenue Service does not). No matter what technology you use -- computer, smart phone or tablet, on the cloud or not -- print out a hard copy of your schedule or safely back it up so you can. Record the details of the travel, entertainment and meals, including time, place, who was present, and the specific business purpose.
2. Receipts and itemized bills for meals and entertainment instances under \$75 don't require a receipt (an entry in your “diary” will do); lodging, meals and entertainment OVER \$75 do. For these costs, keep all receipts and itemized bills.

Here are the exceptions (you knew they were coming!):

1. Receipts for transportation expenses of \$75 or more are required only when they are readily obtainable. This is in response to our era of “ticketless” travel. In this case, if you do have a boarding pass or receipt, keep it.

2. A canceled check or credit card statement is not usually considered adequate in and of itself, though many IRS agents will accept them as corroborating evidence. If you cannot provide a bill, receipt or voucher, you may be able use other evidence such as written statements from witnesses.

Receipts should show the following:

- ✓ Amount of expense
- ✓ Date of expense
- ✓ Where the expense occurred

In addition to the above information (which would typically be preprinted on most receipts), the artist should get into the habit of writing the “who, why and where” directly on the receipts or in their diary/schedule book. For a meal or entertainment expense jot down:

1. **Who** was there.
2. **Why** they were there – what the business purpose was (and be as specific as possible!).
3. **Where** the event was – was it in an atmosphere conducive to business discussions?

The IRS always wants itemized receipts of such things as hotel bills in order to ferret out personal items such as phone calls, gift purchases and movie rentals that may be lurking on the bill.

Are there excuses for NOT having adequate records?

1. **Substantial Compliance:** If you have made a good faith effort to comply with IRS requirements, you will not be penalized if you do not satisfy every requirement. In other words, missing one or two receipts or forgetting to make notes on a few meals receipts will not necessarily be grounds for the IRS to throw out an expense.
2. **Accidental Destruction of Records:** House fire, flood, mudslides or other circumstances beyond your control cause your records to be destroyed. In this situation you are allowed to reasonably reconstruct your deductions.
3. **Exceptional Circumstances** – I doubt if anyone knows what the heck this means; the IRS certainly doesn’t explain it in its regulations. The IRS states that if due to the “inherent nature of the situation” you are unable to keep receipts or records you may present alternative evidence.

Be very careful in relying on these “excuses.” As Internal Revenue Service audits have become more stringent, I am not sure that these would prove very effective.

The “QPA” – Qualified Performing Artist

The concept of the QPA entered the tax code during the tax act of 1986. In that act, many, many deductions were diminished or completely abolished by moving them around on the return. One such move was the Form 2106, used to deduct employee

business expenses. Prior to 1986, the 2106 was a very common form, quite logically used to take employee business deductions directly on the front page of the 1040 with no need to itemize. In 1986, the 2106 was moved from the front page of the 1040 and became an itemized deduction on Schedule A. Not only that; it was now subject to a dreaded 2% floor! **NOW** under 2017 tax reform TCJA employee business deductions have been entirely eliminated! Due in part to the work of Actors' Equity Association and of Stage Source (among others), a provision was installed in the code of 1986 for what is termed the Qualified Performing Artist. The IRS explains the QPA this way in its Publication 529:

If you are a qualified performing artist, you can deduct your employee business expenses as an adjustment to income rather than as a miscellaneous itemized deduction. To qualify, you must meet all three of the following requirements:

- 1. You perform services in the performing arts for at least two employers during your tax year. (You are considered to have performed services in the performing arts for an employer only if that employer paid you \$200 or more.)*
- 2. Your related performing-arts business expenses are more than 10% of your gross income from the performance of such services.*
- 3. Your adjusted gross income is not more than \$16,000 before deducting these business expenses.*

If you do not meet all of the above requirements, you must deduct your expenses as a miscellaneous itemized deduction on schedule A subject to the 2% limit.

Special rules for married persons. *If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year. If you file a joint return, you must figure requirements (1) and (2) above separately for both you and your spouse. However, requirement (3) applies to your and your spouse's combined adjusted gross income.*

Where to report. *If you meet all of the above requirements, you should first complete Form 2106 or Form 2106-EZ. Then you include your performing-arts related expenses from line 10 of Form 2106 or from line 6 of Form 2106-EZ on line 32 of Form 1040. Then write "QPA" and the amount of your performing-arts related expenses on the dotted line next to line 32 (Form 1040).*

There has been great consternation regarding the fact that the QPA is so limited. These thresholds have NEVER been increased since the measure was adopted in 1986! So, the QPA provision is useful to fewer and fewer folks each year, but it is still a great tax benefit for low income performers.

The "Hobby Loss" Issue

When you begin your career in the arts, it is quite likely that your expenses will exceed your income, resulting in a loss on your tax return. When this happens in succeeding years you have the potential for the IRS to declare your career as an artist a “hobby.” How does the IRS deem an activity to be a hobby (something “not engaged in for profit” to use its terminology)? This is how it is explained in the Publication 535:

If you do not carry on your business or investment activity to make a profit, there is a limit on the deductions you can take. You cannot use a loss from the activity to offset other income. Activities you do as a hobby, or mainly for sport or recreation, come under this limit. So does an investment activity intended only to produce tax losses for the investors.

The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

In determining whether you are carrying on an activity for profit, all the facts are taken into account. No one factor alone is decisive. Among the factors to consider are whether:

- 1. You carry on the activity in a businesslike manner,*
- 2. The time and effort you put into the activity indicate you intend to make it profitable,*
- 3. You depend on income from the activity for your livelihood,*
- 4. Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business),*
- 5. You change your methods of operation in an attempt to improve profitability,*
- 6. You, or your advisors, have the knowledge needed to carry on the activity as a successful business,*
- 7. You were successful in making a profit in similar activities in the past,*
- 8. The activity makes a profit in some years, and how much profit it makes, and*
- 9. You can expect to make a future profit from the appreciation of the assets used in the activity.*

Many things that one would consider a “hobby” are obvious. Examples would include the attorney who attempts to take his stamp collecting and turn it into a business, thus creating a tax-deductible loss, or the doctor who tries to write off his horse-breeding hobby as a business. Unfortunately, the IRS has established a codified “test” for deciding what constitutes a hobby. This “presumption of profit” test below is from Publication 535:

An activity is presumed carried on for profit if it produced a profit in at least 3 of the last 5 tax years, including the current year. You have a profit when the gross income from an activity is more than the deductions for it.

If a taxpayer dies before the end of the 5-year period, the period ends on the date of the taxpayer's death.

If your business or investment activity passes this 3-years-of-profit test, presume it is carried on for profit. This means it will not come under these limits. You can

take all your business deductions from the activity, even for the years that you have a loss. You can rely on this presumption in every case, unless the IRS shows it is not valid.

Using the presumption later. If you are starting an activity and do not have 3 years showing a profit, you may want to take advantage of this presumption later, after you have the 5 years of experience allowed by the test.

You can choose to do this by filing Form 5213. Filing this form postpones any determination that your activity is not carried on for profit until 5 years have passed since you started the activity.

The benefit gained by making this choice is that the IRS will not immediately question whether your activity is engaged in for profit. Accordingly, it will not restrict your deductions. Rather, you will gain time to earn a profit in 3 out of the first 5 years you carry on the activity. If you show 3 years of profit at the end of this period, your deductions are not limited under these rules. If you do not have 3 years of profit, the limit can be applied retroactively to any year in the 5-year period with a loss.

Filing Form 5213 automatically extends the period of limitations on any year in the 5-year period to 2 years after the due date of the return for the last year of the period. The period is extended only for deductions of the activity and any related deductions that might be affected.

This “hobby loss” is an audit trap that you do not want to land in, as it can be very expensive. The IRS is not automatically tracking this deduction through its computer (at least not yet) and it is only likely to come up in an audit situation when the agent has the opportunity (or reason) to look at several consecutive years of returns. Are artists dead in the water if they have had three consecutive years of losses? Not necessarily. The Second Circuit Court said in a decision issued in 1995: “Code section 183 [the section where the “hobby loss” provisions live] isn’t designed to punish the inept -- only those who deliberately engage in unprofitable activities and with a view to sheltering income.” There are numerous instances where the tax court has allowed folks to write off continual losses against the wishes of the IRS, but be prepared for a fight. Complete and detailed records of your ongoing activities can make a huge difference.

To me, the hobby loss is where you see the palpable difference between the person who opens a local hardware store and the artist. That’s because success is obviously and historically far more elusive for the artist than it is for the retail store owner. When Fred opens his corner hardware store he will quickly close it if he is not making money, whereas folks in the arts will often go on for years racking up losses searching for that “big break.”

Unfortunately for us, when this issue rears its head the IRS agent often views the artist and Fred’s Corner Hardware store in exactly the same light. In the same way he or she examines Fred’s hardware store, the IRS agent will look at your career in the arts as strictly a business proposition, so you will need to clearly prove that you have a profit motive. The heart of this matter is that you have to show that you are attempting to **make**

money. It's that simple. Your records need to show clearly a concerted, consistent, ongoing, business-like effort to land the next acting job, sell the next article, publish the new book, get the gig, land the recording contract or sell the artwork. Your career in the arts needs to have all the attributes of a business in every sense of the word.

Start-up Costs

If you are new to your profession as an artist, you may initially incur what the IRS calls "start-up costs." Start-up costs are legitimate, deductible expenses that occur before the business has actually started; for example, a writer who spends the first two years of a career writing his or her first book. Since no manuscripts were produced and, more importantly, no marketing of any of the author's works was undertaken, all the deductions from the first two years would be deemed by the IRS to be start-up costs. If you have start-up costs, the expenses are added together and then written off (*amortized*) over 5 years.

In Closing....

We have looked at some of the larger expense issues and have seen how the IRS views these matters by looking at their publications. Now let us move on to more specific applications. In the next four chapters we will visit our four artists-in-residence in turn and see how all this information plays out in each of their returns.