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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Personal Financial Planning Division

**GUIDE TO PLANNING
FOR PERFORMING AND
CREATIVE ARTISTS**



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The nonauthoritative practice aids in the *Guide to Planning for Performing and Creative Artists* do not present positions but attempt to offer some alternatives that practitioners can choose from and then modify, if necessary, to meet their needs. They are included as time-saving illustrations and tools. They are not intended to establish standards or preferred practices.

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The exhibits presented in the *Guide* were developed by Mitchell Freedman, CPA/PFS, with the assistance of Andrew B. Blackman, CPA/PFS, CFP.

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READER'S NOTE

This *Guide* was finalized prior to the enactment of the Taxpayer Relief Act of 1997. As a result, for tax years beginning after 1998, the definition of "principal place of business" has been expanded from that discussed in paragraphs 3.71 through 3.76 of this *Guide*.

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Personal Financial Planning Division

**GUIDE TO PLANNING
FOR PERFORMING AND
CREATIVE ARTISTS**

***Mitchell Freedman, CPA/PFS
Andrew B. Blackman, CPA/PFS, CFP***

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GUIDE TO PLANNING FOR PERFORMING AND CREATIVE ARTISTS

1. INTRODUCTION

Purpose of This Book

.01 Hollywood! Broadway! Tin Pan Alley! Movies! Theater! Television! Radio! Books! Scripts! The entertainment business, also known as “The Biz,” can be glamorous, exciting, challenging, rewarding, and stressful. Performing and creative artists earn their livelihoods in “The Biz.”¹

.02 There are few, if any, books published that give practicing CPAs the information they need to perform personal financial planning services for artists. CPAs who provide personal financial planning services for artists have obtained their skills by working with others who have experience in the field. On-the-job training has been the only practical way to obtain the requisite proficiency. It has, therefore, been almost impossible for a CPA to add these services to his or her practice without prior work experience in this field.

.03 Artists have unique personal financial planning needs. The authors, having approximately forty years of combined experience representing artists, have prepared this work to give practitioners the education, competence, and other skills that are needed to properly represent artists in personal financial planning engagements. Both authors have extensive practices representing artists and have practiced in New York and California, the two primary states where artists tend to reside and earn their incomes.

Action Tip

Although most people associate the entertainment industry with such places as New York, California, and Nashville, performing and creative artists live and work all over the country. In your community, they may be —

- Actors in local or regional theater companies.
- Musicians in local or regional symphonies, chamber orchestras, or other musical groups.
- Performers, singers, or musicians in local clubs.
- Dancers in local or regional dance companies.
- Local television or radio personalities.
- Local writers.

¹ Although the main focus of this book is creative and performing artists in the entertainment business, much of it also applies to creative artists who are not in the entertainment field, such as painters and sculptors.

Differences Between Artists and Other Clients

.04 Unlike executives, professionals, salaried persons, and self-employed individuals, artists generally do not have reliable income streams to depend upon. They also tend to have less predictable careers in terms of duration and progression in financial growth than most other types of clients you may be accustomed to representing. Artists' earnings tend to be exceptionally volatile from one year to the next. A hit television series, record album, or motion picture does not guarantee continued success in future projects. Even the most successful artists, whose careers have endured for decades, get "hot" and "cold." It is the nature of "The Biz." This means there can be long periods of time between projects, or the next project may not bring in much money. Superstars can also be creators of, or performers in, flops. The peaks and valleys of artists' careers require them to have the mental capacity to deal with rejection on a daily basis.

.05 Artists may find that dealing with their finances is a distraction from creative undertakings and may therefore prefer to avoid dealing with money. They may also be a target for incompetent or unscrupulous individuals or organizations who want to take advantage of them. Therefore, they will often seek out and hire professionals to help prepare and implement their financial plans. Many artists will hire a business manager to handle everything that has to do with money. While the target market of artists is not terribly large, handling such clients can prove to be rewarding.

The Guilds

.06 There are a number of unions, known as guilds, that represent artists. In order to properly assist an artist, you should be knowledgeable about what these guilds provide to their members. They protect members in the contract area by negotiating certain minimum contract terms — minimum payments for services and minimum reuse or residual payments — with producers and studios. Working conditions are also included in the negotiations. Furthermore, those who use artists, such as producers and studios, must become signatories to the guilds' contracts in order to hire artists and they are precluded from using nonguild members in virtually all domestic productions and many foreign ones as well. Familiarize yourself with the benefits, such as pensions, medical insurance, and life insurance, provided by the guilds. As you will most certainly be involved with planning for retirement and risk management, your knowledge of the guilds' workings and member benefits packages is important.

.07 **Screen Actors Guild (SAG) and American Federation of Television and Radio Artists (AFTRA).** SAG and AFTRA are the guilds that principally represent actors in motion pictures and television, as well as radio personalities. They are being described together because, as of this writing, it appears that these two guilds will likely be merged into one. It is not yet known what the new guild will be called. Currently, SAG represents actors in both motion pictures and television, but AFTRA does not represent artists in motion pictures, just television and radio.

.08 **Writers Guild of America (WGA).** WGA has both East Coast and West Coast branches. It represents writers in motion pictures and television and is a very active guild which has made great strides in obtaining protection and benefits for its members.

.09 **Directors Guild of America (DGA).** DGA represents directors in the motion picture and television fields.

.10 Actors Equity Association (Equity). Equity represents artists on the legitimate stage in plays and musicals on Broadway and in other geographical areas and venues throughout the United States.

.11 American Federation of Musicians (AFM). AFM represents musicians in connection with touring, appearances, and studio (recording) engagements.

.12 International Association of Theatrical and Stage Employees (IATSE). IATSE represents “technical artists,” who work on lighting, sound, editing, designing, and other aspects of production. The members of this union are more in the nature of “craftspeople.”

2. PRACTICE MANAGEMENT

Special Expertise Is Needed by the CPA

.01 The CPA needs to have the skills and knowledge to properly provide services. Each aspect of the entertainment field is different. For example, while there may be similarities between the motion picture and television fields, there are many differences. There are even greater differences between the music field and the television field. Aside from knowing the tax and financial matters related to the entertainment field it is essential to know the language (“buzzwords”), people (“players”), and projects that are planned.

Action Tip

To keep up-to-date, read industry publications, such as *Daily Variety* and *The Hollywood Reporter*, in addition to the *Journal of Accountancy*. Of course, you should keep up with all important professional literature as well.

Engagement Letters

.02 It is important to prepare engagement letters for your client’s signature. Depending on the services you will perform, prepare the letter to clearly describe the services to be rendered. As business management type services tend to be in the nature of comprehensive engagements, it is also important to evaluate and document the services you will not perform and make this clear in the engagement letter or another client communication.

.03 Give attention to the structuring of the language in your engagement letter, clearly stating what responsibilities you are willing to undertake. For example, if you are going to give investment advice, include language indicating that no guarantees are being given as to the performance of investments. This might seem to be fundamental; however, artists commonly have teams of lawyers who can be creative in their effort to find causes of action in lawsuits. Therefore, care in drafting your engagement letter should be a priority. (See exhibit A for a nonauthoritative sample of an engagement letter.) Remember, there is no substitute for a properly crafted engagement letter. It is a good idea to obtain legal counsel’s advice when preparing engagement letters.

Professional Liability Concerns

.04 As mentioned above, the CPA is exposed to liability claims; perhaps even more often when representing artists than other types of clients. Also, the entertainment field can be extremely litigious. Therefore, if you wish to represent artists you must be able to deal with the increased liability exposure. The burden is yours to prove you fulfilled your professional obligations to your client.

.05 Errors and Omissions Insurance. Traditional errors and omissions (E&O) insurance policies should cover the professional services you will provide to artists. However, some insurers may opt not to cover you if a significant portion of your practice is representing artists. If there is a concern about this then discuss it with your current insurance carrier. Contacting other E&O insurance underwriters may help you find out about other options for coverage. Experience has shown that when underwriters are uninformed about what is involved with professional services for artists they tend to refuse coverage. However, if you take the time to educate your underwriters, you will be more likely to obtain coverage.

.06 Liability insurance coverage for investment advice is a tricky matter. Information about obtaining such insurance is beyond the scope of this book. Check with your carrier to ensure that you have coverage for the investment services you provide.

.07 Professional Liability Issues for Business Managers. Business managers tend to have extremely close relationships with their artist clients. Such clients frequently give their business managers check-signing authority. Additionally, it is not uncommon for the business manager to be given the authority to place the client's liquid assets into temporary or long-term investments. This is implementation. Business managers call this their day-to-day responsibility.

.08 Be careful about assuming designated titles on behalf of your clients. If you are named as a trustee of a qualified retirement plan, you are assuming certain legal obligations. Additionally, your E&O insurance may exclude coverage for a CPA holding this title, or require a separate endorsement. Your client, or your client's attorney, may ask you to assume a title of corporate officer as a convenience to the client. Here again, you should make certain that becoming a corporate officer does not have an adverse affect on E&O insurance coverage. It is not uncommon for a client to name a CPA as an executor, a successor trustee of a revocable trust, or a trustee of an irrevocable life insurance or other type of trust. Because of the liabilities assumed and the E&O insurance issues involved, you should consult with legal counsel before agreeing to any such arrangement.

.09 As many business managers take a proactive role in the artist's risk management, this is another area in which you must manage your own risk. The artist's uninsured or underinsured losses may be attributed to your negligent error or omission. Here, again, your engagement letter should spell out the responsibilities you are willing to undertake and those you are not.

.10 Still another area of potential liability is being designated a responsible person for payroll tax purposes. If you are signing checks, or even have check-signing authority that usually is not used, the Internal Revenue Service (IRS) is likely to designate you as a responsible person, subject to the 100 percent penalty, in the event that payroll taxes are not paid. This is a potential trap. Although the authors have never seen the IRS raise this issue, it is still an area to be concerned with.

Relationship of Trust Between Artist and CPA

.11 As a CPA working with artists, you will frequently find that the client wishes to rely on your advice more extensively than you are accustomed to. The reason for this relates to artists being accustomed to listening to and sometimes blindly following the advice or recommendations of professionals. Artists work in a business where directors, editors, producers, agents, personal managers, lawyers, and others “tell” them what to do. They often habitually follow advice and direction. The artists are also routinely living with rejection and criticism. It is not surprising that the artist wants you to tell him or her what to do in a given set of circumstances. You probably are more accustomed to presenting alternatives to a client, who then ultimately makes the decision or selects the option. Providing personal financial planning services to artists, therefore, inherently requires that you be willing to go further in the planning process. Implementation of recommendations, and frequently, monitoring the plan, is usually not a choice when representing artists, it is a necessity. The superior representative of the artist will certainly try to educate the client about the financial matters that require attention. In fact, an effective business manager could have the client ultimately make the decisions. However, the artist will most likely want you to take a very proactive role in the process.

.12 Is the CPA for Artists a Fiduciary? This is a legal question, one, in fact, you may want to address with legal counsel. Whether you take on the legal title of fiduciary with the attached legal exposure when performing services for artists is a gray area. Attorneys for “wronged” artists would no doubt raise certain causes of action against CPAs, including breaches of various fiduciary duties. This exposure area is one of special concern to CPAs who regularly provide personal financial planning services to artists. Attorneys advise that it is prudent to avoid giving an opinion regarding this. In fact, when one of the authors was preparing for testimony as an expert witness in defense of a business manager, the defendant’s counsel encouraged the author to respond to cross examination as follows:

Q. “Do you believe that Mr. Smith was acting in a fiduciary capacity?”

A. “Fiduciary is a legal term. I am a CPA, and I am not qualified to give a legal opinion on that issue.”

The laws of each state may vary with respect to liability of fiduciaries. Suffice it to say that when you provide personal financial planning services to artists you are in a relationship or position of trust, perhaps at a greater level than with most other typical clients.

.13 Fiduciary Acts. It is not unusual for a CPA representing artists to have a signatory power of attorney over the clients’ bank accounts. In addition, CPAs can be trustees of irrevocable life insurance and other trusts. They can also be named as successor trustees to revocable trusts, or even named executors of wills. If these possibilities arise, discuss your concerns with legal counsel. Remember, however, your artist client may expect you to fulfill these roles. Be cautious about what other roles you assume. If you are asked to be designated as a corporate officer, retirement plan trustee, or other title, consult with your E&O insurance carrier to be certain you will be covered for this under the policy. Certain policies will exclude such coverage entirely, while others will permit a CPA to purchase an endorsement for coverage.

Methods of Billing

.14 CPAs who provide personal financial planning services to artists bill, for the most part, similarly to CPAs providing financial planning for other clients, with one major exception: business management services. Many business managers bill a percentage of the client's professional income for substantially all services rendered. A discussion of business management services and alternative fee arrangements follows.

.15 Business Management Services. The term "business management services" is used by those professionals who perform comprehensive bookkeeping and financial consulting services for artists. These services generally include the day-to-day bookkeeping for artists and their controlled entities. It also includes receiving and depositing the artist's moneys, payment of bills, short-term cash management, risk management consulting, filing medical insurance claims, income and other tax planning and compliance, estate planning, portfolio planning and other long-term investment consulting, cash flow planning, and debt counseling and consulting regarding financing. There is an almost endless list of other financial services provided by business managers. The services are adapted to the needs of the artist, the firm procedures of the business manager, or both.

.16 Percentage Fees. Many business managers charge a percentage of the artist's professional income for the day-to-day services. This practice evolved because of the peaks and valleys of artists' earnings. The volume of the business manager's work is not necessarily related to the client's work volume. In fact, experience shows that artists tend to need more services when they are idle, because they have the time to focus on purchases and consumption. So the artist pays the business manager while working, and then is entitled to the same attentive service when not working. It is a billing method that has survived the passage of time because it works. The fee charged is usually 5 percent to 6 percent of professional gross income. Business managers may also charge for such out-of-pocket costs as postage, messengers, overnight mail, telephone, computer usage, and faxes. Others may include such charges in the basic percentage fee. For high-earning artists, the business manager and client may negotiate a maximum fee, or "cap." It is also common to set a minimum fee for the business manager, because of the intense amount of labor required to service the client on a day-to-day basis. Most business managers will exclude certain services from the percentage fee arrangement. Services for litigation, marital disputes, profit participation and royalty audits, representation at Tax Court, nonentertainment-related, and other services may be excluded from the percentage fee arrangement and billed in an alternative way.

.17 Retainer Fees. Business managers may also charge a periodic retainer, or fixed fee. Clients tend to desire this method because it results in a predictable cost. The workload problem here is similar to that which occurs with the percentage method, but here there is no "up side" to the business manager if there is a windfall earned by the artist. A modification of this method would be a periodic retainer, which is "examined" and modified at the end of a specified period, resulting in a one-time additional charge or credit.

.18 Hourly Fees. Charging for services on an hourly basis is another option. The problem, however, is that the concentration of work may not coincide with a time when the client has sufficient liquid funds available to pay the charges. The artist who sees a bill for many thousands of dollars for tax planning work has a hard time understanding why so much work was necessary. If the business

manager skimps on service to keep the fees under control, the services will likely be compromised negatively. This is a major reason why the percentage billing arrangement has endured.

.19 Fee Regulations. Many states do not permit commissions or contingent fees to be charged by CPAs. Review the applicable state laws and regulations in this area, and consult with legal counsel if necessary, when determining your method of billing.

Staffing the Engagement

.20 First-rate professional, paraprofessional, and clerical staff are among your most important assets. This is especially true if you represent artists. Many personal financial planners grouse that it is difficult to leverage staff. Clients generally expect the “top guy” to do the work. While this may also be true with artists, they are accustomed to lower level staff working on their matters. This provides the opportunity for you to represent a larger number of clients.

.21 Hiring Staff. If you represent artists, you will use many of the traditional techniques to hire staff. Remember the importance of good communications skills. Besides being intelligent, your staff members need to be articulate and personable. They must be able to communicate clearly and effectively with clients, bankers, lawyers, agents, personal managers, pension administrators, creditors, money managers, and a myriad of other people. Communicating with the client’s spouse is also exceedingly important.

Action Tip

Look for the following traits when selecting professional staff.

- Analytical skills
- Professional skepticism
- Experience in business, finance, taxation, and investments
- Computer literacy
- Interest in the entertainment field
- Familiarity with the related professional literature
- Communication skills
- Self-confidence
- Patience

.22 Another important matter is that professional staff are not likely to obtain experience that will qualify as auditing experience under state board of accountancy rules. Therefore, you may need to hire professionals who are already certified, or who have already obtained the required auditing experience to qualify them to become CPAs.

.23 Hiring paraprofessional staff is also important. Qualified bookkeepers are an essential part of your team. They may have more day-to-day contact with clients and others outside of the firm than you, and they can serve as your extension in many matters. Clerical personnel are also an important element of staff. They should be competent and always reflect the professional image you want to express. Emphasize to staff that they should not fawn over celebrity clients. No autographs, asking for pictures, or other favors should be requested.

.24 Training Staff. Continuing professional education (CPE) is a challenge for CPA firms that provide services to artists. Certainly personal financial planning and tax planning courses can be used.² In-house CPE can be used as a supplement. On-the-job training is one of the most necessary training grounds for staff that will handle artists. Also, state CPA society committees can provide a forum for professional networking and educational opportunities. The California Society of CPAs' Los Angeles chapter has a CPA Business Managers Committee that meets monthly and draws a substantial audience. It also has an Entertainment and Sports Committee. UCLA has an annual Entertainment Tax Institute to provide CPE in the tax area. The New York State Society of CPAs has an Entertainment and Sports Committee and an annual conference to provide CPE to individuals who are interested in the subject. Your state CPA society may have a network you and your staff can use to keep abreast of current developments in this field.

.25 Delegating Authority. As previously mentioned, if you provide personal financial planning, especially business management services, to artists, you will have the opportunity to leverage staff more than you may be accustomed to, because of the greater amount of original bookkeeping work required, and the amount of tax planning and cash flow planning needed. You must learn to delegate clerical and certain time-consuming tasks to staff.

.26 Supervising Staff. Many CPAs are not used to supervising staff for financial planning work, because they generally do most of the work themselves. When planning for artists, however, you must learn to look at the entire picture and allow your staff to work on the details. But certain responsibilities should not be delegated to lower staff personnel. You, or another qualified professional, should be involved in all investment, risk management, and insurance decisions. Having a series of checks and balances to review work is advisable. See exhibits B through G for examples of checklists you can incorporate into your practice to help ensure consistent procedures.

.27 Retaining Staff. Staff retention is always an important element of practice management. Your investment of time and money to train staff is enormous. Since you rely on your staff to perform a great many tasks, it is in your best interest to retain qualified staff members. The glamour of the entertainment field will rub off quickly. It may attract staff, but it will not keep them. While it is desirable to have staff grow professionally, it is also important to maintain continuity on jobs. Artists, even more than other clients, tend to be uncomfortable with change, and they come to rely on the people who handle their affairs. Your biggest challenge here may be striking a balance between providing career development for your staff and maintaining continuity for your clients.

.28 Using Paraprofessionals. Since professional staff often desire a fast-track career, the use of paraprofessionals should be considered.

² The AICPA has a group study course, *Tax Considerations for Professional Athletes and Entertainers*. Presentations of the seminar are offered through sponsoring state societies.

.29 Bookkeepers. Experienced and knowledgeable bookkeepers can be among the most useful staff members available to the CPA who provides services to artists. They can do much of the analytical work that would otherwise be given to less experienced professional staff. Good bookkeepers can be taught how to prepare tax returns, projections, and an assortment of other projects. You will find many ways to use their skills.

.30 Enrolled Agents. The enrolled agent (EA) is qualified to assist with tax planning, tax research, and tax preparation. You can also teach an EA to perform many of the tasks that would otherwise be given to professional staff.

.31 Other Non-CPA Financial Planners. Other personnel, including economists, certified financial planners (CFPs), chartered financial consultants (ChFCs), and insurance experts, can be used on your team to provide personal financial planning services to artists. Other non-CPAs can also be used, if they have the necessary skills and experience, or if you have the time and inclination to train them.

Engagement Management

.32 Engagement management is a significant challenge, particularly if you are performing business management services. How well you supervise the work is a major factor in determining whether professional standards are met and whether the engagement is profitable. If you are charging fees on a percentage, or fixed fee, basis, your client's earnings may result in the engagement being unprofitable for a period of time. Still, you cannot compromise the quality of the job to save time. The client is entitled to your time and attention, regardless of the fees.

.33 Internal Control. In order to provide adequate control for business management engagements, you should develop and maintain the appropriate internal procedures to avoid major problems or omissions. Adhere to professional and firm standards to maintain control of the work.

.34 Work Programs and Checklists. Various checklists that help staff perform and review the work can be useful tools. Consider giving bookkeepers printed guidance in the form of worksheets and checklists. Schedules of daily, weekly, monthly, quarterly, and annual responsibilities will help maintain quality. Accounting and financial planning staff can also benefit from the use of checklists. (See exhibits B through F, for examples of various work programs, checklists, and responsibilities documents.)

.35 Segregation of Responsibilities. Segregating your key cash control functions and duties is a useful internal control. If you receive clients' cash in the office, consider having someone other than the bookkeepers open the mail and independently prepare a listing of all checks received on a daily basis. (See exhibit G for such a format.) This sets up a barrier that helps prevent temptation. There are other areas, such as preparation and review, where segregation of responsibilities may also be appropriate. Use your professional judgment and knowledge of your office and practice to determine job functions and appropriate segregation of duties.

.36 Office Security. The CPA who represents artists will likely have a good deal of private client information and data in the office, such as checks made payable to the artist, client credit card information, clients' blank checks, or check stock. Detailed information about artists' asset accounts, telephone numbers, and other private matters would also be readily available. Accordingly, it is necessary to set up appropriate security procedures.

Working With Other Professionals

.37 Artists usually surround themselves with a team of professionals to assist them in achieving their professional, financial, and personal goals. This team contributes to the artist's ultimate success. Each member of the team has particular responsibilities and duties. Some work independently while others work with one another to achieve the ultimate goal. An analogy for how this works might be that the artist is the hub of a wheel, and each professional is a spoke in the wheel that leads from the rim to the hub. The rim makes the wheel work. You or the business manager are the hub cap, or wheel cover, through which all financial, and even some personal, information is processed. The artist relies on the business manager to act in this role. If you are interested in representing artists you should learn the etiquette and protocol of dealing with the other professionals on the team and what each professional does for and on behalf of the team.

.38 Agents. Whether they are referred to as booking agents, talent agents, or — in the case of writers — literary agents, they have the same function: to procure employment for their clients. The agent locates the projects the artist will work in or on, communicates regularly with the artist, and negotiates the significant “deal points” for the engagements. The significant deal points include project earnings, deferments, profit participations, term of work, reimbursement for costs or per diem, credits, and other important deal issues such as “pay or play.” The agent generally prepares a “deal memo” outlining the significant deal points. The agent is generally compensated by a commission of 10 percent of the artist's earnings. Agents are state licensed and controlled, and are generally approved by a guild to service clients in a particular field. An agent's contract with an artist is generally subject to standard language negotiated by various guilds, such as the Screen Actors Guild, the American Federation of Television and Radio Artists, the Writers Guild of America, the Directors Guild of America, the American Federation of Musicians, and others. Ordinarily you will work closely with agents in order to have effective communication about negotiations and progress on projects. You will need this information in order to plan effectively for cash flow needs, income tax planning, and assets available for investment. Business managers should also have input regarding certain financial aspects of contracts.

.39 Personal Managers. Personal managers serve varied roles to artists, including career counselors and decision-makers regarding other team members and their functions. Artists generally delegate enormous career and personal responsibility to the personal managers. In many cases the personal manager “speaks” for the artist on almost all issues, both personal and business. Managers are typically compensated by a payment of 15 percent of the artist's professional earnings, although they may accept a lesser amount. In the music field they may earn a larger percentage, which is subject to negotiation at the beginning of the relationship. Personal managers are not regulated or licensed. Accordingly, their duties are sometimes not clearly defined. However, personal managers are not permitted to negotiate contracts for the artists; that is the function of the agent. CPAs generally work very closely with and communicate with the personal managers on numerous business and personal matters pertaining to the artist. The personal manager will usually be the dominant member of the artist's management team.

.40 Attorneys. The entertainment attorney negotiates and drafts the fine points of contracts. As mentioned above, the starting point is the “deal memo.” The attorney will elaborate on the “deal memo” and make it a more definitive agreement. Definitions of profits are negotiated by the attorney, preferably with the assistance of and in consultation with the business manager or CPA. The entertainment attorney generally has a very close relationship with the agent. He or she should also

have good working relationships with studios, record companies, or both. If the artist's attorney is not an entertainment specialist you may want to have significant input in the drafting of contracts to be certain that such matters as definitions of profits, percentages for royalties, tax issues, risk management issues, and any other financial points, such as the entity that will perform the services, are adequately addressed. Other attorneys that are likely to be needed by artists are those specializing in areas such as real estate, litigation, estate planning and charitable giving, family law, and the requirements of the Employee Retirement Income Security Act of 1974 (ERISA). This is not substantially different than with nonartists, except that you are likely to interact more with the attorney and then explain the key issues in understandable terms to the artist.

Action Tip

Understand the appropriate protocol in dealing with attorneys. Some attorneys take a very proactive role with the artist, while others maintain an advisory position. You must draw a fine line between being aggressively involved in legal matters while advising an artist, and potentially offending an attorney, who is also looking out for the artist's interests. Remember, your client's interests always come first, but the attorney is an important networking source. The professionals who work in the entertainment industry generally know each other. Many attorneys, and even CPAs, have clients with competing interests. Charges of conflict of interest against lawyers are increasing with regard to contract negotiations in the performing and creative arts. Therefore, consider which "wars" are worth fighting with attorneys in order to protect both the artist and yourself.

.41 Bankers. The banker is another important member of the artist's team. A banker who is familiar with the entertainment field is valuable both to you and your client. There are a number of banks that have specific departments dealing with the entertainment industry. For good reason, you should seriously consider developing a relationship with one or more such banks.

.42 Banks enjoy servicing artists, particularly those who are represented by business managers. CPAs who are business managers tend to "control" large sums of money that can be deposited into banks. The float alone on the deposits can be significant to the banker. Artists tend to be depositors more than borrowers. The clout for controlling these deposits can give you a negotiating advantage when your clients need to borrow funds. In addition, various services for which banks normally charge fees can be obtained free of charge. Intelligent loan officers will not approve a loan that is destined to go bad. However, when the benefit of the doubt is needed, your deposit base will be considered by the banker. Bankers who understand the industry do not have to be educated about why an artist may need to borrow, because they understand artists and their business. Favorable pricing of loans can also be affected not only by the borrower's creditworthiness but also by your overall client deposit base. Bankers can also provide other needed services, such as real estate escrow (if used in a particular jurisdiction), escrow, safe deposit boxes, credit cards, trust, asset custody, wire services, foreign exchange, and so on. This enhances your value to the artist.

.43 Insurance Professionals. CPAs who represent artists will normally have extensive dealings with their clients' insurance advisors. Your knowledge of insurance is important because you will be called upon to counsel the artist. Review the applicable state requirements regarding providing insurance services. See paragraph 2.52 later in this section regarding licensing. Become knowledgeable about life, health, disability, and long-term care insurance, and related insurance issues.

When representing artists, you will most likely need to develop a working knowledge about both personal and business property and casualty insurance as well. The risk management area is covered in more depth in paragraphs 8.1 through 8.29. There are insurance professionals who are specialists in entertainment industry insurance, both personal and business. Developing strong working relationships with these insurance professionals will help ensure that risk management issues are properly addressed. Good insurance brokers can be lifesavers for you and your clients. They can also be extremely helpful when it comes to pursuing and adjusting claims that artists have.

.44 *Life, Disability, Health, and Long-Term Care Insurance Providers.* You will have little trouble finding salespeople for life, disability, long-term care, and health insurance. However, finding qualified professionals who understand and have experience providing products for artists is a challenge. Nevertheless, professionals experienced in this area will save you a great deal of time and effort in the long run.

.45 *Property and Casualty Insurance Brokers.* The property and casualty insurance professional is also an important component of the team in that he or she helps you advise the artist concerning appropriate personal and business insurance. Experience in the entertainment field is very important in order to avoid unnecessary or unwanted gaps in coverage. Rely on this professional to advise on current issues relating to the artist's property and casualty insurance. Today, most of these insurance professionals send numerous communications in an attempt to keep the CPA, or business manager, and artist informed about insurance matters. Be wary, since the volume of information sent may tend to protect the insurance professional, and put you at some risk. For example, if you are charged with the responsibility of implementing risk management plans, your failure to make a decision, communicate information, or obtain needed data from the artist may result in liability. The authors have observed CPAs make judgment errors, omissions, or both, which have resulted in uninsured or under-insured losses. Therefore, consider limiting your liability in this area by defining, in the engagement letter, the responsibility and limitations you are willing to accept.

.46 *Retirement Plan Consultants and Actuaries.* This professional is also an important member of the team. If there are complications, the consultant may also work with an ERISA attorney. Most business managers will use a retirement consultant to develop and handle private retirement plans for artists. Many business managers do not perform the compliance reporting work for artists. With the myriad changes that have occurred in the retirement planning area over the past twenty-five years, the CPA has become accustomed to interacting with this professional. Recent developments in the private retirement plan area for artists have made the retirement plan consultant even more important. Integration between private plans and guild plans is an evolving area. There are many retirement plan consultants who are not knowledgeable about the specific issues involving artists. Therefore, it would be in the best interest of your clients and yourself to increase your own body of knowledge and keep abreast of current matters. See "Retirement Planning," paragraphs 4.01 through 4.20, for a detailed discussion of this area.

.47 *Investment Advisers.* Many CPAs and business managers for artists give specific investment advice and are involved in implementation of investment plans. They tend to have responsibility for making sure that liquid assets are working for the artist, and frequently are also charged with implementing long-term investment plans. If you do not give specific investment advice, then bring in the expertise of other professionals, such as money managers and stockbrokers, to perform the

portfolio allocation and select the specific investments. Depending on your particular situation, you may need to become a registered investment adviser. See paragraph 2.53 later in this section.

.48 Money Managers. Many CPAs are familiar with and have relationships with money managers. Money managers can be excellent choices to implement the artist's investment objectives. An artist may receive large sums of money in a short time frame. Determining the appropriate mix of investments, along with the timing of their placement and their time horizon, is a challenge. Your role is to help your artist client make an informed decision selecting a money manager whose investment style matches the artist's investment objectives and risk tolerances.

.49 Stockbrokers. Stockbrokers will pound their way to the door of the CPA who represents artists. The reason is obvious: a large sum of money to invest. Your challenge will be finding unbiased stockbrokers who recognize that if they do an effective job for the artist, and thus win favor with the business manager, they will generate more business. You must always keep the artists' investment objectives and risk tolerances focused in a way that works best throughout their particular economic cycles. Since artists tend to be "hot" or "cold" they need to have a sufficient liquid asset position to meet not only emergencies, but also the ordinary cash requirements of time periods between projects.

.50 Real Estate Brokers. The CPA who represents artists will undoubtedly have dealings with real estate brokers and salespersons. Artists, like other clients, buy and sell residences, vacation homes, land for building or investment, and other real estate for either investment or personal purposes. You'll often find yourself involved, possibly even doing substantially all of the negotiations on behalf of the artist, when purchases and sales of real estate occur. Good relationships with professional and knowledgeable real estate brokers and salespeople are important. Real estate professionals who will give honest, unbiased counsel that can be trusted can assist with the sale and purchase transactions. Their experience in dealing with celebrities is helpful in another way, since it is not pleasant for the artist to be fawned over by a starstruck realtor.

.51 Mortgage Brokers and Bankers. When real estate financing is needed for purchases, construction, refinancings, or home equity loans, you can spend an inordinate amount of time and effort tracking down the "best" loans. And anyone who has been involved in assisting with real estate financing in recent years knows that interest rates change daily and loans vary greatly. An informed professional can be a great asset on the artist's team. Furthermore, if you provide significant business to a mortgage loan professional, you're in a good position to negotiate better pricing and get approval for creative and marginal loans. If you keep abreast of the financing market and negotiate with your mortgage professional, using such a person will not cost your client any more money and your own investment of time will likely be substantially reduced.

Licensing as an Insurance Agent

.52 Many states regulate the giving of insurance advice and require licensing before advice can be given for a fee. All states, however, require licensing when the advice is given for compensation from a commission through the placement of an insurance policy. When a CPA renders risk-management or insurance advice rather than recommending specific policies within the context of a PFP engagement, most state regulations exempt the CPA from the insurance licensing requirements. This is also often the case when the insurance discussion is provided as part of a CPA's traditional responsibilities. Therefore, before advising clients, a CPA should consider checking the specific

regulations of the state(s) involved and possibly seeking the advice of legal counsel. Further information on state regulation can be found in services, such as *The Advanced Sales Reference Service* [The National Underwriter, (800) 543-0874], or by contacting the insurance commissioner of the particular state or the National Association of Insurance Commissioners at (816) 842-3600.

Registration as an Investment Adviser

.53 Representing artists in the investment area has its risks. Should an investment or a portfolio not achieve the desired result — or worse, do poorly — you may have some potential liability and there may also be negative publicity about the matter in the media. Many artists have their own publicists to create news releases. If your relationship sours, they could be used to disseminate adverse information about such matters. Even if the artist does not have a publicist, the media is always checking court records for information about lawsuits involving celebrities. CPAs can find that they are “convicted” by the client and the media before a case is decided in the courts. This is a realistic concern. The faint of heart should heed this warning and decide whether or not representing artists is worth this risk. How does this relate to registration? If you are not registered, attorneys are likely to raise the issue of your nonregistration with the SEC and the state in any case alleging malpractice for investment matters. However, if you are operating in a CPA firm, and the investment advice is solely incidental to the practice of accounting, you may be exempt from registration. Refer to the *Guide to Registering as an Investment Adviser*, which is published as part of the AICPA’s Personal Financial Planning Library, and consider obtaining legal advice when determining whether registration is required.

Other Practice Management Issues

.54 Other issues which must be faced, particularly as they relate to artists, follow.

.55 Giving Counsel to Financially Unsophisticated Clients. Most CPAs are accustomed to clients who have earned their money by building a business or obtaining a high income level in a profession or management position in a company. These clients are likely to have higher levels of education and, at the very least, a basic understanding of financial matters. Often these clients are highly sophisticated in finance. Artists, by contrast, even those with higher levels of education, generally have little or no knowledge about finance. They rely on the CPA for substantially all of their personal financial matters. The process of educating artists about finance is, accordingly, demanding.

.56 Communicating With Intermediaries. Your artist clients may want you to communicate some, most, or all important financial matters through an intermediary, such as a friend, family member, personal manager, lawyer, or agent. This is not an uncommon arrangement, but it is worth mentioning the artist’s desire for communication through an intermediary in your engagement letter. Additionally, consider having the artist sign an indemnification agreement, or put such a clause in the engagement letter, to protect you if you rely on statements made by the intermediary. Furthermore, inform the artist that certain matters may have to be communicated directly between you and the artist.

.57 Matters Relating to the Nonworking Spouse. You will likely have a substantial amount of communication with the nonworking spouse if one exists. If the spouse has his or her own personal financial representation, the CPA can be an advocate for the artist. However, this is not usually going to be the case. In most cases, legally and ethically, both the artist and the spouse are clients. But many

times the artist's spouse feels that you are an advocate for the artist. Therefore, consider discussing the effect on both the artist and his or her spouse when giving financial planning advice. In fact, it is a good idea to inform both parties of the pros and cons of various alternatives that must be decided upon by the clients. You should consider discussing these issues with both parties at the beginning of the relationship and adding appropriate language in the engagement letter. Also, be aware that similar issues may exist with respect to nonmarried partners.

3. INCOME TAX PLANNING

.01 Income tax planning is an essential component of the comprehensive services a CPA typically provides to artists. As with many high-income earners, federal, state, local, and foreign income taxes generally comprise the largest category of expense incurred by these clients. Accordingly, minimizing income taxes can contribute significantly towards the achievement of various financial goals.

Performing Services as an Individual

.02 Whether the artist performs services as an individual, or through a corporate entity, there are numerous tax issues to address. A discussion of those related to services provided as an individual follows.

.03 Federal Taxes. Generally, the tax planning that can generate the most significant savings is planning for federal income taxes. The itemized deduction floors (such as percentage of adjusted gross income [AGI] limitations on medical expenses and miscellaneous itemized deductions) and ceilings (such as interest on mortgage debt and the alternative minimum tax [AMT]) usually create the toughest challenges for planning purposes. Planning techniques used with other types of clients would normally apply here. Consider bunching deductions or income. Multiple-year tax projections will help illustrate the effects of this technique. The goal is to lower the total income taxes during the projection period. The time value of money is another element which warrants consideration in this analysis.

.04 Business Deductions and AMT. Generally, the single most influential aspect of federal tax planning occurs with business related deductions, if these trigger the AMT. Accordingly, attentive planning for the AMT can produce the greatest tax savings to the artist. Most artists will typically have various sources of revenue during any given year. The character of the work relationship should govern whether the income is reported as wages or self-employment income, and similarly whether the related business expenses are to be reported on Schedule C (not affected by the floor or ceiling) or Form 2106 (limited to the excess over 2 percent of AGI and perhaps also by the AMT). As a practical matter, however, the reporting on the artist's tax return should normally follow the reporting by the payer (that is, if income was reported to the artist on a Form W-2, report the income on the income tax return as wages, whereas if it was reported on a Form 1099, report the income on the artist's income tax return as self-employment income).

.05 Due to the preferential treatment accorded "above-the-line" deductions, as well as the additional potential benefit of reducing any limitation based upon AGI, it is usually desirable to relate as many business expenses as possible to the self-employment income and as few as possible to the wage income. Some categories of business deductions resemble costs of sales in that they are easily

identified as relating to, and are variable with, specific income and must be incurred in the production of that income (for example, commissions based upon a percentage of the income or out-of-town expenses for a specific project). Many categories of expenses, however, more closely resemble indirect costs or general and administrative expenses in that they are related to income from several different sources (for example, telephone or automobile). While some of these expenses might be directly related to the various categories of income, it is often impractical, if not impossible, to trace them.

Action Tip

To maximize the tax benefit of deductions when a client has both wage and self-employment income, develop methodologies that will justify allocating as much of the general and administrative type expenses as possible to the self-employment income. Consider allocating expenses based upon the relationship of gross income, time devoted, number of projects worked on, or any other reasonable method.

.06 Aliens. Artists who are citizens of other countries may incur U.S. tax liability under certain circumstances. Taxation in the United States can occur either as a resident alien or as a nonresident alien. If an alien passes either the “Green Card Test” (the alien acquires a green card) or the “Substantial Presence Test” (the alien has a substantial presence in the United States), he or she generally would be taxed in the United States as a resident, and accordingly, would pay U.S. taxes on the worldwide income (that is, the alien would be treated for U.S. tax purposes the same as a U.S. citizen). If an alien does not meet either of these residency tests, U.S. tax liability would not apply to worldwide income, but would still generally apply to any U.S.-sourced income. In this instance, the artist would file as a nonresident alien on Form 1040NR. A thorough review of the Form 1040NR instructions will aid in the income tax planning and compliance, as the rules and tax forms that apply to the nonresident alien may be different from those that apply to a U.S. citizen. Also, consider the artist’s spouse, since his or her citizenship, residency, and income may affect your tax planning for the artist (for example, considering whether a joint return can be filed and if it will be beneficial).

Action Tip

The intricacies of these tests and when exceptions might apply are detailed in IRS Publication 519, *U.S. Tax Guide for Aliens*.

.07 Social Security. Many European countries and Canada have bilateral Social Security agreements with the United States to coordinate Social Security coverage and taxation of workers employed in one of the countries in order to avoid duplication of coverage and taxation. Agreements with other countries are expected to be entered into in the future. These agreements generally provide that workers will be subject to Social Security taxes only in the country in which they work. Work for a temporary period, however, in a country other than the country of residence, is generally exempt from Social Security contributions where the worker is covered by the Social Security system of the country of residence. Accordingly, artists may be able to avoid Social Security contributions when working in a country other than their country of residence.

☛ **Action Tip**

A word of caution: reviewing any income tax treaty and Social Security agreement that may be in force at the time of planning is critical. There may be portions of these agreements that supersede the general rules found in IRS Publication 519.

.08 Foreign Taxes. Planning for foreign (non-U.S.) income taxes can take different paths. In addition to their U.S. income taxes, artists who are U.S. citizens and resident aliens of another country may be liable for foreign income taxes when working abroad. Alternatively, nonresident aliens and resident aliens may remain liable for income taxes in their home countries even when all their income is sourced in the U.S. (or some other country or countries). In either case, planning may require the involvement of local tax specialists who are knowledgeable about the tax laws of the foreign jurisdiction(s) and their application to artists. This will be especially true when the artist is an alien (resident or nonresident) who remains subject to taxation in his or her country of citizenship.

☛ **Action Tip**

Irrespective of the artist's tax home, the thrust of tax planning will be the same: construct a plan that allows the artist to pay the lowest income tax on a combined basis (the total of the foreign income tax or taxes and the U.S. income tax). To achieve this goal there are some general rules to follow.

- Start early! Determine the applicable tax rules before work begins. This is especially true if the artist may be able to use a loan-out corporation as an alternative to operating individually. The reason for this is due to the necessity of having the contract entered into by the corporate contracting party. Consult the applicable treaties, if any. Locate and involve a specific country specialist, if necessary. Consider developing and maintaining a network of these specialists. (See a further discussion of loan-out corporations in paragraphs 3.12 through 3.25.)
- Negotiate up-front settlements in unfavorable jurisdictions, if possible.
- Maximize use of foreign tax credits, when available. Try to avoid taxation in jurisdictions where rates exceed those of the tax home country. Try to reduce rates, if possible. Analyze alternative methods (such as paid or accrued) and carrying provisions, if available.
- Avoid double taxation when foreign tax credits are unavailable, if possible.
- Bifurcate the contract, if feasible. This may be of benefit when services for a project are performed in more than one country or tax jurisdiction (and hence compensation should be split between the territories) or when there are pre- or post-production services performed outside the foreign jurisdiction(s). Allocate as much towards the more favorable jurisdiction(s) as can be reasonably justified.
- Request a tax indemnification clause in the artist's contract with the producer when foreign taxes will cost the client more than if services for the project were performed domestically.

.09 State and Local Taxes. Depending upon the artist's state and city of residency, state and local income taxes may also be a significant component of the artist's total expenses. Minimizing state and local income taxes will contribute to the artist achieving his or her financial planning goals. The location where the artist renders services is often more influential a factor than the artist's state and city of residency, as many jurisdictions impose income taxes on nonresident earnings. While this is not a wholly unfamiliar scenario for many CPAs, the instances when a non-artist client has multiple state filing responsibilities tend to be limited, predictable, and repetitive from year to year (such as the client who works in New York City, but lives in New Jersey). This is in stark contrast to the situations that frequently arise for artists. Due to the nature of many artists' careers — they may work for several different parties on a number of different projects in many different locations — there will generally be a variety of state and local taxing jurisdictions to plan around in any given year and these will often change from year to year.

Action Tip

The resident state will generally allow an interstate tax credit for the income taxes paid to the nonresident state(s) in proportion to the income reported to the nonresident state(s); however, this is not in general true for taxes paid to nonresident municipalities. The interstate tax credit is generally further limited to the income tax imposed by the resident state on the nonresident income (that is, the credit is limited by the rate of tax of the resident state, and accordingly, if the nonresident tax rate is higher than the resident tax rate, the credit for taxes paid to the nonresident state will be limited).

Review the tax rules of the nonresident state and prepare individual nonresident state tax projections as projects are completed. Then determine the amount of projected resident tax that will remain after the projected interstate tax credit(s). This will assist the tax planning in at least two ways. First, you'll become familiar with the nonresident state's tax structure, which will allow you to explore alternative approaches of preparing the nonresident state tax return well in advance of the filing date. Second, you'll gain insight into the impact on the resident state tax return of the credit(s) and whether or not additional tax payments to the resident state are required. This may help to avoid penalties from the resident state for underpayment of estimated tax. Most important, avoid overlooking nonresident state tax returns simply because there was no withholding. A required state return that is not filed will ordinarily cause the statute of limitations to remain open. While some states are more aggressive than others in pursuing nonresidents, the potential for losing an interstate credit is at stake. The artist confronted with filing a delinquent nonresident income tax return after the statute has expired on the resident income tax return will likely pay more income taxes in total, as the lapsed statute on the resident income tax return will prevent him or her from receiving the interstate credit which may have been available had the statute not expired.

.10 State and Local Residency. Many artists will have the luxury of being able to choose the state in which they live and some will have residences in more than one state. This will be a function of both their relative affluence and the nature of the industry with respect to the workplace (that is, many writers can work from home, and others, such as directors, thespians, musicians, and other performers, often work on location, and accordingly, do not have a recurring workplace). You should inform your artist clients of the impact that their choice of state for residency will have on their state and local (and occasionally federal) income taxes.

.11 Some artists may be willing to live in low tax jurisdictions in order to reduce state and local income taxes. Be prepared to discuss this option, including identifying when opportunities exist, quantifying the potential income tax savings, and informing the artist of the factors involved in establishing and maintaining residency, as well as how to avoid being deemed a resident by high-tax jurisdictions (such as New York City). While the state and local income tax burden will largely be governed by where services are rendered, there may be a significant opportunity to reduce total state and local income taxes by residing in a low tax jurisdiction when —

- A significant amount of income is from interest, dividends, and capital gains from intangibles.
- A significant portion of earnings is from services provided in low- or no-tax jurisdictions.
- A significant portion of earnings is from services provided abroad.
- A significant portion of earnings is from royalties.
- The artist can work out of his or her residence.

Performing Services Through a Corporation

.12 The Loan-Out Corporation. Performing services through a corporate entity, commonly known as a loan-out corporation, has been a popular income tax planning technique for artists for many years. The loan-out corporation is not a technical term defined in law, but rather an industry term coined because the corporation “lends” the services of its owner-employee to a “borrower” — a studio for example — for a fee. Loan-out corporations have functioned both as C corporations and S corporations.

.13 Background of the Loan-Out Corporation. Most of the initial appeal of the loan-out corporation stemmed from the ability to use the entity to defer vast sums of income. This was done on a long-term basis through the use of pension and profit-sharing plans, and on a short-term basis through the use of fiscal years (using a January 31 fiscal year end) and the accrual basis of accounting (including corporate salary in the personal income of a cash basis owner two and one-half months after the corporation accrued the expense). The fiscal year and accrual basis provided tremendous flexibility in income tax planning and generally ensured that the tax benefits available over the two calendar years involved would be maximized. This was because salary could often be delayed or accelerated as the need for balancing brackets or other planning opportunities arose.

.14 The corporate entity was also viewed as being a safe haven for career-related deductions which might not as readily pass the audit gauntlet on an individual income tax return (including, for example, cable TV, movies, theater, concerts, video, makeup, hairdressing, wardrobe, entertainment, travel, and automobile expenses). These benefits were only minimally offset by the nominal cost of utilizing the corporation. The extra legal and accounting costs were insignificant by today’s standards, and measured against the tax savings at the high tax brackets of yesteryear, they were a small price to pay for using the corporate entity.

.15 Changes Affecting Loan-Out Corporations. Over the years there have been changes on many fronts which have affected the relative benefits of incorporating one’s talents (for example, income taxes, payroll taxes, industry practices, union rules, insurance markets, and the cost and quantity of professional services). These changes have generally reduced the value of incorporating.

.16 *Negative Changes.* There have been several developments affecting loan-out corporations which fall on the negative side. The amount of current earnings that could be deferred into pension and profit-sharing plans was scaled back on several occasions. The two-and-one-half-month deferral on accrued salaries was eliminated. For personal service corporations (PSCs) the tax rates were raised. Also, the ability to use a fiscal year deferral was severely curtailed for PSCs, S corporations, and partnerships. The IRS's ability to reallocate income and deductions between the PSC and its owner-employee in certain situations made some PSCs virtually useless.³ The introduction of imputed interest rules coupled with individuals no longer being able to deduct personal interest expenses made the deferral of withholding taxes on salaries an expensive proposition if the artist were to borrow money from the loan-out corporation before declaration of the salary.

.17 Also, the cost of professional fees rose dramatically for a variety of reasons. For example, each change in the tax law required ever greater legal and accounting services, each pension law change required expensive plan restatements prepared by benefits consultants, and the litigation crisis and the related insurance squeeze caused all professionals to raise their rates. It became apparent that, even though a loan-out is a shell corporation, there was a need to consider workers compensation and general liability insurance, and the premiums on these policies also rose in price rapidly. There have been seemingly endless increases in payroll taxes, which some years ago many loan-out corporations could have the borrower contractually reimburse, but this former industry convention has since all but disappeared. All of these changes have taken their toll on the feasibility of the loan-out corporate entity.

.18 *Positive Changes.* There have been two specific developments that actually enhanced the appeal of loan-out corporations. The introduction of limitations on the miscellaneous itemized deductions of individuals has caused many loan-out corporations to remain economically viable. One such development was the creation of a "floor" by the 2 percent limitation on miscellaneous itemized deductions and the 3 percent reduction on many itemized deductions. The other was the creation of a "ceiling" by the add-back of miscellaneous itemized deductions for alternative minimum tax. Generally, it is this issue — the income tax savings derived from the corporate form when the individual loses deductions to the floor, the ceiling, or both — which currently drives many of the decisions to operate as a loan-out corporation or as an individual.

.19 *Pending Uncertainties.* As many of the developments affecting the utility of loan-out corporations were in the income tax area, it should be anticipated that changes to the income tax laws will continue to reshape this evaluation process. Furthermore, there is a factor on the horizon, the impact of which is already being felt, but the outcome of which cannot yet be predicted. The Internal Revenue Service, as part of its Market Segment Specialization Program (MSSP), has formed a group to gather information, study, analyze, and examine the entertainment industry. The possible effects that this group will have on the future viability of loan-out corporations is discussed in more detail in paragraphs 3.44 through 3.53 later in this section.

³ IRC Section 269A.

.20 *Loan-Out Corporations for Self-Employed Individuals.* It is important to note that many of the potential benefits of incorporating oneself are relevant only for individuals who, absent the use of a loan-out corporation, would be deemed employees rather than self-employed individuals. This is due to the fact that self-employed individuals can fully benefit from their business-related deductions as they are taken on Schedule C of Form 1040 — their deductions will not be reduced by the effects of the floor or ceiling. Furthermore, self-employed individuals do not require the formation of a loan-out corporation in order to enjoy the benefits of a private pension or profit-sharing plan. Since self-employed individuals may establish a Keogh Plan or a Simplified Employee Pension Plan, a loan-out corporation yields no true advantage in this regard. Therefore, you should first determine the method(s) of compensation in order to properly analyze the benefits of forming a loan-out corporation (for example, will the artist, without the formation of a loan-out corporation, be considered an employee or self-employed individual, and if the artist might be considered both, how much compensation will be derived as each?). Consider also that your client's income tax return may trigger an IRS probe into the validity of independent contractor status. (Some practitioners have observed a recent IRS tendency to select income tax returns that include a Schedule C for examination.)

.21 *Examples.* An actor is expected to earn \$1,000,000 for each of two movie roles during the tax year and is contemplating incorporating for these projects. An analysis of the alternatives is necessary to properly advise the actor. Since the decision can depend upon the level of the business expenses incurred, two examples are presented to illustrate this concept. In example 1, the actor pays only his agent on a percentage fee arrangement. His accountant and attorney get paid by the hour, and, therefore, fees will rise significantly when a corporation is used. The actor does not have a personal manager. In example 2, in addition to paying the agent 10 percent, the actor also pays the accountant, attorney, and personal manager on percentage. The combined rate of these three professionals is 25 percent. This expense will, therefore, be constant irrespective of the operating structure. The deferral of income through the use of retirement plans has not been included for simplicity. Additionally, for these examples it is assumed that the actor is living and working in a non-tax state jurisdiction. Furthermore, it is assumed that the actor, absent the use of a loan-out corporation, would be the employee of the production entity. This is typically the case with an actor in feature films. Accordingly, if a corporation is not used, the business deductions will be reported on IRS Form 2106. A summary of the alternatives is shown on the following page.

Example 1

	<i><u>Individual</u></i>	<i><u>Corporation</u></i>
Income	\$2,000,000	\$2,000,000
Less: Agent fee	200,000	200,000
Accountant and attorney fees	20,000	60,000
Other business expenses	50,000	50,000
Corporate insurance	none	5,000
Employer payroll taxes	none	28,000
Employee payroll taxes	33,000	28,000
Employee regular income tax	<u>704,000</u>	<u>635,000</u>
Net income	<u>\$ 993,000</u>	<u>\$ 994,000</u>
Savings from corporation		<u>\$ 1,000</u>

Example 2

	<i><u>Individual</u></i>	<i><u>Corporation</u></i>
Income	\$2,000,000	\$2,000,000
Less: Agent fee	200,000	200,000
Accountant, attorney, manager fees	500,000	500,000
Other business expenses	50,000	50,000
Corporate insurance	none	5,000
Employer payroll taxes	none	22,000
Employee payroll taxes	33,000	22,000
Employee regular income tax	514,000	463,000
Employee AMT	<u>43,000</u>	<u>none</u>
Net income	<u>\$ 660,000</u>	<u>\$ 738,000</u>
Savings from corporation		<u>\$ 78,000</u>

.22 In example 1, the use of the corporation does not produce any meaningful savings, while in example 2, the savings are quite significant. As these examples illustrate, the interplay between the amount of business expenses incurred, the degree of personal deductions lost to the limits on miscellaneous itemized deductions, and the additional expenses of the corporate structure are the determining factors in whether or not a savings can be achieved. The level of income will also influence the results in these types of comparisons. The concepts illustrated in the examples apply to both C corporations and S corporations; however, in a C corporation, enough salary will generally be paid to the owner to "zero-out" the profits.

☛ **Action Tip**

There are several general observations which can be made when you compare operating in corporate form versus as an individual.

- If significant additional professional fees will be incurred in order to operate in corporate form, these additional expenses (along with employer payroll taxes and corporate insurance discussed below) will diminish, and perhaps exceed, the income tax savings the corporate structure provides.
- As the earnings of the artist increase, expenses which are unique to the corporate form will also tend to increase. While payroll taxes can be expected to increase as a function of the officer's salary, it can also be anticipated that higher earnings signify greater notoriety and, as an extension of that notoriety, higher liability premiums. These increased corporate costs will diminish the income tax savings of the corporate structure.
- As the earnings of the artist increase, the loss of deductions due to the 2 percent of AGI limitation on miscellaneous itemized deductions will become more severe, but there will be less likelihood of there being any AMT.
- An artist who pays several advisors by a percentage fee arrangement will likely lose many of these deductions to the limitations imposed by the AMT.
- It used to be commonplace for the artist to obtain reimbursement for the employer's share of payroll taxes. Most users of talent will currently not pay these reimbursements. However, that should not stop you from alerting the artist's agent, entertainment attorney, and manager that there will be a benefit to obtaining a provision for such reimbursements during contract negotiations.

.23 C Corporations. A loan-out corporation will generally operate as a C corporation if a medical reimbursement plan will provide a significant tax benefit to the owner. As 2 percent or greater shareholders of S corporations would not receive tax benefits from a medical reimbursement plan, C corporations would typically be used for owners whose families have high unreimbursed medical expenses. Historically, the industry guilds have provided their members with health insurance which is more than adequate for most medical expenses. Consequently, the usefulness of a medical reimbursement plan is generally limited to an instance where the medical coverage is less than ideal. A common example is a high level of psychiatric care. Apart from the ability to derive a tax benefit from a medical reimbursement plan, a C corporation may present a significant planning problem. Since loan-out corporations which operate as C corporations will generally qualify as personal holding companies (PHCs), and perhaps even PSCs, any taxable income that remains as of year end would be subjected to a punitive rate of income tax. Consequently, a C corporation requires more of your attention and precision in income tax planning at year end, especially if it is both a PHC and a PSC.

.24 *S Corporations.* A loan-out corporation will generally operate as an S corporation if a medical reimbursement plan is not being used as part of the income tax planning strategy. This occurs because the taxable income and separately stated tax attributes of an S corporation pass through to the owner without the punitive taint of the PHC or the PSC rules. Additionally, there is the traditional benefit of only one level of income taxation. These benefits will generally cause an S corporation to be a more simplified entity structure to work with for income tax planning purposes. Also, there is a less obvious income tax planning benefit for a loan-out corporation which operates as an S corporation. In the event of an income tax examination of the loan-out corporation, any disallowed deductions will pass through as additional income to the owner. This would only result in additional income taxes at the individual level. The same occurrence in a C corporation, however, would create a double level of income taxation in addition to punitive taxes should the loan-out corporation qualify as a PHC or a PSC.

.25 Furthermore, there is a possible savings of payroll taxes with an S corporation. Unlike a C corporation, which will generally pay the owner enough salary to “zero-out” the profits in order to avoid the aforementioned income tax problems, an S corporation may leave a reasonable amount of profits to pass through as taxable income. While such taxable income will have the same income tax effect on the individual owner as it would have had if it had been converted to salary, the payroll tax paid by both the S corporation and the owner will have been eliminated on the taxable income which was not converted into salary. Exercise caution when using this technique to avoid a possible IRS attack as an evasion of payroll taxes due to paying an unreasonably low compensation. Use your professional judgment because there is no evidence of an official IRS position on this matter.

Personal Service Corporation Issues

.26 In dealing with loan-out corporations that operate as C corporations, you need to consider the possibility of being classified as a PSC and the resulting ramifications.

.27 **Definition.** Personal service corporations are C corporations which meet two tests enumerated in Internal Revenue Code (IRC) Regulations,⁴ a function test and an ownership test. If both tests are met by a corporation, it will be qualified as a PSC and must follow the required year⁵ and minimum distribution⁶ rules. The description of the function test includes eight different fields of service which may qualify a corporation as a PSC. The ownership test defines the required percentage of ownership required to be a PSC. Together these tests will cause a corporation to be classified as a PSC if at least 95 percent of the time the corporation’s employees perform services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting and at least 95 percent of the value of the stock is held by the employees or their estates or beneficiaries. Accordingly, a loan-out corporation for a performer which operates as a C corporation will typically be a PSC.

⁴ Treasury Regulation Sections 1.448-1T(e)(4) and (5).

⁵ IRC Section 444.

⁶ IRC Section 280H.

.28 Nonperforming Artists. It should be noted that the regulation which defines the fields of service targets performing artists yet omits creative artists from the PSC category. Accordingly, you may have clients in the field of entertainment who are apparently unaffected by these rules, such as writers, directors, producers, and composers, just to name a few. Also, a significant question may arise about the field of service classification of performing artists with respect to corporations formed for endorsement income, especially if the endorsement services involve filmed or taped advertising. For example, how should you categorize an athlete's services when he or she appears in television or radio commercials to endorse a product? Would the answer be any different for an actor who forms a separate corporation for commercials? Is the remuneration being paid for the "performance" or the individual's celebrity status? Furthermore, into what category does the use of name and likeness fall when the celebrity does not appear on television or radio? These are thought-provoking questions without apparent answers. Accordingly, exercise caution until the IRS issues rulings on these types of questions or until there is case law for guidance. Avoiding C corporation status, however, may be the most prudent choice.

.29 Required Year. Once defined as a PSC, a corporation is subject to the required year rules and, if applicable, the minimum distribution rules. The corporation would be required to use a calendar year for its tax reporting. Alternatively, the corporation may elect a fiscal year that will not create more than a three-month deferral (that is, a fiscal year ending month of September, October, or November).⁷ The use of a fiscal year, however, imposes a restriction under the minimum distribution rules on deductions allowed to the PSC. PSCs that were in existence prior to the enactment of the 1986 Tax Reform Act were permitted to retain their existing fiscal year ends under a grandfathering provision.⁸

.30 Minimum Distribution Rules. The minimum distribution rules⁹ are highly complex. Use caution and carefully review them to comply with the requirements. Basically, to comply with the requirements the corporation must pay to its employee-owners an "applicable amount" (in general salaries, but it includes all amounts paid to the employee-owners which are includible in gross income other than dividends and gains from sales or exchanges) by the end of the calendar year that is at least equal to the lesser of these two amounts:

- a. The previous fiscal year's applicable amounts prorated for the "deferral period" (the number of months between the fiscal year end and the end of the calendar year; for example, a September fiscal year corporation would multiply the prior year's applicable amounts by 25 percent — 3 months over 12 months).
- b. The corporation's taxable income measured as of the end of the calendar year multiplied by the "applicable percentage" (defined as the percentage, up to 95 percent, arrived at by dividing the applicable amounts paid during the three previous taxable years by the sum of the prior three years' taxable income and the prior three years' applicable amounts).

⁷ IRC Section 444.

⁸ IRC Section 444(b)(3).

⁹ IRC Section 280H.

31 Unless the corporation meets this “minimum distribution requirement,” the deductible applicable amounts paid during the fiscal year to the employee-owners is limited to the “maximum deductible amount”. The maximum deductible amount is calculated as

a. The applicable amounts paid during the deferral period

plus

b1. The applicable amounts paid during the deferral period divided by the number of months in the deferral period multiplied by

b2. The number of months in the nondeferral period.

Accordingly, failure to comply with the minimum distribution requirement can be devastating as otherwise deductible amounts for the year would be limited, causing the punitive rate of tax to apply to the nondeductible amounts. It is important to carefully review the minimum distribution and deductible calculations. See exhibit H for an example of a worksheet to calculate the minimum distribution.

Action Tip

Given the complexity of the minimum distribution rules, it may be difficult to visualize when you would make an election to use a year other than a required year. If deferral of income is desirable, the election of a fiscal year may still accomplish this goal. It is not uncommon for artists to experience peaks and valleys in their earnings. When a peak year follows a valley year the minimum distribution rules can be utilized to defer income if a fiscal year election is in effect. Because the income that must be paid out during the deferral period is the lesser of the prorated prior year applicable amount or the current year deferral period income multiplied by the applicable percentage, the lesser amount in the aforementioned scenario is generally the prorated prior year applicable amount. This can result in significant deferrals of income. Furthermore, assuming the minimum distribution rules are properly applied, the use of a fiscal year will not leave the artist in a worse position than if a required year had been used.

32 *Example.* Assume the following facts: A PSC has an election in effect for a September fiscal year.¹⁰ In the year preceding the year being planned, the corporation paid its sole shareholder-employee \$600,000 as salary and there were no other applicable amounts paid. The applicable percentage for the PSC is calculated to be 98 percent. Accordingly, it is limited to 95 percent. The PSC has taxable income for the current year through the end of December of \$3,000,000. To comply with the minimum distribution requirement,¹¹ the sole shareholder-employee would be paid the lesser of \$150,000 (that is, $3/12 \times \$600,000$) or \$2,850,000 (that is, $95\% \times \$3,000,000$). As the lesser amount of \$150,000 is all that is required to meet the minimum distribution, a sizable deferral of income is accomplished in this scenario. The actual deferral should be measured as the difference between the amount required to be paid (\$150,000) and the amount that would have been paid had the PSC used a required year (an amount approaching \$3,000,000).

¹⁰ IRC Section 444.

¹¹ IRC Section 280H.

Action Tip

Be alert to planning opportunities when income tax rates are different in two consecutive calendar years. For instance, contrary to the prior example, when the earlier year has a lower tax rate, it may be advantageous to accelerate salary into the earlier calendar year in order to obtain a permanent income tax savings.

Loan-Out Corporation Issues

.33 Court Cases Involving Loan-Out Corporations. In pursuing audit issues, the IRS would likely follow the line of reasoning it successfully developed in 1989 in a case involving a hockey player. In *Sargent v. Commissioner*,¹² the IRS attacked the loan-out corporation of a hockey player on the basis that the professional hockey team, and not the taxpayer's loan-out corporation, had the manner and the means to control the player's activities. Essentially, the IRS argued that the income of the athlete had been assigned to the loan-out corporation. Although the 8th Circuit Court of Appeals overturned the Tax Court's ruling, the IRS has not acquiesced to this decision.

.34 Furthermore, after *Sargent*, the IRS enjoyed another Tax Court victory within the jurisdiction of the 5th Circuit in a case involving a team sports player and his loan-out corporation. In *Leavell v. Commissioner*,¹³ the IRS attacked the use of a loan-out corporation by a professional basketball player and was successful in persuading the Tax Court to uphold the conclusions it reached in *Sargent*. The Tax Court went so far as to specifically state that it believed the 8th Circuit Court of Appeals was wrong in overturning *Sargent* and then, in an obvious attempt to thwart a similar appeal to the 5th Circuit, proceeded to address the deficiencies the 8th Circuit found in its earlier decision.

.35 A two-pronged test was cited in both *Sargent* and *Leavell*, which had evolved from case law beginning with *Lucas v. Earl*,¹⁴ and had been applied in a string of earlier cases which held that income was not reallocable under the assignment of income doctrine when both prongs were met.¹⁵ The two-pronged test indicates that in order for a loan-out corporation to be respected as the employer of the service-provider (that is, in *Sargent* and *Leavell*, the athletes), the corporation must have the right to direct and control the activities of the service-provider in a meaningful sense *and* the loan-out corporation must be recognized by the service-recipient (that is, in *Sargent* and *Leavell*, the team), preferably by contract, as the true employer of the service-provider.

¹² *Sargent v. Commissioner*, 93 T.C. 572 (1989), reversed, 929 F.2d 1252 (8th Cir. 1991).

¹³ *Leavell v. Commissioner*, 104 T.C. 140 (1995).

¹⁴ *Lucas v. Earl*, 281 U.S. 111 (1930).

¹⁵ See *Keller v. Commissioner*, 77 T.C. 1014 (1981), affirmed, 723 F.2d 58 (10th Cir. 1983); *Pacella v. Commissioner*, 78 T.C. 604 (1982); *Johnson v. Commissioner*, 78 T.C. 882 (1982), affirmed, 734 F.2d 20 (9th Cir. 1984); *Bagley v. Commissioner*, 85 T.C. 663 (1985), affirmed, 806 F.2d 169 (1986); *Haag v. Commissioner*, 88 T.C. 604 (1987), affirmed, 855 F.2d 855 (8th Cir. 1988); and *Pflug v. Commissioner*, T.C. Memo 1989-615 (a case involving an actress), although slightly different issues were at stake and a different conclusion was reached.

.36 In deciding *Leavell*, the majority opinion stressed the manner and means analysis put forth by the IRS, while the dissenters felt the two-pronged test supported the validity of the loan-out corporation. It is important to note, however, that *Sargent* and *Leavell* involved taxpayers who were athletes performing in a team sport. As the nature of team sports places the athlete squarely under the control of the coach or manager, as well as the team management, throughout the playing season, and in many cases the off season as well, these taxpayers were easy targets for the IRS. In fact, in both *Sargent* and *Leavell*, the IRS argued for the Tax Court to reject the two-pronged test entirely and apply a so-called team sports doctrine. While team sports athletes do have similarities with artists, the latter will typically have far more freedom in their endeavors and it remains to be seen if the IRS can attack their loan-out corporations as easily.

.37 In a case decided after *Leavell*, *Idaho Ambucare Center, Inc. v. United States*,¹⁶ the taxpayer's position was sustained in a situation that is arguably more analogous to an artist's loan-out corporation than either of the team sports cases. In this case, the IRS assessed payroll tax deficiencies against a medical corporation that contracted with a doctor's loan-out corporation for the doctor's services. The IRS argument, that the loan-out corporation should be ignored since the medical corporation was the de facto employer of the doctor, was rejected. The Court recognized the contract between the loan-out corporation and the medical corporation to be representative of the true relationship between the parties. The contract between the corporations stipulated that the medical corporation would not provide the doctor with employment benefits and that the doctor was not the employee of the medical corporation. The Court's finding was that the two-pronged test was satisfied by the relationships of the parties and the contract between the corporations, even though the doctor did not have an employment agreement with the loan-out corporation.

.38 *Loan-Out Corporation Relief?* The IRS released its *Training Manual on Worker Classification* on August 6, 1996. The manual states that when "...corporate formalities are properly followed and at least one non-tax business purpose exists, the corporate form is generally recognized for both state law and federal law purposes, including federal tax purposes." The manual further indicates that only in cases of clear abuse will the corporate form be disallowed. It additionally states that such disallowance is "...an extraordinary remedy..." The manual cites both the *Sargent* and *Leavell* cases. While this turn of events sounds like an easing of the IRS's position on loan-out corporations it should not be considered an elimination of the problem.

.39 **Loan-Out Corporations and the Taft-Hartley Act.** In addition to the control argument successfully used in *Leavell*, the IRS has considered using a new weapon. The IRS Entertainment Industry Task Forces in Los Angeles and New York believe that the IRS is evaluating using the Taft-Hartley Act to attack the use of loan-out corporations. Passed by Congress to prevent organized crime from qualifying non-union workers as participants in union pension plans, the Taft-Hartley Act states that union pension contributions may only be made on behalf of employees of the payer. Accordingly, union pension payments by motion picture studios to the various industry guilds would apparently violate the Taft-Hartley Act where the party contracting with the studio is not an individual employee, but rather a loan-out corporation controlled by that individual. It remains to be seen if the IRS will actually pursue this route, and if it does, the degree of success it can achieve using a criminal statute to change a well-established tax planning strategy.

¹⁶ *Idaho Ambucare Center, Inc. v. United States*, 57 F.3d 752 (9th Cir. 1995).

Accounting Methods

.40 Generally loan-out corporations are permitted to use the cash method of accounting for calculating their taxable income. Loan-out corporations that are not qualified PSCs may use the cash method of accounting for all prior tax years when the \$5,000,000 gross receipts test is met.¹⁷ The \$5,000,000 gross receipts test is met for any prior tax year if the corporation had \$5,000,000 or less of average annual gross receipts for the three-tax-year-period ending with such prior tax year, or, if shorter, the period of its existence.¹⁸ Loan-out corporations that are also qualified PSCs are specifically permitted to use the cash method of accounting irrespective of the level of their gross receipts.¹⁹

Action Tip

Due to the complications presented by various tax rules for PHCs and PSCs as well as other complications inherent in the accrual method of accounting, the cash method of accounting is usually the preferred accounting method.

Partnerships

.41 Although the partnership structure is not widely used, there are occasions when it is appropriate. You may see the opportunity to use such a structure when your client is a group of performing artists, such as a musical group, or a collaborative team of creative artists, such as a writing team. Partnerships have also been used in production. This can occur when creative artists need funds to produce a project they have created or control. A limited partnership between the creative artists, as general partners, and the investors, as limited partners, has been the result. Other than identifying when a partnership structure might be appropriate, there is really nothing unique to the use of a partnership structure.

Other Forms of Entity

.42 Traditionally, apart from individuals, corporations, and partnerships, there has been little use of alternative forms of business structure. While the impact of the introduction of limited liability partnerships (LLPs) and limited liability companies (LLCs) has not been measured, the evolution of these entity structures and the planning opportunities presented by these business forms should be evaluated. Of course, their use can be anticipated to be alternatives to partnerships. Whether they can be viable alternatives to loan-out corporations, which traditionally have only one shareholder, will largely depend on the evolution of the tax laws pertaining to the taxation of one-member limited liability entities.

¹⁷ IRC Section 448(b)(3) and Temporary Regulation Section 1.448-1T(f)(1).

¹⁸ IRC Section 448(c)(1) and Temporary Regulation Section 1.448-1T(f)(2).

¹⁹ IRC Section 448.

.43 Trusts have been utilized to a certain extent in a traditional way, as an estate planning vehicle. Certain rights (for example, name and likeness) that may live beyond the grave have been put in trust by some artists for exploitation and profit for their heirs. This type of use can probably be anticipated to spread as developing technologies permit “performances” by people many years after their demise (as in the movie “Forrest Gump,” scenes such as the one where Forrest meets and converses with President John F. Kennedy, in the recording of Natalie Cole performing “duets” with her late father, Nat King Cole, and in commercials with the late Jackie Gleason or Fred Astaire).

The Market Segment Specialization Program

.44 The Program. The IRS has begun to train its auditors as industry specialists to better monitor and enforce taxpayer compliance. This program of training and developing industry specialists is known as the Market Segment Specialization Program (MSSP). One of the targeted industries is the field of entertainment. To analyze the entertainment business and to foster a better understanding of industry specific issues, the IRS has formed task forces to study different areas of the entertainment community.

.45 The Entertainment Industry Task Forces. Task forces have been formed in major metropolitan areas having connections to specific niches in the field of entertainment. These groups have been developing audit guides for MSSP auditors to follow. Although there will be some overlap, task forces in different communities will be primarily responsible for creating audit guides focusing on the industry niche of their geographical location. The main groups appear to be based in Los Angeles (motion pictures and television), Nashville (music), New York (stage), and Washington, D.C. (international issues). Other groups already exist in Chicago, Fort Lauderdale, and Cleveland, and several other districts have expressed interest in beginning similar projects.

.46 Audit Technique Guides. The task forces have collaborated on three audit technique guides (ATGs) which cover broad areas of IRS interest in the entertainment industry. These ATGs have been produced as part of the library being created to serve MSSP auditors. The entertainment ATGs are entitled *Entertainment: Music*, *Entertainment: Foreign Athletes and Entertainers*, and *Entertainment: Important 1040 Issues*. They contain background information on the entertainment industry and guidelines for auditors to follow when confronted with audits of various types of entertainment industry taxpayers. The guides may be obtained by practitioners, as well as the public at large, through the IRS Freedom of Information Reading Room in Washington, D.C. (tel. 202-622-5164) for a nominal charge. Because all individual orders are automatically allowed a \$15.00 credit, some guides may be obtained at little or no cost. Practitioners advising clients in industries addressed by MSSPs should consider obtaining, reviewing, and understanding these audit technique guides.

.47 Key Audit Issues. Although it is still relatively early in the development of the MSSP, several key audit issues have already been identified. The classification of workers as independent contractors or employees in various industry job classifications potentially has the widest applicability. This issue affects the corporate side of the industry (for example, motion picture studios) as much as it affects individuals due to the obligation to withhold payroll taxes and to pay the employer’s share of employment taxes. The issue is also being looked at to attack the use of loan-out corporations. Loan-out corporations appear to be a popular target and are likely to face challenges from other strategies being developed by the IRS. Other significant audit issues involve the validity of many popular industry deductions, the possible taxation of perquisites, and the proper allocation of deductions when a division of expenses is appropriate.

.48 Deductions. According to the IRS ATGs, deductions, whether through a loan-out corporation or deducted by an individual, which for the average taxpayer would be viewed as strictly personal, will be carefully scrutinized. The IRS auditors will look for credible documentation supporting the existence of specific connections between these types of deductions and the taxpayer's trade, and the ordinary and necessary nature of the expenditures. Without these facts and circumstances these deductions may be reduced or disallowed in their entirety.

.49 This category of deductions includes the following:

- cosmetic surgery
- physical conditioning (such as personal trainers, health clubs, and massages)
- grooming (such as hairdressing, cosmetics, and manicures)
- admission tickets to theaters, movies, concerts, and so forth
- cable and other forms of pay TV
- music and video purchases (such as tapes and compact discs)
- video rentals
- security costs (such as security systems and bodyguards)
- other similar deductions

Deductions that have always been difficult to support, such as gifts, entertainment, and wardrobe, will also draw increased attention.

.50 The general quality of recordkeeping will be targeted for review, especially in the area of listed property. Also, expenses deducted currently for projects that may be completed in the future will be reviewed for possible capitalization and deferral.

.51 Perquisites From Producers. Contractually provided perquisites ("perks") will be examined for inclusion in income (that is, the value of "star treatment" will be quantified). Perks deemed lavish and extravagant, such as chauffeur-driven vehicles, personal chefs, and special travel arrangements, accommodations, or amenities, will also be evaluated.

.52 Allocation of Deductions. Allocation issues come in several forms. Allocations of deductions that relate to different types of income (that is, wages reported on Form W-2 and self-employment income reported on Form 1099) will be rigorously challenged. Any allocation which appears to favor above-the-line deductions (Schedule C deductions) over below-the-line deductions (Form 2106 deductions) will draw close attention.

.53 Another allocation issue arises for the income and expenses of nonresident alien athletes and entertainers between foreign and U.S. characterization as to their source. These allocations of foreign athletes and entertainers will be targeted as areas of potential abuse, as well as treaty shopping (the practice of a nonresident alien claiming the benefit of a particular country's treaty while the facts and circumstances dictate that a different, less taxpayer-friendly country's treaty actually applies), treaty misinterpretation (the incorrect application of a treaty article), and income misclassification (for example, excluding, under a beneficial treaty article, income as a royalty, when in fact it is not a royalty).

Taxpayer Compliance Measurement Program (TCMP) Audits

.54 In addition to these industry-specific issues, however, there is an additional problem posed by these task forces. All MSSPs as a group had planned to generate in excess of 150,000 TCMP audits. It is not unreasonable to assume that a fair share of these audits would be aimed at the entertainment community. In October 1995 these TCMP audits were postponed. Although this program has not been rescheduled due to current political opposition, there is always the possibility that it may be rescheduled in the future.

Perquisites

.55 It is important to realize that there may be certain perks which may escape taxation. While the MSSP task forces are beginning to focus on these benefits, they have traditionally “fallen through the cracks.” It has not been uncommon for the top talent in the industry to receive special treatment over and above compensation included in contractual arrangements.

.56 For example, consider a performer who requires special cuisine be served during the course of a project. The producer hires a chef to prepare such cuisine and places the chef on the payroll for the project. Accordingly, the chef’s pay is included in the budget and appears to be a necessary contributor to the completion of the project, as meals and food service on the set are quite common. An arrangement structured in this way might not be taxed to the performer, even though it is clearly being provided solely for the performer’s benefit. Had the performer been compensated an additional amount and then hired the chef directly, this apparent loophole would not exist. Other types of perks may be treated similarly, such as an assistant to handle correspondence and errands during the course of production, an exclusive chauffeur, or a personal trainer.

.57 Perks are not limited to the hiring of special personnel for the benefit of the performer. Providing the artist with a specially equipped or more opulent than normal trailer or dressing room or living accommodations while on location might be another example. The items that might qualify as perks are only limited by one’s imagination. Being aware of these types of arrangements obviously provides a planning opportunity for the top performers in the industry. As mentioned in the preceding section, however, be aware that these perks may generate increased attention with the advent of the MSSP.

Employee Benefits

.58 Many artists enjoy a variety of employee benefits. While some are available only to those artists using a C corporation for their activities (for example, a medical reimbursement plan), other benefits are no different than those enjoyed by any union employee. This is because the entertainment industry is dominated by artists who are members of various industry guilds or unions. These organizations generally provide pension, medical, and dental benefits to their members. While there are union dues paid by the members, these benefits are largely funded by contributions assessed on the producers who create the projects in which the artists participate.

.59 It is important to determine the union or guild benefit plans applicable to the artist, and analyze how to obtain the maximum benefits from them. Review literature from the guilds to acquire an understanding of the benefits available. In order to achieve efficiency and avoid problems, review and address the issues of integration between multiple guild medical plans when an artist is eligible to collect from more than one guild medical plan, and between guild pension and loan-out corporation pension plans to determine if aggregation is appropriate.

Problematic Deductions

.60 Certain deductions, such as those for entertainment and meals, wardrobe, home office, research, and physical appearance, are more difficult to defend and should be carefully documented.

.61 Entertainment and Meals. The expenses incurred by artists will usually contain a high percentage of expenditures for entertainment and meals. Accordingly, the degree to which these expenses are deducted on the artist's income tax return can have a meaningful impact on his or her income taxes, despite the limitation of the 50 percent disallowance on these types of deductions. The success in defending to the IRS the deductibility of the artist's entertainment and meal expenses will depend on the same rules in effect for all other taxpayers. The expenses would need to be business rather than personal in nature. They would have to be ordinary and necessary, but not lavish or extravagant. The artist would be required by the IRS to document the who, where, when, and why of the expenditures.

.62 These tests of deductibility do not present an overwhelming problem when a taxpayer has maintained clear and concise written records with adequate supporting documentation. In practice, however, it is frequently difficult to obtain all that is required from artist clientele. It is important to understand the environment in which artists operate. Due to the nature of their careers, the average artist travels and entertains frequently. This frequency can and does make the obligatory recordkeeping difficult. Furthermore, the large volume of these expenditures, and the amounts, which often may appear high, can lead to a natural skepticism on the part of IRS auditors, especially if they are unfamiliar with auditing these types of clients. (A possible benefit to the MSSP would be for auditors to become educated about these circumstances and better able to differentiate between artist clientele and other taxpayers when it comes to this issue.)

.63 The social circles of artists are dominated by entertainment industry relationships, many of which can and do directly relate to their opportunities to participate in future projects. In this respect, artists are similar to salespeople, who regularly entertain in order to keep themselves and their products or services in the minds of their prospective clients. Every industry contact for an artist is a potential lead to employment. Every industry contact will undoubtedly be working somewhere else or with someone else in the near future, thus in a position to bring employment opportunities to the artist. Fostering and nurturing alliances and keeping abreast of what is new is essential to the maintenance of a lifeline to continued employment. Accordingly, it is possible for most of the socializing of artist clients to take on the characteristics of deductible business entertainment.

.64 Give the same advice regarding adequate recordkeeping to your artist clients that you would give to any other clients. Generally, up-front counseling about good recordkeeping habits will not ensure the artist's compliance. To the extent, however, the artist is willing to devote time to reconstructing any missing information, the results may be worth the effort.

.65 The issue most common to non-entertainment meals, and which may occur for entertainment meals as well, is whether the dining was lavish or extravagant. Although there really are no true benchmarks, since every expense should be evaluated in light of the facts and circumstances of each taxpayer, common sense should be your guide. While the threat of limiting deductions with lavish and extravagant criteria does not appear to be a problem in practice, it is nevertheless an issue you should be prepared to defend if necessary. With the reduction in 1994 from 80 percent deductibility to 50 percent deductibility for entertainment and meals, the relative importance to the IRS of auditing these items may have declined.

.66 Wardrobe. An area which is generally straightforward for the average taxpayer can become more complicated for artist clients. With wardrobe, however, it is generally performing artists who incur high wardrobe costs and may seek to deduct some or most of them.

.67 Unfortunately for these taxpayers, the argument that they must always carry their image, and therefore, that the clothing to maintain that image is deductible, will no more work for them than for the well-dressed business person. For any taxpayer to secure a valid wardrobe deduction, the clothing must not only be inextricably tied to the ordinary and necessary performance of their duties in their trade or business, but must also be unique in such a way as to not otherwise be usable in a common, everyday, non-business setting. Consequently, it is generally a uniform or clothing with a special purpose usage that meets these requirements. Accordingly, performers will usually look to the special purpose usage concept (that is, costumes) to gain deductions.

.68 An interesting dilemma arises for popular musicians who may start clothing trends by wearing clothing not customarily seen in public. At what point does an article of performance wardrobe take on the aura of clothing suitable for everyday wear? How much will the musician's use of the clothing offstage to perpetuate their image hurt the unique aspect of the garment? Does the adoring public's adoption of "the look" signal that the wardrobe is suddenly acceptable for everyday usage?

.69 While most case law involving performers supports the plain meaning of the statute, some notable exceptions exist. One very old, yet still valid, example is *Charles Hutchinson*,²⁰ wherein the court allowed the deduction by an actor of ordinary clothing which was destroyed while performing stunts. Evidently, the court focused on the loss of utility in reaching its decision. A much more recent example is *Regan v. Commissioner*,²¹ wherein an actor was permitted a deduction for "period" clothing representative of the 1930s which was purchased for a play about that era. This raises questions about how old clothing must be to be considered out-of-style, especially since we have witnessed trends that recycle old styles.

.70 The most taxpayer-favorable decision in this area, however, stands alone and is virtually in complete contradiction of the statute. The decision in *Oswald "Ozzie" Nelson et al.*²² upheld the taxpayer's deduction of contemporary clothing suitable for personal wear because the taxpayer proved to the court that the garments were used solely for the television show on which he appeared. These last two examples demonstrate that the courts have at times been willing to consider broad interpretations of law and aggressive arguments made on behalf of the taxpayers. Clearly, it is worth examining the artist's wardrobe expenses and considering the uniqueness of every given situation.

.71 Home Office. To be deductible as a business expense, a home office must be used regularly and exclusively for business.²³ Regular use is ongoing and not occasional or sporadic. This is usually not a problem for people engaged in the entertainment industry. Exclusive use means the office area is distinct from the personal use areas of the home and is dedicated to only qualified business use.

²⁰ *Charles Hutchinson*, 13 BTA 1187 (1928).

²¹ *Regan v. Commissioner*, T.C. Memo., 1979-340, filed August 28, 1979.

²² *Oswald "Ozzie" Nelson et al.*, T.C. Memo., 1966-224, filed October 11, 1966.

²³ IRC Section 280A.

.72 Qualified use falls into one of four categories:

- a. The principal place of business
- b. A place for meeting clients or customers
- c. A separate structure which is not attached to the personal dwelling area
- d. A storage space for inventory

.73 The fourth of the qualifying uses may be satisfied by artists who store props, promotional materials such as posters, and merchandise for sale such as tapes, compact discs, videos, and T-shirts. The third qualified use either exists or it does not apply. A separate structure equipped and used as a sound studio would be a good example of a facility that would likely sustain a home office deduction. The second qualified use, while not impossible to accomplish, is likely to be improbable in many instances. In the entertainment industry, unless the artist has a “marquee name,” potential employers and clients will have the artist come to them to conduct business meetings. However, even if there are occasions when an artist has meetings at a home office, the relative infrequency of these meetings may call into question the regularity of business use.

.74 Generally, due to the foregoing circumstances, it is the first qualified use which you’ll find applicable most frequently for your artist clients to justify their deductions for home offices. The ability to successfully make this argument, however, has been badly hampered by the decision in *Soliman v. Commissioner*.²⁴ After this decision, performers would need to demonstrate that any function done at home, including rehearsing, could not be done elsewhere and was truly essential to their work. The IRS has stated that it is its opinion that *Soliman* has effectively eliminated home office deductions for entertainers, as their essential aspects of work are performed on a stage or set.

.75 Another Tax Court case, *Hamacher v. Commissioner*,²⁵ involved an actor who used his home office in connection with his work. Unfortunately, he also used his home office as a location to perform services for a theater where his responsibilities were administrative and he was also a teacher. Since the theater provided him with an office, this home office was not for the convenience of the employer. The IRS and Tax Court both concluded that the home office deduction was not valid because of the nonqualifying use related to the employment at the theater. On the other hand, the IRS has also stated that creative artists may be able to demonstrate that the essential aspects of their work are performed in home offices if they create their work in the home offices.

.76 If artists are employees, in addition to meeting all of the aforementioned requirements they would also have to demonstrate that the home offices are required by and are for the convenience of their employers. If the artist used a loan-out corporation, the home office issue might be dealt with by having the corporation rent the home office from the artist, thereby effectively moving the home office deduction to the corporate entity. Unfortunately, the artist will now have rental income to report that offsets the effect of the rental deduction of the corporation. Furthermore, if the artist attempts to

²⁴ *Soliman v. Commissioner*, 113 S. Ct. 701 (1993).

²⁵ *Hamacher v. Commissioner*, 94 T.C. No. 21.

deduct the expense of the home office against the rental income, he or she will most likely be limited to deducting only the pro rata portion of mortgage interest and real estate taxes.²⁶ It is also important to note that failure to sustain a home office deduction will ordinarily convert deductible business mileage into nondeductible commuting.

.77 Research. “Research” expenses for artists may include the following:

- Movie, concert, theater, and other similar event tickets
- The purchase or rental of video and audio tapes and discs
- Computer applications and related expenses
- Books and magazines
- Travel

.78 The argument to support the deduction of expenses in the first four categories for many of your artist clients is that they must be up-to-date regarding their contemporaries’ efforts as well as current events in order to remain competitive. These expenses might also be viewed as being in the nature of continuing education to the extent that they improve or maintain the skills of the artist. Regardless of the point of view, knowing what is “hot” (that is, the themes, topics, performers, and so on that are finding success with and appealing to the general public) is undeniably critical to artists.

.79 While the arguments cited above may be enough to convince the IRS that these expenses fulfill the requirement that they be ordinary and necessary for these types of taxpayers,²⁷ it is not enough to overcome the strict guidelines for deduction of business expenses which are generally considered to constitute amusement, entertainment, or recreation.²⁸ The expenditures enumerated in the first four categories will be tested under these strict guidelines by a knowledgeable auditor.

.80 Traditionally, there has been much anecdotal evidence to suggest that the IRS auditors have allowed some, most, and even all of these deductions intact upon audit when taxpayers have made a variety of persuasive arguments, including that, for them, these deductions should not be viewed as entertainment. This state of affairs, however, has changed with the introduction of the MSSP. MSSP auditors are now armed with instructions to disallow these deductions where the required documentation²⁹ does not exist and to ignore any arguments that these deductions meet the definition of research or experimental expenditures.³⁰

²⁶ IRC Section 280H.

²⁷ IRC Section 162.

²⁸ IRC Section 274.

²⁹ IRC Section 274.

³⁰ IRC Section 174.

.81 Accordingly, artists will need to maintain documentation (such as a diary, log, or some other form of contemporaneous notes) which sufficiently describes the educational benefit achieved or how these expenses directly related to a particular project in which the artist was involved or at least contemplated. While this requirement may be burdensome, and more of an effort than most artists are willing to make, it is required. Make your artist clients aware of the need to maintain the necessary documentation. Explain that, in essence, this is not a departure from the routine they should have been following to support deductions for travel as a research expense.

.82 Since travel as a research expense, unlike the other research expenses, is generally an infrequent occurrence, it should not be a difficult task to document the reasons for the travel. Also note that when a specific project is cited as the reason for incurring a particular research expense, unless the project is begun or abandoned during the year, an approach upon audit may be that the expense needs to be capitalized until one of those two events occurs.

.83 **Physical Appearance.** Physical appearance expenses have been deducted, almost routinely, by performing artists. These expenses include the following:

- Makeup or cosmetics
- Hairdressing
- Physical conditioning (such as personal trainer fees, health club dues, massages, facials, and purchase or rental of exercise equipment)
- Cosmetic surgery and dentistry

.84 Based upon mostly anecdotal evidence of audit results, these deductions for performing artists have been defended with at least partial success. There have also been notable taxpayer victories in court.

.85 A significant decision, albeit an old case, is *Charles Hutchinson*,³¹ wherein the court sustained these types of deductions for an actor. In this case, the court allowed deductions for massage, physical trainer fees, rental of gym facilities, and other related costs which the actor incurred to maintain the “first-class condition” expected in his profession.

.86 In another, but far more recent, taxpayer victory, *Hess, Reginald R.*,³² the wife, an exotic dancer known as “Chesty Love,” was permitted to depreciate the cost of her breast implant surgery as it was found to have been incurred solely in furtherance of her business and was not performed for personal reasons. Unfortunately, because this case is a Tax Court Summary Opinion, it has no value as precedent, but does demonstrate that the Tax Court can be open-minded when presented with solid fact patterns.

³¹ Charles Hutchinson, 13 BTA 1187 (1928).

³² Hess, Reginald R., T.C. Summary Opinion, 1994-79.

.87 Irrespective of the past, this is another category of deductions which can be expected to be more difficult to defend successfully under the MSSP. Unlike the various categories of research expenses, however, the expenses for maintaining or improving one's physical appearance do not fall into the documentation net of business-related entertainment, meal, and gift expenses.³³ Accordingly, the IRS does not have that powerful statutory weapon to aim at deductions for physical appearance. Still, this lack of specific authority has not prevented the IRS from stipulating to its MSSP auditors that these deductions are inherently personal in nature and should be disallowed absent a specific connection to a particular source of revenue. Considering the way in which these deductions have been viewed by judicial scrutiny in the past, the IRS may in fact be taking too harsh a position on this subject. The deductions may still be viable if they are handled with care and not taken frivolously. It would be wise, in light of the anticipated aggressive, adversarial posture from the IRS, to encourage your clients to improve the quality of documentation kept to support such deductions.

4. RETIREMENT PLANNING

.01 Although retirement planning for artists often involves many of the same elements common to retirement planning for other high income taxpayers, the strategies can differ. The general strategy for most high income taxpayers is to defer as much money as possible from current income taxation through the use of qualified retirement plans. There is usually little concern that the remaining current income will not be sufficient to cover pre-retirement funding goals and current living expenses. This assumption, however, often does not apply to artists.

.02 Consequently, there are unique aspects of retirement planning for artists which warrant discussion. For example, the use of a corporate retirement plan is usually one of the attractions in deciding to form a loan-out corporation; should the planning strategy not include the use of a corporate retirement plan, the use of a loan-out corporation would not be as attractive. If a corporate plan is part of the planning strategy, the career and financial circumstances of the artist will affect the type of retirement plan you'll recommend for the loan-out corporation. Similarly, these circumstances should shape the investment philosophy for the assets in any qualified plan directed by the participant (such as, an IRA, SEP, Keogh, or loan-out corporation plan). Also, if contributions are made to both industry guild plans and loan-out corporation plans during the same income tax year, the IRS position on such arrangements could affect the course of retirement planning because of potential contribution limitations. (See a further discussion of this issue in paragraphs 4.13 through 4.18.) As of the 1990s, the viewpoint taken by the industry guilds on this same subject is also relevant information to include in a retirement plan analysis for your client. Finally, you should also consider the legal, accounting, and actuarial costs of plan administration when discussing a strategy for your client's retirement planning.

Private Qualified Plans

.03 The corporate retirement plan is one reason loan-out corporations are useful. Having a tax deductible retirement plan — either a defined benefit or a defined contribution plan — can help achieve retirement planning goals.

³³ IRC Section 274.

.04 Loan-Out Corporation Plans. One of the motivating factors in deciding to create a loan-out corporation is that the formation of a corporate entity allows artists to adopt corporate qualified retirement plans. Absent a loan-out corporation, most performing and creative artists would be classified as employees of the parties that hire them. Accordingly, an artist would generally be denied the ability to adopt a tax deductible retirement plan, as he or she would be the employee of some other party. But even if the other party has a retirement plan established for the business, the artist will generally not be employed for long periods of time, and accordingly, will be denied retirement benefits due to problems of eligibility, vesting, or both. When a loan-out corporation is set up for an artist, he or she can consider adopting a defined benefit pension plan, a defined contribution pension plan, or a profit-sharing plan.

.05 Choice of Qualified Retirement Plan. The artist will have a choice of retirement plans to adopt if a loan-out corporation is formed or if the artist is self-employed. While the choices are not any different for artists than for others confronted with this decision, their differing income patterns will influence these choices significantly. As an example, if your artist client can only expect an irregular income stream, you might suggest installing a profit-sharing plan. This choice would allow flexibility with respect to contributions as it is not mandatory to fund a profit-sharing plan (that is, contributions could be limited in years when revenues are low and maximized in years when revenues are high).

.06 The downside to adopting only a profit-sharing plan is that the maximum contributions allowed by law cannot be achieved. Accordingly, many artists consider adopting a money purchase pension plan alone or in conjunction with a profit-sharing plan. This combination allows the contributions to be made at the maximum level allowed by law. There is, however, at least one downside to forming both plans. The adoption of a second plan will increase all the costs associated with having a retirement plan (legal fees to draft the plans, legal fees to amend the plan every time Congress changes the rules, accounting fees to account for the plan assets, fees for tax return preparation, other plan administration costs, IRS user fees, and so on). But there's a more fundamental problem with adopting a money purchase pension plan. Generally, the money purchase pension plan must be funded every year regardless of the availability of funds, so if the artist's income stream is not fairly regular, the artist may not be able to fund the plan.

.07 Both of the aforementioned plans are defined contribution type plans. These are generally the type of plan favored for artists who are successful at a relatively early age (that is, before age 45). This is because the alternative, a defined benefit plan, will not appreciably enhance the amount of current income that can be deferred for a young to middle-aged individual. Additionally, a defined benefit plan is generally a more problematic plan to administer. As to the amount of deferral, the annual contribution required to fund a defined benefit plan is based upon a variety of factors including the participant's age. Since the defined benefit plan contribution has a positive correlation with the participant's age (that is, the younger the participant, the lower the required contribution, while the older the participant, the higher the required contribution), generally an artist will opt for the defined benefit plan only when retirement accumulations are first beginning at a later stage in life.

.08 As to the problems that a defined benefit plan presents, it is a more expensive plan to administer and is usually open to greater IRS scrutiny than its defined contribution plan counterparts. The greater administrative expense comes from the greater complexity of the computation of the contribution for a defined benefit plan. While the funding of a defined contribution plan is extremely

straightforward (that is, it is a predetermined percentage of the compensation, with both the amount of compensation and the amount of contribution being limited to a statutory maximum), the calculation of the required contribution of a defined benefit plan involves calculating the future benefit available to the participant based upon a variety of factors such as the participant's compensation, current age, assumed retirement age, current accumulated plan assets, and the theoretical future rate of return on those assets over the remaining life of the plan, and accordingly, requires the services of an actuary. This additional service will add significantly to the cost of the administration of the plan. This complex method of determining the plan contribution can also make it a more costly plan to amend. Additional IRS scrutiny also arises. Since the amount of contribution is based upon several assumptions, these assumptions are open to question by the IRS.

.09 Finally, while many of the factors you'll consider when selecting a retirement plan will focus on the issues of maximizing income deferral and retirement savings for the artist, limiting administrative costs and IRS intrusion, and retaining planning flexibility, the ultimate decision may be further influenced if your artist client has one or more employees. When the artist is not the only participant, the evaluation process for the selection of a retirement plan or plans will invariably take on the additional issue of the cost of the non-owner employee contributions.

Guild Retirement Plans

.10 Artists often belong to guilds which provide pension plans. These plans need to be considered as part of the overall retirement plan for your artist client.

.11 Funding of Guild Plans. The various entertainment industry guilds, whose members work on motion picture, television, radio, and stage productions (for example, Screen Actors Guild, Writers Guild of America, Directors Guild of America, American Federation of Television and Radio Artists, and Actors Equity Association), by and large have collectively bargained defined benefit plans that are funded by contributions made by the producers (that is, the motion picture studios, independent production companies, the television networks, and other producers) based upon the compensation paid to the various cast and crew members involved with any given guild-sanctioned project. Accordingly, these guild retirement plans are generally noncontributory as to the participants. One notable exception is the Directors Guild of America, which in addition to the producer-funded defined benefit plan, has a mandatory supplemental defined contribution plan funded by deductions from the compensation of the participant (that is, if the participant is an employee of the producer, the deduction is from the payroll check, but if the participant is the employee of a loan-out corporation, the deduction is from the fee paid to the loan-out corporation).

.12 Caution. It is important to consider the amounts contributed by the director to the supplemental defined contribution plan when you evaluate the maximum allowable contribution to any nonguild retirement benefit plan for the director's services.

Integration With Loan-Out Corporation Retirement Plans

.13 When an artist is a guild member and performs services as an employee of his or her loan-out corporation rather than as an employee of the producer, the producer is still required by the collective bargaining agreement with the guild to make retirement contributions to the guild retirement plan based upon the fees paid to the loan-out corporation for the personal services of its employee.

Accordingly, the producer contributes the same amount to the guild retirement plan for an employee of a loan-out corporation as is contributed for an artist who performs the services as an employee of the producer. Consequently, if the loan-out corporation adopts a qualified retirement plan of its own, it is making contributions to its retirement plan for the benefit of its employee-owner in addition to the contributions made by the producer to the guild retirement plan.

.14 Due to this unique situation, practitioners have debated whether or not the plans need to be aggregated for benefit limitation purposes. After all, from the common sense standpoint, the same income stream is being utilized to fund contributions to two different qualified retirement plans. The Internal Revenue Code and Treasury Regulations state that plans must be aggregated where an employer (the loan-out corporation) maintains both a non-multiemployer plan and a plan for a common participant.³⁴ It is undeniable that a loan-out corporation is maintaining a non-multiemployer plan with respect to the qualified retirement plan that it adopts. It is not clear, however, that a guild plan, in which the corporation owner participates, is a plan that is maintained by the loan-out corporation. Facts to consider in evaluating this last point are —

- The status of the loan-out as a signatory to the guild collective bargaining agreement.
- The methodology employed in funding the guild contributions (that is, whether the loan-out corporation pays the contributions into the guild plan and is reimbursed by the studio, or the studio pays the contribution directly to the guild).

The most conclusive scenario for aggregation would be if the loan-out corporation is signatory to the collective bargaining agreement, as this would appear to place the loan-out corporation in the position of maintaining the guild plan.

.15 Courts cases do not exist that are on point. The next best indication of authority is the IRS position expressed in a private letter ruling.³⁵ While this has no value as precedent, it does shed light on the thinking the IRS applied in at least one instance. The IRS took the position that aggregation was only required when the loan-out corporation made contributions to the guild plan. It is this ruling that plausibly created the rush to adopt loan-out corporation pension plans. The letter ruling, however, was issued almost three years before regulations were issued.³⁶ It is questionable whether in the aftermath of that regulation a similar private letter ruling would be issued today. If in fact the correct position is that the plans should be coordinated, the formation of a loan-out corporation qualified plan is perhaps questionable and maybe even counterproductive. Aggregating could severely reduce the benefit of adopting a plan.

.16 Worse yet, however, might be ignoring aggregation entirely. Using a loan-out corporation plan that is not aggregated exposes an artist to the risk of the guild reducing its benefit payout when the artist retires in order not to exceed the benefit limitations. If by deferring current compensation through the use of a loan-corporation plan, the guild member will suffer a reduction in pension benefits

³⁴ Treasury Regulation Section 1.415-8(e).

³⁵ PLR 7816007, issued January 17, 1978.

³⁶ Treasury Regulation Section 1.415-8(e).

received from the guild plan, will the guild member accomplish anything other than permanently forfeiting a share in the contributions made by the producers? Until the early 1990s, the guilds ignored the aggregation issue. They paid out pension benefits to their retirees without any reduction for amounts that were accumulated in loan-out corporation plans or their successors (for example, rollover IRAs). Lately, however, the guilds have begun to take a new approach. Apparently concerned that the IRS might one day raise the issue of aggregation, guilds have asked their members to disclose information regarding the existence of loan-out corporation plans or their successors. Guilds have refused to begin the payment of benefits until members have responded to these requests for this information. If the retiree admits to the existence of such a plan or plans, the guild benefits may be reduced for the amounts accumulated in the loan-out corporation or successor plans.

.17 Guild members without loan-out corporation plans and without maximum guild benefits are the beneficiaries of this reduction, as their benefits are increased. Naturally, the guild members who are losing their benefits or are having them reduced are up in arms at this recent turn of events, especially since the IRS is not pressuring the guilds to do so. The IRS may not be pressing the issue because —

- The limits placed on benefits actually cause longer deferral of revenue recognition and the related income taxation.
- The potential for excise tax revenue would be reduced.
- The possible resulting disqualification of the guild plans could create serious public relations problems for the IRS.

The only possible resolution to this dilemma may lie in a class action suit brought by members against the guilds. Until this problem is clarified, any discussions with artist clients considering establishing a qualified retirement plan through a loan-out corporation should include examining the effects of aggregation. Although the same situation appears to exist if the guild member is self-employed and establishes a Keogh plan, this situation is not being addressed by the guilds.

.18 New Rules in the Year 2000. When the Small Business Job Protection Act of 1996 (also known as the Minimum Wage Bill) was passed on August 21, 1996, it included some significant modifications to rules affecting retirement plans. As mentioned above, integrating the combined contribution and benefits limits with the guild plan is something you should consider. One particular provision of the Act which takes effect in the year 2000 eliminates the combined limit. Thus, beginning in the year 2000, both a defined benefit plan and a defined contribution plan may be maintained and funded to the maximum. What this means is that loan-out corporations will be in a position to set up a different type of plan than the guild plan and make full contributions. What will this mean for those who did not aggregate prior to the year 2000? There are differences of opinion among ERISA attorneys on this point. Some feel that prior contributions by a loan-out corporation may be tainted, others feel that the new law will affect the position of the IRS and it will be lenient in this area. Be advised to move cautiously in this area until after the year 1999.

Nonqualified Plans

.19 Many highly compensated business owners have considered utilizing nonqualified retirement plans in order to attract and retain key employees and to provide themselves with additional deferred compensation benefits. Nonqualified plans are used in order to provide deferred compensation to key employees and owners which cannot be deferred through qualified plans due to the contribution, benefit, and nondiscrimination limitations of qualified plans. Nonqualified plans do not have any of the vast restrictions or requirements found in the qualified plan area. Accordingly, nonqualified plans can be arranged to be completely discriminatory and can be used to provide benefits to the owners, key employees, or both, without including the rank and file. Additionally, a nonqualified plan does not require a trust to receive and hold the contributions until benefits are finally paid out.

.20 There are, however, unfavorable attributes of nonqualified plans. The most significant is that the deferred compensation accumulated under a nonqualified plan is not currently deductible by the business. The deferred compensation only becomes deductible when it is paid. Furthermore, unlike qualified plans, the assets of a nonqualified plan are not beyond the reach of the creditors of the business. Because of the nondeductible contributions and the fact that most entertainment industry loan-out corporations employ only the owner-artist, nonqualified plans are generally not used by artists. As nondeductible contributions will result in current taxation, but with future enjoyment of the income, there is a disincentive to using such an arrangement. This is especially onerous for a PSC or a PHC since the taxable income of these corporations can be subjected to punitive tax structures. As there are generally no other employees apart from the owner, there are no key employees to impress and retain. Consequently, there are few situations where nonqualified plans make sense. Of course, if the artist has a significant organization, similar to a traditional business, then you should examine the pros and cons of a nonqualified plan.

5. ESTATE PLANNING

.01 Estate planning for artists involves many of the same issues and techniques common to other clients. There are, however, some assets that are virtually unique to artists which present special valuation problems at the time of a transfer of assets to another. These assets are generally intangibles representing an entitlement to future income. Accordingly, an estate tax valuation for these types of assets involves a forecast of future revenue amounts in order to arrive at a discounted present value. Additionally, certain tangible assets either created or owned by an artist may have a premium value above that normally associated with similar items not created or owned by an artist. This type of tangible property would usually be considered memorabilia.

Special Problems

.02 Valuation problems are often present when dealing with copyrights, royalties, profit participations, and memorabilia. A discussion of the issues involved in dealing with these types of assets follows.

.03 Copyrights. A copyright is the exclusive legal right for creative artists to exploit their works for a specified period of time. As some works of creative artists can be exploited in a variety of ways (for example, a novel can be published in hard cover or soft, read aloud on an audio tape, excerpted or serialized in a periodical, developed into a stage play, teleplay, or screenplay, serve as the basis for a toy or game, serve as the basis for an amusement park attraction, and so on), valuation of a copyright can pose special problems.

.04 Situs. Copyrights are granted by governments and are enforceable against residents and nonresidents alike within the jurisdiction of the issuing authority. Accordingly, U.S. copyrights belonging to nonresident aliens are likely to be within the reach of the U.S. estate tax.

.05 Valuation of Copyrights. While all of the existing licensed uses of a copyright can be evaluated using a scientific approach to forecast their future revenue potential, such as using historical data to predict a value of the future discounted cash flow, the possible future uses are largely unpredictable, and accordingly, create a problem. Because all of the possible uses of a copyrighted work may not be known at the time of a valuation, there is a possibility of undervaluation with respect to these unknown possible future uses. Accordingly, the valuation of the copyright should be segregated into two separate valuations, one of the future uses of the copyright and one of the existing agreements.

.06 The valuation of the future uses of the copyright is the more difficult to formulate and support because of the variety of uncertainties regarding future exploitation. Avoid the temptation to ignore this valuation as an unnecessary element. Any credible attempt to develop a value is better than no attempt. Have an expert in appraisal of these rights help you develop a value. Due to the extreme subjectivity, most reasonable approaches may be enough to avoid a proposed IRS valuation adjustment. The valuation of existing agreements, such as royalty agreements, is discussed next.

.07 Royalties. In general, a royalty is a fee paid pursuant to an agreement with a grantor or creator for the use of, or privilege to use, the property. Royalty agreements can apply to both tangible property and intangible property. As a result of the proliferation of oil and gas investment limited partnerships, many practitioners have become familiar with royalties paid to the owners of tangible assets. A royalty paid in the oil and gas area is generally based upon a measurement of the number of units of production extracted. Similarly, an artist might be paid a royalty based upon a measurement of the number of units sold (for example, compact disks, books, T-shirts, toys, or posters).

.08 Examples. Authors, songwriters, sculptors, and painters create books, plays, songs, sculptures, and paintings. When produced in multiple formats for marketing, the creative artists are generally selling the right to use or reproduce their creations to a licensee, for a specified period of time. The licensee receives the right to mass produce the property for the agreed-upon time period and earns the revenue from sales of the mass produced version. One of the licensee's costs of producing the property is a royalty fee that is paid to the creator. The royalty payment is generally based upon the number of units sold by the licensee. Alternatively, performing artists perform the works of creative artists. Their performances, however, can be captured and preserved for replay through a variety of mediums. For example, sales of a music album will generate royalties not only for the creative artist songwriters, but also for the performing artist musicians.

.09 Valuation of Royalties. Since royalties are fixed by contract, the amount due on each unit sold or otherwise exploited is already known, as is the remaining term of the royalty agreement. Accordingly, as long as you use the correct royalty rates and term, the accuracy of the valuation will hinge upon the projection of future sales volume and timing, as well as the discount rate applied. The historical factors to consider in projecting the sales are the pattern and the amount of past sales. Hindsight is always 20-20 vision and there will undoubtedly be discrepancies in the value of actual future revenues and those predicted, even in situations where reliable historical data exists. An expert appraiser's credible reasoning (appraisal theory and approach) and documentation can help you develop the best projection of the future sales and discount rate, and help defend against an IRS challenge if projections fall short of the mark.

.10 Residuals. Residuals are intangible assets of performing and creative artists largely operating in the motion picture and television industry. Residuals are specific monetary amounts paid by the producers pursuant to the collectively bargained agreements they have with the motion picture and television industry guilds. The residuals are paid to guild members participating in a motion picture or television project based upon the repeated showings of that project. The rate paid by the producers will generally decline as the number of reuses increases. The same methods and principles of valuation applicable to royalties also apply to residuals.

.11 Profit Participations. One of the most difficult intangibles to value is a profit participation. Generally speaking, a profit participation is a contractual right to receive a specified percentage of the profits of an exploitable intangible property in perpetuity. This type of right is generally only given as a form of additional contingent compensation, as an added incentive to a proven artist. It is a compensation arrangement that is most commonly found in the motion picture industry, although it can apply in the television field as well.

.12 Example. An established writer is hired to write the screenplay for a theatrical release major motion picture. The writer's contract provides for a significant up-front fee. In order to further compensate the writer, in the event the movie is a major financial success, the writer is also given the right to receive 2 percent of the net profits. This right to receive 2 percent of the net profits is known as a profit participation.

.13 Definition of Profits. Usually only the top name performers, directors, writers, and producers are compensated with profit participation interests. Furthermore, within this group of fortunate few, there are other distinctions. While the number of "points" (each point is one percent) paid is one factor that will vary with how important a participant is to a given project, it is frequently more significant to obtain a favorable definition of how profits are calculated as well as a gross profit or revenue participation rather than a net profit participation. These favorable definitions are rarely seen, and only a few marquee name artists will ever have the opportunity to even negotiate for these factors.

.14 Valuation of Profit Participations. In order to value a profit participation interest, first determine all of the definitional factors listed above. Then make a projection of the future collections. To estimate a present value, consider —

- How long ago the property was first exploited.
- How much has already been paid under this right.

- The reporting schedule specified in the contract.
- The trend of revenues and expenses to date.
- The likelihood of fresh exploitation from remakes.
- New delivery systems and new markets.
- The timing of additional revenues projected to be received.
- The appropriate discount rate.

This multitude of factors is what makes the valuation of profit participations exceedingly difficult. Consequently, the gifting of a profit participation is a very risky prospect, as in time the valuation may prove to be too low. Accordingly, the valuation question is usually resolved by the executor and the estate advisors.

.15 Memorabilia. Your artist clients can present unique valuation problems concerning assorted types of memorabilia. These tangible assets fall into two general categories, acquired property and created property. Acquired property is generally classified as a capital asset. Created property does not qualify as a capital asset in the hands of the artist who created it. Not all artists possess memorabilia which is more valuable merely as a result of it belonging to them. Generally, the only memorabilia that will take on an enhanced value belong to celebrities who are either popular artists or cult figures.

.16 Examples. The three Irwin guitars owned by Jerry Garcia at his death are examples of memorabilia that are acquired property. These musical instruments have significant additional value above their intrinsic value (which is high for these custom-made guitars) based upon their use by the infamous “Captain Trips.” Alternatively, John Lennon’s personal letters and other writings (for example, song lyrics in Lennon’s handwriting) are examples of property that was personally created. The value of these types of memorabilia can be directly attributed to their historical importance as the personally created writings of a former Beatle.

.17 Valuation of Memorabilia. While you would use some form of projection of future exploitation revenues to value intangible assets, the most appropriate valuation method for memorabilia is a comparable market value approach. Because of the high degree of subjectivity concerning comparability of market value for different celebrities, as well as the general lack of readily available market data on celebrity memorabilia, it is essential to obtain the services of a qualified appraiser. Those appraisers who work for the leading auction houses (such as Sotheby’s or Christy’s) or the government (such as The Library of Congress or The Smithsonian Institute) are likely to be the most qualified for an appraisal of celebrity memorabilia. One rule of thumb that can usually be followed — the more closely associated an item of memorabilia is with the artist’s craft or significant career moments, the more valuable it will be.

.18 Example. The value of the comic book collection owned by Jerry Garcia at his death was reportedly \$25,000. As the comic book collection compiled and owned by Jerry Garcia, it should be worth more than its normal value as simply a rare comic book collection. In this case, the premium charged (as a percent of the norm) is less than it would be for an item of memorabilia that was closely associated with Garcia’s musical career. This “celebrity premium” should be at a higher percent of the normal value for his three custom-made guitars than it should be for his comic books.

Liquidity

.19 Liquidity can be a problem for many artists' estates for many of the same reasons it can be a problem for other high-net-worth individuals with low cash positions. The estates of artists, however, may suffer the additional ills of having a high percentage of the net worth residing in the value of intangible property rights and memorabilia. Some or all of the memorabilia might be sold to raise cash, as well as to avoid the valuation issues. This may not be difficult to do via auction, if the artist is an important celebrity. The intangible assets, however, are much more difficult to convert to cash as there is no market for these interests. Accordingly, if intangibles make up a significant percentage of the estate, consider using life insurance as a liquidity solution.

6. CASH FLOW PLANNING

Lack of Predictable Income Stream

.01 The artist's earnings tend to be unpredictable and compressed into a short period of time, due to the exigencies of the entertainment industry. Artists in the motion picture, television, and variety branches of the entertainment field generally work on a project-by-project basis. Such projects can vary in duration for an actor. For example, a television movie usually takes four weeks; a feature film, ten weeks; a television situation comedy, six, thirteen, or twenty-two episodes encompassing about one week per episode; a one-hour television drama, six, thirteen, or twenty-two episodes encompassing about ten days per episode.

.02 A recording artist's income comes in the form of various kinds of royalties, which are typically paid only twice a year. If there is no current income from performances or touring, the recording artist must rely on prior earnings or advances on future royalties to meet cash flow requirements.

.03 It is not uncommon for an artist to experience long periods of time between projects. It is typical for a motion picture director, for example, to complete a project in a year to one and one-half years. It may then take a year or longer for even a successful director to receive another project. Motion picture producers can go years between projects.

.04 These examples illustrate the potential extent of cash flow planning problems. In the authors' experiences it is necessary to periodically prepare and review the cash flow projections for the artist. You will most likely devote substantially more time to cash flow planning for artists than for other types of clients.

Action Tip

When the planning of cash flow is difficult for a particular artist, maintain a continuous monthly cash flow projection for a six-month to one-year period, and roll it forward each month in order to monitor actual and projected cash flow and to keep the projection current.

Typical Artist's Spending Habits

.05 Artists' work projects tend to be shorter in duration than those of the average worker or professional, and the work hours are very long. Therefore, artists are usually not able to spend or commit to spend significant sums of money while they are working. Being engaged to work on a television show can mean working twelve, fifteen, or more hours each day. The average person does not comprehend how much time is needed to put an episode of film or videotape "in the can." The continuously working artist client is earning the money needed to help fulfill his or her financial goals, and generally does not have the problem of a cash shortage.

.06 When artists are between projects and idle, they have the time to spend money. The artist sometimes compensates for the boredom of not working by compulsive spending. Stay in close contact with your artist client when he or she is between projects in order to stay informed, and to be in a position to prevent spending irregularities. Sometimes the artist will want to spend a large sum of money on something you think is unnecessary or even frivolous. This is not a rare occurrence when dealing with artists. Be prepared for clients who decide to purchase jewelry, cars, or houses, or to redecorate a house, on the spur of the moment. You must have the sensibility to advise the client and cope with these occurrences.

Dealing With Cash Flow Deficiencies

.07 The artist may blame you if there is not sufficient cash to meet his or her current spending desires. You should prevent this by continuously educating and informing your client about the cash availability. Business managers are in the unique situation of actually paying the client's bills. Accordingly, they can and should have a current handle on an artist's liquidity. Good senior bookkeepers will keep you and your client abreast of these matters. Compared to the complicated financial planning you do for your client, cash availability may seem mundane. But to the artist, it may be the most important thing. It is, therefore, sound professional practice to keep informed of your client's spending patterns and major cash needs. For example, if you know that a client is planning an addition to a residence, make certain that the cash or financing resources are in place, or at least planned for, to avoid having to abandon, delay, or, worse, stop a construction project in process.

.08 When the artist has or is anticipated to have a cash deficiency, your banking relationships will become crucial. There are certain banking institutions that understand the ways and means of the entertainment industry. They are not as fearful of lending money to artists for specific cash needs, or for working capital when the client has a deficiency. Having relationships with these kinds of banks is an important aspect of servicing artist clients.

Management of Debt

.09 The artist may become your client when he or she is in debt. Or the artist may have to incur debt at some time during your representation. As mentioned above, strong banking relationships are an important asset you can offer the artist client. Managing the artist's debt is as much an art as it is a science. Remember that the way you deal with a creditor can affect the way that creditor will perceive and receive your future requests.

.10 Being consistently up-front, honest, candid, and realistic will hold you, and accordingly your artist clients, in good stead with lenders. Most lenders will be realistic and will compromise terms if they feel that they are not being “snowed” by the artist. In fact, the very celebrity of an artist may make it possible for him or her to achieve a result that a person who is not a celebrity could not achieve. The irony is that most people, even creditors, enjoy being associated with famous people. They also want to help celebrities. This may explain why so many artists, athletes, and other celebrities get into financial trouble, as creditors actually aid them by approving borrowing levels not usually approved for the general public.

.11 Income Tax Debt. This is one of the worst kinds of debt for an artist to incur. If income taxes are not properly managed, or if there are significant disallowances from tax examinations that result in tax assessments, you will have your work cut out for you. Since the artist’s earnings tend to be so unpredictable, you should make sure that income taxes are taken care of on a pay-as-you-go basis. Set aside time for extensive communications with the artist to keep him or her informed about tax issues (and to protect yourself).

.12 Credit Card Debt. Credit card debt and income tax debt are two of the most serious debt problems. The artist may abuse credit cards and become deeply mired in credit card debt. The interest charges can become a burden. The earnings potential of artists is so high that they tend to have no problem extending limits on their credit cards. When earnings are low, an artist may not adjust spending downward. With strong banking relationships you may be able to help your client consolidate credit card debt over an extended period, at a lower interest rate. Stay involved to ensure that the artist does not rebuild credit card debt after the lines of credit on his or her credit cards have been cleared. If this debt is not carefully monitored your client can easily get back into the same situation.

.13 Retirement Plan Loans. Vested benefits in qualified retirement plans can be useful tools for managing cash flow for the artist. Be cautious, however, because of the penalties and restrictions under the tax and ERISA laws and the risk of losing benefits if the artist cannot repay the borrowings. This resource should be looked at as a “last resort” for obtaining cash for operating or special needs.

Possibility of Abrupt End to High Earnings

.14 The artist’s high earnings may end at any time. Royalties, residuals, profit participations, and such decline over time, and are likely to become inconsequential over the long term. The artist’s earnings can come to an abrupt end if there are no new projects. You should educate the artist about this possibility, although doing so is a challenge. Very few artists have enormous earnings potential for many years. It does happen, but they are the exception, not the rule. Do not be derailed in your efforts at realistic planning by the enthusiastic artist who feels that high earnings will continue. Confidence on the part of the artist is important, but your function is to provide perspective and experience.

7. INVESTMENT PLANNING

Measuring the Artist’s Risk Tolerance

.01 Most artists do not know their own risk tolerances; they generally do not have the same body of business experience or education that many of your other clients have. Many artists have struggled for years, working at menial, low-paying jobs, in the hopes of “making it.” If they achieve financial

success their immediate spending might leave them little to invest. Business managers tend to be involved when artists have financial success. If you are a CPA who is not involved in the artist's financial matters on a day-to-day basis, you are at a disadvantage because your "charge" is different. The business manager can immediately begin serious discussions with the artist to determine investment risk tolerance. In fact, the business manager can prepare the artist for financial success even before it comes by educating the artist. If you can also establish a very close dialogue with the artist, determining an appropriate risk tolerance will be easier.

.02 Some CPAs and business managers will directly advise their artist clients about investments. Others will recommend that the artist use stockbrokers or money managers for advice regarding investments. Sometimes the circumstances are appropriate for the CPA or business manager to work closely with the artist's stockbroker(s) and money manager(s) at the request, and for the benefit, of the artist. Depending on your particular situation, you may need to become a registered investment adviser, as discussed in paragraph 2.53. You should take the investment area, particularly the assessment of the artist's risk tolerance, very seriously. It is important to advise clients to invest in appropriate investments. If an investment, even a relatively conservative investment, should decline in value or fail, your client's attorney will not have a difficult time proving that the artist was naive, uneducated, or misinformed about the investment. Artists are vulnerable to promoters of investment schemes, and the courts and juries generally favor them in lawsuits against individuals and firms that give them advice on investments. Also keep in mind that there is a significant risk related to inflation. Evaluate the artist's net real rate of return (after inflation and taxes) and discuss the results with the artist so he or she recognizes that there is a price for what many consider to be conservative investments.

.03 Emergency Fund Portfolio Structure. Since artists' earnings are unpredictable, you should encourage your artist client to set aside a significant liquid asset pool for emergencies. The amount of this liquid asset pool will be influenced by the artist's cash flow needs, career path, and comfort level. Keeping this liquid asset pool in money market funds (taxable and tax exempt), money market accounts, certificates of deposit, U.S. Treasury bills, and other short-term investments is a common practice. Unless there is a good reason to do otherwise, recommend this type of investment policy for your client's liquid assets. Where applicable, consider making certain that the assets are insured under government or private programs.

.04 Inform the artist, preferably in writing, that even these types of very conservative investments do have risk. During 1994 there was at least one money market fund that "broke the one-dollar-per-share barrier." While a money market fund cannot generally invest in paper that will mature beyond thirteen months, and therefore, one can assume that the problems of the 1994 fixed income securities "crash" are over, we all know that history tends to repeat itself. Therefore, cautioning and educating your artist client is important.

.05 Intermediate-Term Portfolio Structure. The artist may have plans to buy a new home, build an addition to an existing home, buy a second home, or some other foreseeable expenditure. Investing available funds to execute these plans can have a longer time frame. Accordingly, the artist's risk tolerance for investing this pool of funds may be somewhat greater. If the artist has a reasonably precise target date for implementing the plans and tapping the designated funds, you may be able to help the artist obtain greater yields, while maintaining low risk. Using intermediate-term certificates

of deposit, U.S. Treasury notes, and intermediate-term bond funds (both taxable and tax exempt) can increase yields while still keeping the risk of loss of capital to a minimum. Of course, be sure the artist understands that there is always a risk of loss, even in fixed income investments.

.06 Periodically monitor the artist's personal income tax bracket to determine if the mix between taxable and tax exempt investments should be altered. The artist's effective yield after taxes can change dramatically as interest rates and tax brackets change. Additionally, the artist's work prospects will impact what portion of the investment portfolio should be in taxable and tax exempt vehicles. You will have to make quick adjustments to your planning if the artist's circumstances change.

.07 Long-Term Portfolio Structure. Your planning for an artist's long-term investments will be similar to that for other types of clients. There are no significant differences regarding establishment of portfolio structure for artists as compared with other clients. There may be a tendency to keep a lower level of real estate in the investment portfolio than for other clients because the artist may very well have a significant investment in real estate, considering principal and secondary residences.

.08 Some advisors have concluded that because many artists have retirement plans from the various guilds, as well as from their private pension and profit-sharing plans, it is not necessary to commit a significant portion of the long-term portfolio to equities. Many artists are also fearful of "playing the stock market." The authors have seen situations where artists' long-term investment portfolios consist primarily of long-term tax-exempt securities. However, it is usually appropriate for the artist to have a measurable portion of his or her long-term portfolio in equities, both domestic and foreign. It is also frequently appropriate for the artist to have a portion of the long-term fixed income investment portfolio in foreign currency designated securities. There may also be a place for precious metals, most notably gold (or gold stocks), in the long-term investment portfolio. In other words, portfolio allocation is similar to that for other clients.

Asset Growth Versus Conservatism in Portfolio Structure

.09 The major argument against taking increased risks in the artist's portfolio is that the artist's income is erratic and unpredictable. Furthermore, the artist's career can end rapidly by choice or because of the public's disinterest. Therefore, one can make the argument that ultraconservatism is appropriate. However, as discussed above, inflation and income taxes can actually cause an ultraconservative portfolio to lose spending power over the intermediate and long term. Modern portfolio theory, applied to the artist's portfolio, may enable the artist to achieve desired results within planned risk tolerances. Be careful not to make any unilateral investment risk decisions for the artist. The ultimate decisions related to portfolio allocation should be the artist's. Your role is as the sounding board to help the artist make sensible investment decisions.

8. RISK MANAGEMENT

.01 Insurance risks are a major concern for artists. If they are famous or recognizable they are exposed to the risk they will be sued. Artists are targets of lawsuits if they get involved in minor automobile accidents or personal or business incidents. It is an unfortunate truth that many people will file a spurious claim against an artist because of a mistaken belief that they have an opportunity to "win the lottery" with such a claim. Therefore, it is important for you to have more than a working

knowledge of insurance issues as they pertain to artists. Typically, a business manager will be delegated the responsibility of working with the artist's insurance professionals and assisting the artist in understanding and making decisions about insurance and risk management issues. See paragraph 2.52 regarding licensing requirements when providing insurance advice.

Liability Insurance

.02 Since artists are frequent targets of unwarranted claims (and sometimes even warranted claims) it is of vital importance that liability insurance issues and risks be explored. Evaluate the amounts of coverage required not only by weighing the artist's assets, but also his or her earning power. An uninsured, or underinsured judgment may be able to be satisfied by an artist's future earnings stream. Even though liability insurance for an artist tends to carry higher insurance premiums than for non-artists, the additional premium costs may be well worth the price, particularly if the premium will be tax deductible.

.03 Personal Liability. Compare the premium costs for obtaining various levels of coverage. Basic liability coverage is generally obtained in connection with the homeowners or tenants and automobile policies. If, for example, you and your client have determined that the proper amount of personal liability insurance is \$5,000,000, you'll also have to consider the cash flow consequences of how this coverage will be obtained. It is sometimes more costly to increase the basic liability coverage than to have lower limits of basic coverage and higher levels of excess liability or umbrella coverage. Be sure you price the various layers.

.04 Apply extra caution to make certain there are no gaps between basic and excess and umbrella liability limits. This is a common oversight, and an error or omission in this area can cost an artist a significant amount. Carefully evaluate and analyze your artist client's coverage to avoid such a loss, as well as to protect yourself against professional liability claims.

.05 Personal umbrella policies for celebrity clients can be expensive. It is not unusual to encounter minimum premiums of approximately \$2,000 for a level of \$1,000,000 of personal umbrella coverage above primary liability insurance in the homeowners policy. Very high visibility or "marquee" clients are likely to encounter more significant premium costs. Furthermore, such clients may have to obtain such liability insurance coverage from specialty markets.

.06 *Umbrella Versus Excess Liability Insurance.* An excess liability policy follows the form of the underlying liability policy whereas an umbrella liability policy can add additional items of coverage in addition to the higher limits. Therefore, it is more desirable to have the artist purchase an umbrella liability, rather than an excess liability policy. The umbrella policy will provide first-dollar (sometimes subject to a small retention) coverage that is not included in the primary liability policies. Specifically, there is usually no coverage under primary and excess liability policies for —

- Use of non-owned recreation vehicles, such as motorcycles, mopeds, dune buggies, snowmobiles, and so forth.
- Use of non-owned watercraft, such as wave riders, jet skis, and so forth. There are some limits as to the length of the watercraft.

- Damage (except for fire) to rented or occupied property caused by the insured's negligence.
- Directors and officers liability for a nonprofit organization.
- A non-owned or hired automobile outside the United States and Canada.

.07 In addition, if personal injury (such as libel, slander, defamation of character, mental anguish, and so forth) is not covered under the primary personal liability policy, it is important for the personal umbrella policy to include personal injury coverage and not a "following form" personal injury endorsement.

.08 Business Liability. It is important to address business liability insurance. Typical homeowners and umbrella liability insurance policies do not cover an individual for business liability. This is also true for artists. If an artist is operating in corporate form, consider obtaining comprehensive general liability (CGL) insurance and non-owned and hired auto insurance policies naming the business entity and the individual for business liability exposure. You should also consider purchasing business umbrella or excess liability policies. Weigh premium costs against liability exposures to determine the optimum practical level of insurance for your client. Alert your client that the insurance coverage may be worth purchasing just for the ability to have liability claims against the artist defended by the insurance company. Defense of a claim can be extremely expensive, even if there is no liability determined. Protecting against this is a valuable intangible that should be weighed into your client's decision. Generally, the cost of defending a claim will reduce the amount available to pay such a claim.

.09 Named Insureds. When an artist enters into a contract to create for or perform in a particular project it is sound practice to negotiate for the artist to be a named insured under the liability policy of the production entity. Therefore, if an actor, director, or other artist is going to be involved in a motion picture project, becoming a named insured under the studio's liability policy provides the artist with another level of liability insurance coverage.

.10 This coverage can typically be obtained through negotiation — usually without giving up any financial or other benefits under a contract. Yet, it is one of the most frequent omissions from a negotiation, either because agents and attorneys do not know how important it is, or they fail to address the issue. As more CPAs or business managers develop relationships with various agents and attorneys, such artist representatives will become aware that this is something which should be requested during a negotiation. You should not, however, assume that this is going to be done. Be sure to inform the artist's agent and attorney that this is an essential "deal point." Note, however, that this is not a substitute for the artist's own insurance or that of the artist's loan-out corporation.

.11 Named Versus Additional Insured. It is more desirable to have the artist be a "named" insured rather than an "additional" insured under these policies. As a named insured, the artist is given the full benefits of the policy. As an additional insured, the artist's coverage afforded is restricted to his or her actions on behalf of the studio or production company and within the scope of the contract or employment with such studio or production company. The additional insured coverage is generally all the insurance carrier wants to provide the artist and is basically acceptable. However, it is important to remind the artist of the need to have his or her own coverage to provide protection outside of the contract.

Workers' Compensation Insurance

.12 This is another high risk area for artists. You must be knowledgeable about the risks and exposures in order to protect your client. As with liability insurance premiums, you have to evaluate the cost versus the benefit, as well as exposure, with respect to the workers' compensation insurance area. An artist working as an individual on a project is generally covered under the employer's workers' compensation insurance policy. This is true of virtually all employees of studios. Every state requires that employers carry some form of workers' compensation insurance to protect employees if they are injured on the job. However, if you have an artist client scheduled to work outside the United States, make sure that the artist will be covered. If the artist will be working as an independent contractor (such as a variety or music performer) or operating in corporate form through a loan-out company, there may be no coverage or there may be a dispute as to who is required to carry such insurance. Guild plans as well as private health insurance policies exclude coverage for on-the-job injuries. An injury may occur while "working," such as when practicing for a role, but before employment begins. Under such a scenario, the artist may not yet be covered under workers' compensation.

.13 The authors have heard attorneys state that if an artist is injured on the job and a dispute about workers' compensation arises the attorneys will likely be able to raise some causes of action, such as negligence, to obtain a recovery for an artist. This seems to beg the point. As a rule of thumb, if money is not an issue, and your artist client is operating in corporate form, it is important for the artist to seriously consider purchasing a workers' compensation insurance policy. It may be a doubling-up of coverage, but it is a small price to pay for the protection. Stages and television and movie sets are dangerous places and injuries are common. The cost of a workers' compensation policy to cover an artist in his or her loan-out company is usually less than \$2,000 per year. The policy should contain an "all states" rider. However, be aware that there are certain monopolistic states that require employers to obtain workers' compensation insurance with a state-controlled insurance entity. The monopolistic states are Nevada, North Dakota, Ohio, Washington, West Virginia, and Wyoming. Do not assume that the policy will cover the artist everywhere. Consult with the artist's insurance professional to make certain that there is appropriate coverage.

Foreign Coverages

.14 Typically, CGL policies will only cover the artist in the United States and Canada. If the artist is going to work outside of this area you should investigate purchasing separate CGL and umbrella liability policies. The costs of such policies are usually comparable to policies that cover the artist for liability in the United States and Canada. The state's workers' compensation policy may extend benefits to U.S. employees if they are injured in a foreign country; however, the policy may not provide repatriation coverage (covering the cost of returning the injured individual to his or her country of origin). It is therefore desirable to consider a foreign or worldwide workers' compensation policy when an artist is working outside the United States and Canada to obtain the repatriation coverage. Seek the advice of a qualified insurance professional. If your artist client regularly works both within and outside the United States, it would be wise to consider a policy or policies that provide worldwide coverage.

Touring

.15 Artists who tour have special insurance needs. The locations or venues in which they work may be dangerous places and the artist should have liability protection. Sets, props, instruments, lighting, and costumes are extraordinarily expensive to replace if they are stolen, damaged, or destroyed. Workers' compensation insurance is also needed. Coverages for pyrotechnics, trucks, buses, and other items should be considered. Nonappearance insurance may be needed to protect touring artists in the event that they cannot perform due to illness or foul weather. Also consider non-owned aircraft coverage, if appropriate. The policy can also be designed to include coverage if the equipment fails to arrive due to breakdown, collision, and so forth. Package policies are available to cover touring artists for their exposures. It is important to analyze the need for insuring these exposures. Doing business with insurance brokers who are knowledgeable about touring artists and their risks is vital.

Property Insurance

.16 As artists tend to have significant assets, both personal and business, decisions regarding insuring such property are extremely important. Furthermore, there may be a blurry line between what is personal and what is business. Evaluating your client's individual situation and discussing it with his or her insurance professional will help you fulfill the artist's risk management objectives.

.17 Personal Property. The personal property insurance needs of artists are not substantially different from those of other types of clients. Artists do, however, tend to accumulate assets with significant value. As the typical homeowners insurance policy limits coverage for personal property to one-half of the amount of the dwelling coverage, you should determine whether it may be necessary to increase such limits. Carefully monitor coverage for personal property and personal articles.

.18 Artists are also known for giving away valuable items that they have purchased. Periodically review schedules of items insured, to make certain that the items are still in the artist's possession. Conversely, it is also not unusual for an artist to receive valuable gifts. Periodically raise a question about receipt of gifts to see if such items need to be scheduled under a personal articles insurance policy.

.19 Business Property. Property used in the artist's business activities should be considered for insurance coverage. Variety and music performers may have extensive wardrobes, props, sets, drops, instruments, valuable papers, music scores, and other items. Additionally, the use of high-tech sound, lighting, and computer systems to operate them has become commonplace. Therefore, you'll need a thorough knowledge of your artist client's business assets to effectively help protect his or her business property.

.20 Insuring such items under business property insurance policies is essential. The authors have seen situations where having the proper insurance saved an artist enormous amounts of money and a number of problems. For example, acts in Las Vegas may be required to provide their own marquees. Usually, the hotel's insurance will not cover the artist's marquee. One of the author's clients received a high five-figure recovery when a windstorm damaged a marquee. The insurance for this coverage was less than \$2,000 per year.

Kidnap and Ransom Insurance

.21 Artists may be highly visible individuals. Television, motion pictures, and the mass media make the artist's image available to all. It is no secret that visible people can be targets for the unscrupulous and the criminal element. Kidnap and ransom insurance can provide protection from financial loss from this type of extortion. As this is a special type of coverage, you should discuss its propriety with both the insurance professional and the artist. Such insurance policies are remarkably affordable, and a business tax deduction may be sustainable. These insurance policies generally cover all members of the artist's household. They also include information on how to contact the carrier's investigators should an incident occur. These investigators are highly trained in this area and become immediately involved in securing the safe return of the individual.

National Flood Insurance Program

.22 While insuring for flood damage may not be unique to artists, it is worth mentioning because many artists are affluent and they may have exotic homes that are ocean-front, lake-front, river-front, hillside, or mountain-top properties. These dwellings may be exposed to flooding due to natural disasters. If appropriate, advise your artist client to acquire National Flood Insurance Program policies to cover for flood damage. The coverage is limited to \$250,000 for the residence and \$100,000 for contents. However, in the event of a covered loss the artist will be thankful for this coverage. If insurance beyond these limits is required for the structure and contents there are other markets the insurance broker can tap to obtain excess limits above those provided by the National Flood Insurance Program policy. It is essential, however, to have the basic National Flood Insurance Program policy in order to qualify for the higher excess limits.

Earthquake Insurance

.23 Like flood coverage, the need for earthquake insurance is not limited to artists. However, many artists do reside or have second homes in areas that are earthquake-prone. It is, therefore, important to be versed in this kind of insurance. In some states, if an insurer offers homeowners insurance it must also offer earthquake insurance. While there are insurance companies that periodically offer stand-alone earthquake policies, it is more common for policyholders to obtain an earthquake endorsement to their homeowners policies. Earthquake insurance tends to have high deductibles, typically 10 percent of the loss. Prior to the Northridge Earthquake in January 1994 it was possible, with a limited number of insurance companies, to obtain coverage with a 5 percent deductible. The authors are not aware of any current markets at this level. In fact, higher deductibles, such as 15 percent, are becoming commonplace. Also be aware that these coverages, with very few exceptions, have separate deductibles for the structure and contents.

.24 As of January 1, 1996, California passed legislation that has resulted in major changes in earthquake coverage. This new legislation created the California Earthquake Authority (CEA) which mandates that insurance companies offer a "mini-policy." The result is that deductibles are higher, coverage is more restrictive, and premiums are higher. Furthermore, it may be impossible to obtain standard coverage for the full value of the property. As this is an evolving matter, be sure to investigate current policies if advising artists about earthquake coverage.

Brush Area Fire Insurance

.25 Having a residence in a brush area, as in flood and earthquake prone regions, is not limited to artists. Your client may have a residence located in an area that is fire-prone. The insurance industry has designated these locales as “high brush” or “brush” areas. If a residence is located in one of these designated brush areas, traditional homeowners fire insurance policies generally are not provided by the insurance industry. In California, all insurers providing homeowners insurance must participate in the California Fair Plan (CFP) Association program, which provides for fire insurance, at high rates, to individuals owning residences in the brush areas. Other states may have similar programs. The CFP policy limits coverage to \$1,500,000. Therefore, if coverage beyond this limit is needed or desired, you should consider other options. Since these policies only offer limited coverages, individuals must insure their residences for many other risks by purchasing either a wraparound or difference-in-conditions (DIC) policy, to insure for all of the other normal risks covered by typical homeowners policies. A wraparound policy is more desirable than a DIC policy because of broader coverage.

Health Insurance

.26 Many artists have their medical insurance covered under a guild or union insurance plan. The Screen Actors Guild, American Federation of Television and Radio Artists, Directors Guild of America, Writers Guild of America, and some other guilds have excellent health and welfare plans, which include generous health insurance programs. If the artist is covered by one or more of these programs there can be both a substantial savings in health insurance premiums as well as an excellent tax-free fringe benefit. These plans typically include coverage for the artist, the artist’s spouse, and children of the artist. A drawback to these plans is that the artist must have a minimum of a certain amount of “covered” earnings to qualify for the benefits. If the artist is covered and then does not have the minimum amount of earnings required for continued coverage, COBRA provisions may apply. Another drawback of guild coverage is that in most cases there is a lifetime limit of \$1,000,000 of coverage. Therefore, when money is not an issue many CPAs recommend that artists carry an individual health insurance policy for an added level of protection. While this action can ensure that there will be a health insurance policy, it is a costly decision.

Life Insurance

.27 The decision to acquire life insurance is a personal one for all individuals. For a successful artist there are many considerations to evaluate before purchasing life insurance. While the decision-making process is not unique to artists, the amounts considered may be higher than those normally considered by your non-artist clients. Initiate a candid discussion with your artist client concerning his or her needs and desires. It is frequently desirable to buy several policies from a number of insurance companies in order to provide an extra level of comfort, since there could be some difficulty collecting on claims when very large amounts of insurance are involved.

Disability Insurance

.28 Disability insurance in desirable amounts may be difficult to obtain for artists. Artists may claim they are disabled, yet their disabilities in relation to their work may be difficult to measure. For example, how can one tell if a writer cannot write anymore? The most frequent kind of disability

coverage available to and purchased by artists is for a lump sum payment in the event of the disability. As with any client, you should investigate the definition of disability to be certain your client can collect when there is a claim.

Professional Liability

.29 An artist who is a composer, record producer, or music publisher may need to consider errors and omissions coverage. Furthermore, as an officer and director of his or her own loan-out corporation, the artist will have put his or her personal assets at risk for lawsuits from employees, suppliers, competitors, lenders, contractors, and so on. These types of exposures can be covered by employment practices liability or directors and officers liability policies.

9. SPECIAL AREAS AND PROBLEMS

.01 Artists are a unique breed of client. As with any type of business or industry, there are matters unique to performing and creative artists that you are not likely to encounter with your other clients. This section deals with these special areas.

Balancing Artists' Financial Planning Goals With Career Decisions

.02 With your help, your artist client will develop financial planning goals. Artists, however, must make frequent decisions about whether or not to accept certain jobs, engagements, or projects. These decisions relate to whether or not a particular project is good for the artist's career. Frequently, an artist will turn down a project for artistic reasons. You can be helpful by trying to influence the artist in developing a lifestyle that will not be so "high" that he or she is forced to accept certain projects just for the money. While taking such jobs may solve a short-term problem, doing so might actually hurt the artist's long-term ability to enhance earnings. You are not responsible for the artist's lifestyle, but you can have an effect on his or her financial decisions. Developing a relationship wherein you can suggest "no" to an artist's desires to expand a lifestyle can be helpful in the fulfillment of his or her overall financial and career goals.

Working Minors

.03 Special issues are involved with representing artists who have not yet reached majority. Minors who earn significant sums of money may have unique problems and concerns. State laws may govern who has ownership and control of a minor's income and accumulated assets. The field of the arts in which the minor earns money will have significant legal and financial planning consequences.

.04 Radio, Motion Pictures, and Television Earnings. In California, if a minor works in radio, motion pictures, or television there are distinct legal rules that must be followed. These rules are commonly known as the "Coogan Law," after the actor Jackie Coogan. Coogan was a child star who earned significant sums of money more than fifty years ago. His parents "misused" his earnings and assets. As a result of this specific abuse, and many others, the "Coogan Law" was passed in California. This law provides that 25 percent of the gross income earned by a minor in radio, television, and movies must be placed into blocked accounts that can only be used for the benefit of the minor. Furthermore, contracts for engagements in these fields of the arts are subjected to court

approval. Therefore, each time a minor enters into a contract for services in California in these fields, a judge must approve the terms of the engagement and verify that 25 percent of the compensation is being placed into blocked accounts. Other states may have similar laws.

.05 When one considers that artists, even minors, must have a talent agent (10 percent commission), and that they may also have other professionals, such as personal managers, entertainment lawyers, business managers, and publicists, with fees of up to another 25 percent of gross income or more, and the minor must also pay income taxes, there may be very little, if any, additional discretionary funds available for possible misuse by parents.

.06 Other Projects for Minors. While the "Coogan Law" protects the minor in California in the fields of television, radio, and movies, it does not apply to other sources of income. Therefore, such income as endorsements, commercials, personal appearances, and music royalties are not subject to the "Coogan Law." Be aware of the possible need to protect the minor's income and assets in these situations and in locations without similar laws.

.07 Investment Options for Minors. As mentioned above, California requires that 25 percent of a minor's gross earnings from television, radio, and movies must go into the aforementioned blocked accounts. The money in these accounts must be invested "very conservatively." This presents a severe limitation. Since the money in the blocked accounts must be invested in such instruments as certificates of deposit or United States Treasury bills, there is not very much latitude with respect to recommendations for investing these funds.

.08 In fact, the California law that protects the minor from misuse of funds by parents or guardians ends up hurting the minor when it comes to investment growth and yield. While the courts recognize the need for conservatism, they ignore the insidious nature of inflation. Therefore, minors, who can most benefit from a long-term investment horizon, are saddled with investments that are likely to actually decrease in purchasing power over time due to inflation, resulting in a negative "real return." The good news is that since only the income from television, movies, and radio is subject to the "Coogan Law," you will have more latitude in recommending investments for funds not subject to this law.

.09 One Planning Opportunity. The authors have been successful in obtaining approval from California courts for the consideration of qualified retirement plan contributions as a portion of the funds to be considered to be placed into the blocked accounts. This technique can result in more net after-tax income being available to the minor.

.10 State Laws. Check state and local laws with respect to any matters relating to the income and assets of artist minors.

Artists and Divorce

.11 Is there any subject more controversial or more likely to cause a rift between an artist and a CPA than divorce? Statistically, more than 50 percent of marriages in the United States end in divorce. While the authors are not aware of any specific studies on the subject, they recognize that the percentage of failed marriages involving one or more artists is higher than the national average. Certainly, the financial stakes are likely to be higher when an artist is involved in a failed marriage.

.12 The CPA's Role. What is the CPA's role in a divorce when an artist client is involved? This is a difficult question to answer. Consider all of the issues before deciding to give counsel. The *Guide to Planning for Divorce*, which is part of the Personal Financial Planning Library of the AICPA, can be of assistance. However, this area is never easy. Be aware that in most situations both spouses are clients. Therefore, giving counsel to the artist at the expense of the nonpropertied spouse can expose you to professional liability problems.

.13 Artists' Property Rights. While the value of an artist's property in divorce is subject to state law, keep in mind that valuation of intangibles can have a significant impact on a property settlement. Residuals, royalties, profit participations, and so on all can have a significant impact on the total value of a property settlement. There is also a trend to judge "celebrity goodwill" as a marital asset. Keep this issue in mind in any divorce planning situations involving artists.

.14 Prenuptial Agreements. Be aware of the potential value of prenuptial agreements when an artist with significant earnings and assets is considering marriage. The prenuptial agreement can be a useful vehicle to protect the artist in the event a marriage ultimately fails. You may find substantial resistance on the part of legal counsel for the nonpropertied party, generally the person who is not the artist, towards entering into a prenuptial agreement. However, to successfully represent artists in this arena, you must be able to cope with the personal anxiety engendered by the two parties to a prenuptial agreement.

Artists' Tendencies to Be "Soft Touches"

.15 Recognize that artists will be targets for a myriad of individuals and organizations that wish to separate the artist from the assets that were so difficult to accumulate. Call it naiveté, foolishness, guilt, or a desire to give something back for their good fortune. You name it, there will be someone looking to get or borrow money from the artist. It is not uncommon for the business manager or CPA to be placed into the position of being the buffer or "bad guy" to protect the artist from those who want his or her money. Frequently, you may need to volunteer to fill this role in order to protect the artist.

.16 Loans to Family and Friends. The successful artist *will* be approached by family members and friends (some who have been lost for years) for loans. What should you recommend? Of course, the first line of defense is "no." However, frequently the artist will want to help. The authors' experience is that more likely than not the artist wants to give money to family members and friends without any real expectation that the money will be repaid. This may result in an unanticipated gift, with resulting gift tax or loss of a portion of the unified credit. If you intercede, you can frequently fully, or at least partially, protect your client.

.17 Investing in and Lending to Businesses. The artist is often approached to invest in businesses or schemes that others develop. An artist who is naive in business or finance may be taken in by fast-talking promoters. Promises of high returns and rapid repayments of investments or loans may tempt the artist to take a chance on something that on its face appears to you to be imprudent. Encourage your artist client to come to you in such situations for advice about the propriety of investing in or lending to these ventures.

.18 Income and Transfer Tax Traps. Having borrowers sign promissory notes which include appropriate rates of interest can help to deflect an IRS or state taxing authority charge that a loan is a gift. Furthermore, with planning and proper documentation you might be able to help the artist secure a nonbusiness bad debt deduction for income tax purposes if the loan is not repaid. The facts and circumstances of each situation must be examined individually.

.19 Altruistic Motivation. Your artist client might want to offer financial aid to unsuccessful or new artists in return for an “angel” who aided him or her in a time of need. Approach this area of planning with a sympathetic strategy so you can help the artist fulfill his or her altruistic desires without jeopardizing his or her own financial security. Effective communication with the artist can prevent or reduce the likelihood of unexpected loans or gifts.

Charitable Giving

.20 Many artists have philanthropic desires. They can benefit from your guidance and education in this area. We are all inundated with literature from charities and other not-for-profit organizations trying to convince us to give to their organizations. Artists can be particularly vulnerable to these pitches because of their desire to “give back to the community” as a way to say thank you for their financial success.

.21 Educating the Artist. It is important to educate the artist about the tax deductibility, or lack thereof, of donations to different organizations. Artists will frequently donate money or property to political organizations in the mistaken belief that such contributions are tax deductible. They are also asked to, and often do, buy tables at charitable events mistakenly believing that the entire cost is tax deductible. They may also be tempted to make donations to organizations that are not efficient with their use of charitable contributions or to whom no tax deduction is allowed. Educate your client to ask the appropriate questions of the organization or to consult with you before he or she makes charitable contributions.

.22 Charitable Donation Structure. Artists are frequently asked to commit large sums of money to charitable organizations. You can help the artist narrow the choice by considering the overall impact of charitable giving on his or her cash flow and other financial planning goals. This section offers some practical advice you can use when advising artists in the charitable giving area.

.23 *The Artist’s Alma Mater.* The artist’s alma mater, if there is one, will hound the successful artist for large and recurring contributions. If such contributions are being considered and, in fact, decided upon, consider advising the artist to enter into a long-term commitment to make the contributions. This technique will give the artist flexibility as to when to give the contributions and provide some measure of control over cash flow.

.24 *Property Belonging to the Artist.* If the artist’s cash flow cannot accommodate current cash contributions the artist can consider giving property that he or she owns. Property belonging to a well-known artist may have considerable market value because of its celebrity use. While there may be little or no tax basis for some of this property, and therefore little or no tax benefit, the artist can fulfill altruistic intent by providing something of value to the charity, which can generate needed cash for the charity with little or no cost to the artist.

.25 *Appreciated Property.* If an artist wants to give as much as possible with the least out-of-pocket and after-tax cost, consider advising him or her to give appreciated property.

.26 *Private Foundations.* Although the use of private foundations is not unique to artists, it can provide practical solutions to two problems artists have in the charitable giving area: erratic cash flow and celebrity status. First, in the tax planning area, foundations may enable the artist to time charitable deductions to maximize tax benefits. Second, the artist can be “sheltered” from direct solicitations for contributions by indicating that requests for donations must be presented to the foundation’s “board” for consideration. This can insulate the artist from having to respond directly to a solicitation.

.27 *Charitable Trusts.* This is another strategy not unique to artists, that you should suggest if appropriate. As artists’ cash flow tends to be erratic, there will be occasions when the use of charitable trusts will result in significant gift, estate, and income tax benefits to the artist.

28. *Other Ideas.* Artists have successfully used other techniques to raise money for charities. Celebrities have used profits from traditional businesses to go to charity. One of the author’s clients donates one-half of all merchandising royalty revenue received to a particular cause that has attracted him. Telethons for a myriad of causes have been created. As can be seen, cash money is not the only way to provide value to the artist’s charity of choice.

.29 *Nondeductible Contributions.* Artists are frequently solicited to make contributions to organizations for which no charitable deduction can be obtained for tax purposes. Educate the artist about the differences between deductible, nondeductible, and political contributions. Additionally, advise the artist to explore the possibility of making a donation to an educational subdivision of the organization which could result in a tax deduction.

.30 *Charitable Intent.* You can offer valuable guidance by having a discussion with the artist about charitable giving. Suggest that, rather than giving vast numbers of contributions in small or modest amounts to a great number of organizations, the artist could select one or a small number of organizations to support. Although this involves extremely personal decisions by the artist, you will usually find that the artist appreciates your input. Sensitivity in such communications with the artist shows that you understand the need or desire to give.

Artists’ Outside Business Interests

.31 As artists accumulate wealth they may occasionally desire to go into other businesses. Restaurants, bars, and other high-risk ventures are the most frequent choices. There was a time when you could rationally advise against these types of ventures because the vast majority of them failed — quickly. However, in recent years, artists and other celebrities have been able to achieve major financial success in concept-type ventures. The Hard Rock Cafe, Planet Hollywood, Dive, and other similar ventures have proven to be highly successful business ventures. However, these are still the exceptions rather than the rule. Many more artists have invested in everything from hotels and casinos all the way to entire towns, failed in these ventures, and ended up losing their entire investments. Help your client consider the effect adverse publicity concerning a business failure or bankruptcy will have on his or her artistic career. Some artists are able to operate their artistic careers as well as participate in the management of an outside business interest. This is an extremely difficult feat to achieve and you would be wise to caution artists to move deliberately in the area of outside investments.

10. CONCLUSION

.01 So there you have it! The combined experience of two practicing CPAs who are also business managers. This work could not possibly relate all that the CPA needs to know about the financial representation of artists. Yet it should provide a good starting point. As you gain experience, competency, and confidence, the mystery of this field will likely diminish. Participating in networking and educational sessions at the state CPA society level will help you to stay abreast of current developments in the performing and creative arts and for artists. Additionally, the American Institute of Certified Public Accountants, some state CPA societies, and some major universities have seminars, conferences, and institutes dealing with the financial and tax issues related to the performing and creative arts. Remember, the entertainment field is not glamorous from the CPA's point of view. The work can be exceedingly tedious. But the professional rewards can be considerable. You will also have the satisfaction of knowing that you have aided clients who have a profound need for your services and skills.

The practice aids shown in the exhibits to this *Guide* were developed by Mitchell Freedman, CPA/PFS, with the assistance of Andrew B. Blackman, CPA/PFS, CFP.

Exhibit A
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SAMPLE LETTER AGREEMENT

Date

Client Name
Client Address

Dear Client:

I am sending this letter agreement to you to outline and confirm the services that we will perform and our charges for such services. [Optional sentence: This letter is required by our professional liability insurance company.] It will also delineate the responsibilities that we will undertake with respect to the services that we will render. We are excited to represent you with respect to the services requested.

The services we will provide include the depositing of funds due to you and your controlled entities that are received by us and the payment of expenditures out of your and your controlled entities' funds under the control of our office. We will maintain books and records for you and your controlled entities and provide you and those controlled entities with periodic financial statements consisting of statements of assets and liabilities resulting from cash transactions and statements of revenues received and expenses disbursed. We shall also send schedules of cash receipts and disbursements to you. We shall mutually agree on the frequency of the financial statements and schedules.

Our services will also include the preparation of income tax projections, as we deem appropriate, which we will periodically discuss with you. We will also prepare income and other tax returns for you and your controlled entities.

We will prepare the aforementioned tax returns from information that you furnished to us and information generated by our office on your behalf. We will not audit or otherwise verify the data that you submit, although we may ask you to clarify some of it. All of the information you submit to us will, to the best of your knowledge, be correct and complete and will include all income, deductions and other data necessary for the preparation of the tax returns. You are responsible for keeping the necessary records to substantiate your deductions and business expenses and of business and personal use of certain property.

We plan to perform reasonable research to support the positions taken in your income tax planning and in preparation of your income tax returns. We will attempt to have you pay the least possible tax while complying with the tax laws. We do not, however, want to be responsible for penalties in our attempt to help you minimize your taxes. Accordingly, should a penalty for substantial underpayment of tax or aiding and abetting an understatement of tax liability or other preparer penalty be assessed, you will pay it and you will not look to us for reimbursement.

Exhibit A
(Page 2 of 3)

Your tax returns may be subject to review by the taxing authorities. Any items which may be resolved against you by the examining agent are subject to certain rights of appeal.

We are available to advise you of the tax and other financial implications of major transactions which you may contemplate undertaking.

We are not registered investment advisers. At your request, we will review investment opportunities in order to advise you of the economic and tax aspects of such investments as they relate to you. We will also attempt to maximize your return on excess cash through the use of conservative securities such as, but not limited to, money market funds, U.S. Treasury bills, saving accounts, and certificates of deposit.

We also will consult with your insurance broker(s), as we deem necessary, regarding your insurance coverages and advise you as to any recommendations they or we may have regarding your coverages.

Our fee for these services is five percent (5%) of your professional income inclusive of five percent (5%) of your share of the professional income received by business entities, in the performing and creative arts, in which you participate. These fees shall be based on your earnings during the term of this agreement (including the notice period), whether or not received during the term of this agreement (including the notice period). We will render a check payable to (name of firm) on the 25th of each month for such fees. We will also bill for out-of-pocket costs which include telephone, copying, postage, messenger service, telecopier, computer usage charges, etc. Our percentage fees will not include services for assistance in litigation matters such as, but not limited to, tax court, marital, co-habitation or contract disputes. They will also not include services for royalty or profit participation audits. Furthermore, they will not include services for major non-entertainment business transactions. Should you require such services in the future, we shall bill you monthly at our standard hourly rates then in effect. If any percentage and/or hourly invoices shall remain unpaid for thirty days, a 1½% per month service charge shall be added to the next month's statement. If invoices remain unpaid for ninety days, services will cease.

You and we specifically agree to resolve any and all differences and disputes arising from services and charges pursuant to this letter agreement by binding arbitration in accordance with the rules of the American Arbitration Association. The prevailing party shall be entitled to reasonable arbitration fees and costs and other expenses incurred in pursuing the matter.

This agreement can be terminated by either party upon thirty days written or oral notice. Upon termination, any and all fees and costs due to us shall be promptly paid concurrent with such notification. Any fees and costs that shall become due during the notice period shall be paid promptly at the end of the notice period.

Exhibit A
(Page 3 of 3)

If this letter is in accordance with your understanding, please sign the enclosed copy in the space provided and return it to us. I appreciate your confidence in us and I look forward to a long and mutually rewarding relationship.

Best wishes.

Cordially yours,

CPA Name

AGREED: DATE _____

SIGNATURE _____

Enclosures

Exhibit B
(Page 1 of 6)

SAMPLE BUSINESS MANAGEMENT CLIENT WORK PROGRAM

CLIENT: _____

YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
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1. JOURNALS

A. Verify that quarterly cash receipts, cash disbursements, general and payroll journals, statements of assets and liabilities resulting from cash transactions, and statements of revenues received and expenses disbursed have been printed and inserted into the current year's binder

B. Scan cash receipts, cash disbursements, general and payroll journals for the following:

- i) Coding errors
- ii) Anticipated receipts not recorded
- iii) Recurring or other anticipated payments not recorded
- iv) Unusual or unexpected expenditures

C. If corrections are required, make sure that revised journals have been printed and filed into the current year's binder

2. CASH AND EQUIVALENTS

A. Scan bank reconciliations for reasonableness and old reconciling items requiring attention

B. Verify that the personal checking account activity for the prior quarter has been recorded in the general ledger

C. Agree general ledger balances to cash controls, bank statements, bank reconciliations or other documentation

D. Scan dividends and interest for reasonableness of amount and classification

3. EXCHANGE¹ AND PETTY CASH

A. Verify that exchange and petty cash items are being handled in a timely manner

B. Investigate any outstanding balance

¹ "Exchange" refers to the general ledger account "Loans and Exchanges," used to post items that will clear in a short period of time that do not have a material effect on the results of operations or financial position.

Exhibit B
(Page 2 of 6)

CLIENT: _____

YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
_____	_____	_____	_____

4. SECURITIES

A. Verify that any purchases and/or sales of securities occurring during the quarter have been properly recorded

5. RECEIVABLES

A. Verify that signed documentation has been prepared and filed in support of loans evidenced by notes made during the quarter and that they have been properly recorded in the general ledger

B. Verify that payments have been received in accordance with the repayment terms of the note(s)

C. Where applicable, verify that payors have been invoiced

D. Scan distribution of principal and interest for reasonableness

6. PARTNERSHIPS AND S CORPORATIONS

A. Verify that signed documentation is filed to support any investments or dispositions made during the quarter and that they are properly recorded

B. Verify that any distribution checks have been properly recorded

C. Agree general ledger to Forms K-1 at year end

7. REAL PROPERTY, IMPROVEMENTS AND FURNISHINGS (PERSONAL ONLY)

A. Verify that any acquisitions or dispositions of real estate during the quarter have been properly recorded

B. Scan improvements and furnishings accounts to determine if items have been properly recorded

8. RETIREMENT PLANS (PERSONAL ONLY)

A. Verify that the general ledger balance has been adjusted for any contribution(s) made

B. Review asset report for reasonableness

Exhibit B
(Page 3 of 6)

CLIENT: _____
YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
----------------	----------------	----------------	----------------

C. At plan year end, adjust fair market value of corporate plans in the general ledger

D. At calendar year end, adjust fair market value of IRA and Keogh plans in the general ledger

9. OTHER ASSETS

A. Scan asset accounts for the following:

- i) Capital items have been recorded as such
- ii) Items are on the books of the proper entity

B. Where applicable, verify that appropriate documentation has been filed (e.g., invoices)

C. Where appropriate, verify that insurance concerns have been addressed

10. INTER-COMPANY ACCOUNTS

A. Agree inter-company accounts, investigating and correcting any discrepancies

B. Verify that exchange items and outstanding loans from officer are being paid before any salary is declared

11. PAYABLES

A. Verify that signed documentation has been prepared and filed in support of any liabilities incurred or liquidated during the quarter and that they are recorded properly in the general ledger

B. Be alert for any items that should be capitalized (closing costs, points, etc.)

C. Verify that payments are being made in accordance with the repayment terms

D. Scan distribution of principal and interest for reasonableness

E. Verify allocation between short-term and long-term **(BUSINESS ONLY)**

Exhibit B
(Page 4 of 6)

CLIENT: _____
YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
----------------	----------------	----------------	----------------

12. EQUITY

- A. Scan for reasonableness any transactions posted to equity accounts and investigate any unanticipated entries
- B. Update working paper(s) in permanent file

_____	_____	_____	_____
_____	_____	_____	_____

13. PROFESSIONAL INCOME

- A. Where appropriate, agree to continuous income schedule, contract, deal memo, or other documentation
- B. Verify that withholdings, etc., have been properly booked
- C. Be alert to any upcoming dramatic change in income stream and discuss ramifications with in-charge partner

_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

14. REIMBURSED EXPENSES

- A. Scan coding of reimbursed expenses to verify that they have been properly recorded (e.g., meal penalties² coded in error to reimbursed expenses rather than income)
- B. Where appropriate, agree to continuous income schedule, contract, deal memo, or other documentation
- C. If reimbursement (i.e., per-diems) are to be received on location, verify that the client has received them and that they have been properly recorded

_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

**15. RENTAL INCOME AND EXPENSES
(PERSONAL ONLY)**

- A. Verify that lease/rental payments have been received in accordance with the lease or rental agreement
- B. Verify that cash disbursements relating to the rental property have been properly recorded

_____	_____	_____	_____
_____	_____	_____	_____

16. FEES BASED ON PERCENTAGE OF INCOME

- A. Reconcile percentage fees and commissions and follow up on any discrepancies

_____	_____	_____	_____
-------	-------	-------	-------

²A meal penalty is an additional compensation to an actor if his or her work requires that a meal be missed.

Exhibit B
(Page 5 of 6)

CLIENT: _____
YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
----------------	----------------	----------------	----------------

17. GUILD REPORTS

- A. Verify that guild dues are up-to-date and that, where applicable, earnings reports have been prepared and submitted to the guild
- B. Determine who is responsible for the preparation of guild pension, health and welfare reports and verify that reports have been filed
- C. Where applicable, verify that reimbursements have been received and payments by studios have been made directly

_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

18. MEDICAL

- A. Where relevant, verify that all claims for medical reimbursement have been submitted to the client's insurer(s)
- B. When applicable, verify that reimbursements under the client's medical reimbursement plan are current, and investigate any outstanding balance (**BUSINESS ONLY**)

_____	_____	_____	_____
_____	_____	_____	_____

**19. RETIREMENT PLAN CONTRIBUTION
(BUSINESS ONLY)**

- A. Communicate with pension administrators and/or actuaries to determine the amount of allowable plan contribution(s) that can be made in light of the IRC §415 aggregation rules and all other pertinent facts

_____	_____	_____	_____
-------	-------	-------	-------

20. PAYROLL TAXES

- A. Verify that any required tax deposits have been made
- B. Verify that depository receipts have been filed in the payroll tax file
- C. Verify that quarterly payroll tax returns have been prepared and submitted to the proper authorities

_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

21. INCOME TAXES

- A. Where applicable, verify that quarterly estimates have been made
- B. Evaluate the need for an updated tax projection

_____	_____	_____	_____
_____	_____	_____	_____

Exhibit B
(Page 6 of 6)

CLIENT: _____
YEAR ENDING: _____

<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
----------------	----------------	----------------	----------------

22. CORRECTING ITEMS

- A. Prepare any needed corrections based upon work program and submit to the bookkeeper
- B. Verify that corrections from prior quarter's work program have been made and that hard copy items have been filed
- C. Verify that hard copy general ledger has been printed and inserted in the current year binder

_____	_____	_____	_____
_____	_____	_____	_____
_____	_____	_____	_____

23. PRECLOSE (BUSINESS ONLY)

- A. Prior to the 15th of the month, notify bookkeeper of the upcoming fiscal year end and request necessary materials
- B. Initial all checks dated after the 15th of the month
- C. Initial all cash receipts dated after the 15th of the month
- D. Complete preclose work program

24. POST YEAR END

- A. Request working trial balance, final general ledger and annual journal entries from bookkeeper
- B. Extend trial balance and prepare relevant working papers
- C. Prepare tax return(s) and any necessary estimates
- D. Prepare closing and opening journal entry and submit to bookkeeper

NOTES:

Exhibit C
SAMPLE BUSINESS MANAGEMENT CLIENT BOOKKEEPER SIGN-OFFS

CLIENT NAME: _____ **FYE:** _____

Monthly

1. Record dividends and interest
2. Record personal checking account activity
3. Reconcile bank and investment accounts
4. Reimburse exchange account(s)
5. Complete retirement plans asset report

	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th	11th	12th
1. Record dividends and interest												
2. Record personal checking account activity												
3. Reconcile bank and investment accounts												
4. Reimburse exchange account(s)												
5. Complete retirement plans asset report												

Quarterly

1. Record dividends and interest (other than those recorded monthly)
2. Complete quarterly payroll, sales and other tax returns
3. Complete quarterly guild reports
4. Print interim general ledger, cash receipts, cash disbursements, payroll, and general journals
5. Print preliminary financial statements
6. Print final financial statements

	1st	2nd	3rd	4th
1. Record dividends and interest (other than those recorded monthly)				
2. Complete quarterly payroll, sales and other tax returns				
3. Complete quarterly guild reports				
4. Print interim general ledger, cash receipts, cash disbursements, payroll, and general journals				
5. Print preliminary financial statements				
6. Print final financial statements				

Annual

1. Record prior year's closing and opening journal entry
2. Print final general ledger, cash receipts, cash disbursements, payroll, and general journals and working trial balance
3. Purge paid bills file and transfer all relevant files to file box
4. Prepare next year's files
5. Complete W-2s and 1099s for recipients
6. Complete annual guild reports
7. Transmit W-2s and 1099s to taxing authorities
Personal Only
8. Prepare journal entry to update cash value of life insurance
9. Prepare journal entry to update cash value of IRA
10. Prepare journal entry to update cash value of corporate retirement plan (to be done at corporate fiscal year end)

	1st	2nd	3rd	4th
1. Record prior year's closing and opening journal entry				
2. Print final general ledger, cash receipts, cash disbursements, payroll, and general journals and working trial balance				
3. Purge paid bills file and transfer all relevant files to file box				
4. Prepare next year's files				
5. Complete W-2s and 1099s for recipients				
6. Complete annual guild reports				
7. Transmit W-2s and 1099s to taxing authorities <i>Personal Only</i>				
8. Prepare journal entry to update cash value of life insurance				
9. Prepare journal entry to update cash value of IRA				
10. Prepare journal entry to update cash value of corporate retirement plan (to be done at corporate fiscal year end)				

Comments

Exhibit D
(Page 1 of 2)

SAMPLE BUSINESS MANAGEMENT PRECLOSE WORK PROGRAM

CLIENT: _____
FYE: _____

<i>Preparer</i>	<i>Reviewer</i>
-----------------	-----------------

- | | | |
|--|-------|-------|
| 1. Pay all outstanding corporate bills as of cutoff date. | _____ | _____ |
| 2. Run general ledger and working trial balance at cutoff date. | _____ | _____ |
| 3. Scan general ledger for appropriateness of amount and classification for cash receipts, disbursements and journal entries. | _____ | _____ |
| 4. Contact relevant persons (agent, manager, etc.) to determine any additional income anticipated to be received prior to fiscal year end. | _____ | _____ |
| 5. Trace and agree balances, interest and dividends per general ledger to bank statements and/or reconciliations. | _____ | _____ |
| 6. Compute estimated dividends and interest for preclose month. | _____ | _____ |
| 7. Scan bank reconciliation(s) for outstanding items that should have cleared ("stale" checks). Investigate where appropriate. | _____ | _____ |
| 8. Compute depreciation for prior years' assets and prepare journal entry. | _____ | _____ |
| 9. Compute depreciation of assets acquired in the current year and prepare journal entry. | _____ | _____ |
| 10. Reconcile fees and commissions based upon percentage of income (business manager, agent, etc.). | _____ | _____ |
| 11. Analyze officer loan activity and, if appropriate, calculate any interest due to or from the officer. | _____ | _____ |
| 12. Analyze exchange accounts on both personal and corporate books and resolve any outstanding balances. | _____ | _____ |
| 13. If applicable, contact the pension administrator to determine what information will be required in order to properly calculate the amount of the retirement plan contribution to be made for the current year. | _____ | _____ |
| 14. Discuss with the in-charge partner the required and available retirement contributions for the current year, so that the options can be discussed with the client. | _____ | _____ |

Exhibit D
(Page 2 of 2)

CLIENT: _____
FYE: _____

Preparer **Reviewer**

- 15. Determine amount of dividend to be paid to shareholder based upon corporation history and current year performance. _____
- 16. Analyze payroll tax account. _____
- 17. Prepare preclose worksheet and compute salary due shareholder/employee. _____
- 18. Stop and think, "What have I missed?" Revise working papers, if necessary. _____
- 19. Give preclose package to accountant for review. _____
- 20. If necessary, revise preclose working papers based on accountant's review. _____
- 21. Prepare list of checks to be written prior to fiscal year end (including check to the accounting firm). _____
- 22. Prepare personal tax projection based upon suggested preclose salary and dividend. _____
- 23. Repeat step 18. _____
- 24. Discuss preclose with in-charge partner. _____
- 25. If necessary, revise preclose working papers and personal projection based upon in-charge partner's review. _____
- 26. Prepare final journal entries and cut payroll and other checks. _____
- 27. Post, close and print out financial statements. _____
- 28. Examine financial statements to determine correctness of "bottom line." _____
- 29. Repeat step 18. _____

Exhibit E
(Page 1 of 7)

SAMPLE BOOKKEEPER ROUTINES

DAILY

1. **Deposits**
 - a. Monday, Wednesday, and Friday
 - b. Verify that payees are correct
 - c. Prepare deposit tickets in duplicate
 - d. Endorse checks for deposit
 - e. Photocopy checks with deposit tickets
 - f. Place deposits in envelope and give to receptionist for bank's courier
 - g. Code cash receipts using clients' charts of accounts
 - h. Enter into computer
 - i. Enter into manual cash file
 - j. File cash receipts into current cash file
 - k. File confirmation of deposits, attach to copy of deposit

2. **Mail**
 - a. Read all mail
 - b. Handle all urgent items immediately
 - c. File clients' bills in bills-to-be paid files
 - d. All tax notices should be given to in-charge accountant

3. **Personal Checking Accounts**
 - a. Verify checking balances on Tuesdays, Thursdays, and Fridays
 - b. Make necessary transfers and enter into computer
 - c. Enter transfers into manual cash control file

4. **Handle and prioritize client matters as they come up**

Exhibit E
(Page 2 of 7)

WEEKLY

1. **Cash Reports**
 - a. On Mondays compare cash balances in computer to manual cash controls and correct as necessary
 - b. Print three copies of cash reports (one copy to partner, one to accountants, one to clients who requested copies)

2. **Payables**
 - a. Bills are to be paid every week
 - b. Match all receipts sent by clients to credit card statements
 - c. Determine if charges are business or personal expenses. You may have to consult client and/or accountant and determine payor
 - d. Code bills using clients' charts of accounts (if unable to code bill put in exchange and clear within 2 weeks)
 - e. Review all tickler cards for payment
 - f. If clients have cash flow problems, verify cash available for paying bills and prepare payable list
 - g. Make necessary transfers of funds to cover bills paid
 - h. Enter bills into computer and prepare checks
 - i. Separate checks and attach bill to yellow copy
 - j. Enter check totals into manual cash files
 - k. Give checks to partner for signature

3. **Signed Checks**
 - a. Respond to any partner notes attached to checks immediately
 - b. Mail all signed checks (mark envelope with clients' initials so that postage can be rebilled)
 - c. File yellow copies in paid bill file in alphabetical order and place current bills in front

4. **Medical Claims**
 - a. Prepare and send medical claims for new medical bills received
 - b. Update status of claims from new Explanations of Benefits received
 - c. All checks for medical expenses written out of a personal checking account must be reimbursed by the corporation (if applicable) and claims must be prepared and sent. If you have requested information from the client (in writing) in order to process the claim and they do not respond within 60 days, the medical expense will be treated as a personal expense and journalized accordingly

Exhibit E
(Page 3 of 7)

MONTHLY

THE FOLLOWING ITEMS ARE TO BE COMPLETED BY THE 20TH OF THE MONTH

1. Money Market Statements
 - a. Review statement
 - b. Enter cash receipt journal entry for interest or dividends earned
 - c. Update manual cash control in money market file
 - d. Verify that computer balances match manual control balances
 - e. File statement in money market file

2. Bank Reconciliation—Master Checking Accounts
 - a. Clear all checks and transfers
 - b. Post through last day of month
 - c. Print bank reconciliation report
 - d. Verify that the ending bank reconciliation balance matches manual cash balances
 - e. Enter preparer's initials and date on bank reconciliation report
 - f. Investigate any stale items (special attention to tax checks)

3. Bank Reconciliation—Personal Checking Accounts
 - a. Code all checks to clients' charts of accounts
 - b. Enter all checks as cash disbursements
 - c. Follow instructions on above bank reconciliation section above (a, b, c, e)
 - d. Make copies of all checks coded to exchange so that they may be attached to reimbursement check from corporations, if applicable

4. Securities Brokerage and Mutual Fund Accounts
 - a. Review statements
 - b. Make necessary journal entries to record transactions
 - c. File statements in appropriate files
 - d. For clients who have personal portfolios of stocks or mutual funds, enter the number of shares, cost, and value at month end on the cash report that includes the first Monday of each month

Exhibit E
(Page 4 of 7)

5. Retirement Plan Accounts
 - a. Review statements
 - b. Enter activity on manual cash controls
 - c. Prepare asset reports and give copies to accountants and partner
 - d. Mail copy to clients that have requested them
 - e. File statements

6. Filing
 - a. File month's cash receipts and transfers into annual files

7. Percentage Billings—Due on 25th of Every Month
 - a. Print cash receipts report from last day of previous report through the 25th of current month
 - b. Calculate 5 percent of income received or minimum payments due, plus out-of-pocket expenses from prior month
 - c. Print checks and attach to the front of files
 - d. Give files to partner

8. Preclosings
 - a. By the 15th of the closing month do the following:
 - 1) Pay all bills
 - 2) Post all interest and dividends
 - 3) Prepare bank reconciliations
 - 4) Pay 5 percent due to accounting firm
 - 5) Prepare bank reconciliation for personal checking account
 - b. Post and close through that day
 - c. Run the following reports:
 - 1) General ledger
 - 2) Working trial balance
 - 3) Cash receipts journal
 - 4) Cash disbursements journal
 - d. Give reports to accountant
 - e. **DO NOT DO ANYTHING ELSE FOR THIS CLIENT WITHOUT DISCUSSING IT WITH THE ACCOUNTANT FIRST. ALL CHECKS AND CASH RECEIPTS MUST BE INITIALED BY ACCOUNTANT AFTER THE 15TH OF THE PRECLOSE MONTH**

Exhibit E
(Page 5 of 7)

9. After Preclose
 - a. Prepare files for new fiscal year end
 - b. Place into storage boxes paid bills, cash receipts, cash disbursements, payroll register, journal entries, and bank statements
 - c. Enter interest and dividends for the month of preclose
 - d. Post, close, and print the following reports:
 - 1) General ledger
 - 2) Working trial balance
 - 3) Cash receipts (year)
 - 4) Cash disbursements (year)
 - 5) Journal entries (year)
 - 6) File documents

10. Prepare Computer Transaction Reports By the 20th of Each Month
 - a. Print the following reports:
 - 1) Cash receipts
 - 2) Cash disbursements
 - 3) Journal entries
 - 4) Payroll register

11. **VERY IMPORTANT: NO CHECKS SHOULD BE DRAWN THAT WILL REFLECT THE CASH ACCOUNTS ARE OVERDRAWN AT ANY TIME, ESPECIALLY AT THE END OF A MONTH. THE BOOKKEEPER MUST BE ALERT TO THIS!**

Exhibit E
(Page 6 of 7)

QUARTERLY

1. Quarterly Payroll Tax Returns
 - a. Close payroll quarter and print reports
 - b. Prepare quarterly returns
 - c. Give to accountant for review
 - d. Mail by the end of the month following the quarter that closed

2. Guild Earnings Statements
 - a. Print cash receipts reports for the quarter
 - b. Complete form, give to accountant to review
 - c. Mail by the end of the month following the quarter that closed

3. Print General Ledger Reports Through Quarter Closed

4. Prepare Quarterly Financial Statements and Give to Partner

Exhibit E
(Page 7 of 7)

ANNUALLY

1. Closing Books and Records for the Year
 - a. Post all interest and dividends
 - b. Enter all journal entries
 - c. Post and close general ledger
 - d. Print the following reports:
 - 1) General ledger
 - 2) Working trial balance
 - 3) Cash receipts (whole year)
 - 4) Cash disbursements (whole year)
 - 5) Journal entries (whole year)
 - 6) Payroll journal
 - 7) File documents in proper binder
 - e. Place into storage boxes all paid bills and files
 - f. Prepare an inventory of box and issue box number

2. Set Up Files for New Year

3. Payroll and Tax Information Reporting
 - a. Prepare annual payroll returns
 - b. Prepare W-2s, W-3s, and state reports
 - c. Prepare 1099s, and transmittal forms
 - d. Initialize payroll for new year
 - e. Update payroll withholding tables

4. Closing and Opening Journal Entry
 - a. Enter into computer the journal entry for updating of new fiscal year

Exhibit F
(Page 1 of 3)

SAMPLE PRECLOSE WORKSHEET

PREPARED BY: _____
REVIEWED BY: _____ DATE _____

CLIENT: _____
FYE: _____

	FEDERAL	STATE
NET INCOME PER TRIAL BALANCE DATED _____ →	_____	_____
ADDITIONAL INCOME		
ADDITIONAL INCOME ANTICIPATED—SEE SEPARATE SCHEDULE →		
ADDITIONAL DIVIDENDS & INTEREST TO YEAR END →	_____	_____
TOTAL ADDITIONAL INCOME: →	_____	_____
ADDITIONAL EXPENSES		
ADDITIONAL EXPENSES—SEE SEPARATE SCHEDULE →		
ADDITIONAL MEALS & ENTERTAINMENT →		
RETIREMENT PLAN CONTRIBUTION(S) →		
STATE DEPRECIATION ADJUSTMENT →	N/A	_____
TOTAL ADDITIONAL EXPENSES: →	_____	_____
NET INCOME BEFORE PRECLOSE SALARY: →	_____	_____
BOOK/TAX ADJUSTMENTS:		
ADD: 50% MEALS & ENTERTAINMENT (TOTAL =) →		
FEDERAL & STATE TAXES & PENALTIES →		
OTHER ADJUSTMENTS (NOL, ETC.) _____ →	_____	_____
TAXABLE INCOME BEFORE PRECLOSE SALARY & PAYROLL TAXES: →	_____	_____
PRECLOSE SALARY →	_____	_____
PAYROLL TAXES →	_____	_____
TOTAL SALARY AND PAYROLL TAXES: →	_____	_____
TAXABLE INCOME →	_____	_____
TAX:	_____	_____
LESS PAYMENTS		
PRIOR YEAR OVERPAYMENT APPLIED →	_____	_____
ESTIMATED TAXES PAID →	_____	_____
TOTAL PAYMENTS →	_____	_____
NET TAX DUE WITH THE RETURN (REFUND): →	_____	_____
RECONCILIATION OF RETAINED EARNINGS		
RETAINED EARNINGS, BEGINNING		
NET INCOME, PER BOOKS (AS ADJUSTED)		
PRECLOSE SALARY AND PAYROLL TAXES		
DIVIDEND (ENTER AS A NEGATIVE) _____	_____	_____
RETAINED EARNINGS, END OF YEAR	_____	_____

Exhibit F
(Page 2 of 3)

CLIENT: _____

FYE: _____

ADDITIONAL INCOME:

1.	_____	_____
2.	_____	_____
3.	_____	_____
4.	_____	_____
5.	_____	_____
6.	_____	_____
7.	_____	_____
8.	_____	_____
9.	_____	_____
10.	_____	_____
11.	_____	_____
12.	_____	_____
13.	_____	_____
14.	_____	_____
15.	_____	_____
16.	_____	_____
17.	_____	_____
18.	_____	_____
19.	_____	_____
20.	_____	_____
21.	_____	_____
22.	_____	_____
23.	_____	_____
24.	_____	_____
25.	_____	_____
26.	_____	_____
27.	_____	_____
28.	_____	_____
29.	_____	_____
30.	_____	_____
31.	_____	_____
32.	_____	_____
33.	_____	_____
34.	_____	_____
35.	_____	_____
36.	_____	_____
37.	_____	_____
38.	_____	_____
39.	_____	_____
40.	_____	_____
41.	_____	_____
42.	_____	_____
43.	_____	_____
44.	_____	_____
45.	_____	_____

TOTAL

=====

Exhibit F
(Page 3 of 3)

CLIENT: _____

FYE: _____

ADDITIONAL EXPENSES (EXCEPT MEALS AND ENTERTAINMENT)

1.	_____	_____
2.	_____	_____
3.	_____	_____
4.	_____	_____
5.	_____	_____
6.	_____	_____
7.	_____	_____
8.	_____	_____
9.	_____	_____
10.	_____	_____
11.	_____	_____
12.	_____	_____
13.	_____	_____
14.	_____	_____
15.	_____	_____
16.	_____	_____
17.	_____	_____
18.	_____	_____
19.	_____	_____
20.	_____	_____
21.	_____	_____
22.	_____	_____
23.	_____	_____
24.	_____	_____
25.	_____	_____
26.	_____	_____
27.	_____	_____
28.	_____	_____
29.	_____	_____
30.	_____	_____
31.	_____	_____
32.	_____	_____
33.	_____	_____
34.	_____	_____
35.	_____	_____

TOTAL ADDITIONAL EXPENSES

ADDITIONAL MEALS AND ENTERTAINMENT

36.	_____	_____
37.	_____	_____
38.	_____	_____
39.	_____	_____
40.	_____	_____

TOTAL ADDITIONAL MEALS AND ENTERTAINMENT

Exhibit H
(Page 1 of 2)

**SAMPLE WORKSHEET FOR CALCULATING THE
MINIMUM DISTRIBUTION AMOUNT**

WORKSHEET FOR CALCULATION OF MINIMUM DISTRIBUTION AMOUNT

CLIENT'S NAME: ABC PRODUCTIONS, INC. PREPARED BY: XX
 ELECTION PERIOD: 1/1/X6-3/31/X6
 DEFERRAL PERIOD: 4/1/X6-12/31/X6 MONTHS: 9

<u>APPLICABLE AMOUNT PAID</u>	<u>PER WORKING TRIAL BALANCE 12/17/X6</u>	<u>1ST PRECEDING YEAR 3/31/X6</u>
OFFICER'S SALARY	40,000	438,500
EXPENSE ALLOWANCE	0	0
INTEREST-OFFICER LOAN	0	1,166
OTHER	0	0
TOTAL APPLICABLE AMOUNT	40,000	439,666

MINIMUM DISTRIBUTION UNDER PREVIOUS YEAR METHOD

APPLICABLE AMOUNT PAID IN 1ST PRECEDING YR	x	<u>MONTHS IN DEFERRAL PERIOD</u> 12
(A)→		<u>329,750</u>

IF THE APPLICABLE AMOUNT PAID IN THE DEFERRAL PERIOD IS EQUAL TO OR GREATER THAN (A) ABOVE, THE PERSONAL SERVICE CORPORATION HAS MET THE MINIMUM DISTRIBUTION REQUIREMENT. IF NOT, GO TO CALCULATION OF MINIMUM DISTRIBUTION UNDER THE THREE YEAR AVERAGE METHOD.

Exhibit H
(Page 2 of 2)

CLIENT'S NAME: ABC PRODUCTIONS, INC.

WORKSHEET FOR CALCULATION OF MINIMUM DISTRIBUTION AMOUNT UNDER THREE YEAR AVERAGE METHOD

	PER WORKING TRIAL BALANCE 12/17/X6	1st PRECEDING YEAR 3/31/X6	2nd PRECEDING YEAR 3/31/X5	3rd PRECEDING YEAR 3/31/X4	TOTAL-THREE PRIOR YEARS
INCOME BEFORE NOL C/O	844,611	27,849	(23,563)	3,372	7,658
ADDITIONS:					
FEDERAL INC TAX	1,800	0	0	0	0
20% MEALS & ENT	299	0	0	0	0
PENALTIES	0	0	0	0	0
ADD'L INCOME	4,150	0	0	0	0
TOTAL ADDITIONS	6,249	0	0	0	0
DEDUCTIONS:					
ADD'L EXPENSES	1,210	0	0	0	0
NOL DEDUCTION	0	23,563	0	0	23,563
TOTAL DEDUCTIONS	1,210	23,563	0	0	23,563
TAXABLE INCOME	849,650	4,286	(23,563)	3,372	(15,905)
ADD APPLICABLE AMOUNTS:					
OFFICER'S SALARY	40,000	438,500	164,500	1,283,500	1,886,500
EXPENSE ALLOWANCE	0	0	0	0	0
INTEREST-OFFICER LOAN	0	1,166	24	2,606	3,796
OTHER	0	0	0	0	0
TOTAL APPLICABLE AMOUNT	40,000	439,666	164,524	1,286,106	1,890,296
ADJUSTED TAXABLE INCOME	889,650	443,952	140,961	1,289,478	1,874,391

$$\text{TENTATIVE APPLICABLE PERCENTAGE} = \frac{\text{TOTAL APPLICABLE AMOUNT PAID IN 3 PRECEDING YEARS}}{\text{TOTAL ADJUSTED TAXABLE INC FOR 3 PRECEDING YEARS}}$$

$$= (B) \rightarrow 100.85\%$$

$$\text{APPLICABLE PERCENTAGE} = \text{LESSER OF 95\% OR (B) ABOVE}$$

$$= (C) \rightarrow 95.00\%$$

$$\text{MINIMUM DISTRIBUTION UNDER THREE YEAR AVERAGE METHOD} = \text{ADJUSTED TAXABLE INCOME FOR DEFERRAL PERIOD} \times (C) \text{ ABOVE}$$

$$= (D) \rightarrow 845,168$$

(i) MINIMUM DISTRIBUTION = LESSER OF (A) OR (D) = 329,750

(ii) APPLICABLE AMOUNT PAID IN DEFERRAL PERIOD = 40,000

IF (ii) IS GREATER THAN (i), MINIMUM DISTRIBUTION TEST IS MET. SECTION 280H LIMITATION DOES NOT APPLY.

IF (ii) IS LESS THAN (i), MINIMUM DISTRIBUTION TEST IS NOT MET. WE NEED TO CALCULATE MAXIMUM DEDUCTIBLE AMOUNT FOR THE CURRENT YEAR.

