

## DEATH AND TAXES – HOW TO FILE RETURNS AND SURVIVE AN AUDIT

By Diane O'Brien Kelly, Attorney at Law/CPA and Becke Turner, R.N.

### Part One – How To File Returns

#### A. The Million-Dollar Question – Is your writing a hobby or a business?

1. Differences in tax reporting for hobby writers versus business writers
  - a. Hobby writers:
    1. Report their gross earnings on the “Other income” line of return (Line 21)
    2. Can deduct expenses only up to the amount of the income
    3. Must deduct expenses as a miscellaneous itemized deduction on Schedule A, which makes the deductions subject to a 2% adjusted gross income floor
  - b. Business writers:
    1. Report their earnings and expenses on Schedule C
    2. Can deduct expenses even if a net loss results
    3. Are subject to self-employment tax (social security tax)
2. The myth of the “Hobby Loss Rule”
3. Factors used by IRS to determine whether an activity is a hobby or business (more fully detailed in the audit portion of the presentation)

#### B. The A's, B's and Schedule C's of Tax Reporting

(Disclaimer: the following information applies to writers who operate their business on the cash basis as a sole proprietorship or a limited liability company that is a disregarded entity for federal income tax purposes)

1. Form 1040 “U.S. Individual Income Tax Return” – Lines relating to your writing biz
  - a. Line 12 “Business income or (loss)” flows from Schedule C Line 31
    1. A business loss can offset other income now
    2. Unused business loss can be carried back two years or forward 20 years
  - b. Line 25 “Health savings account deduction” – if you have a high-deductible health plan, you may qualify to set up an HSA and deduct contributions
  - c. Line 27 “One-half of self-employment tax” flows from Schedule SE Section A Line 6 or Section B Line 13
  - d. Line 28 “Self-employed SEP, SIMPLE, and qualified plans”
    1. Use Form 5305-SEP “Simplified Employee Pension – Individual Retirement Accounts Contribution Agreement” to set up an IRA-SEP
    2. Annual contribution limits apply/contributions due by due date of return not including extensions (usually April 15<sup>th</sup>)

- e. Line 29 “Self-employed health insurance deduction” – premiums for health insurance are 100% deductible if:
  - 1. Your net profit from your writing biz exceeds the cost of premiums
  - 2. You are not eligible to participate in an employer-sponsored plan
- f. Line 34 “Tuition and fees deduction” – some educational expenses relating to your writing biz may qualify you for this deduction (option: business-related educational expenses can instead be deducted on Schedule C as a biz expense)
- g. Line 48 “Dependent care credit” – if you had childcare expenses and earned net income from your writing and/or day job, you can claim a credit up to the amount of the lowest earning spouse’s net earnings by filing Form 2441
- h. Line 50 “Education credits” - some educational expenses relating to your writing biz may qualify you for certain credits (option: business-related educational expenses can instead be deducted on Schedule C as a biz expense)
- i. Line 57 “Self-employment tax” flows from Schedule SE Section A Line 5 or Section B Line 12
- j. Line 63 “Estimated tax payments”
- l. Be sure to state “writer” as an occupation in signature block

2. Schedule C “Profit or Loss from Business” (Business code 711510)

- a. Car expenses
  - 1. Options: standard mileage rate or actual expense method
  - 2. Regardless of method used, you must maintain a mileage log (sample log in IRS Publication 463, p. 35) – *Write down mileage as you go!*
  - 3. Standard mileage rate includes gas, repairs, maintenance, depreciation, insurance, registration, tires, and other normal costs of operating your vehicle. It does not include tolls, parking, interest on a car loan, or state/local taxes, so you can add those to the standard mileage deduction.
  - 4. The actual expense method requires you to keep documentation for every car-related expense, and is subject to complicated depreciation limits and special rules for leased cars.
- b. Schedule C Line 13 “Depreciation and section 179 expense deduction”/Form 4562 “Depreciation and Amortization”
  - 1. Option to expense items through Section 179 deduction up to the amount of your net income (also subject to an annual limit)
  - 2. Depreciation rules are complex – if you are not eligible to claim the Section 179 expense and must depreciate assets, buy tax preparation software with a depreciation feature to compute your depreciation
- c. Line 23 “Taxes and licenses” – deduct state sales tax on book sales made by you from inventory you own here
- d. Line 24a “Travel”
  - 1. To be deductible, the primary purpose of the travel must be for business
  - 2. Travel for research purposes may be a red flag
  - 3. Special limits apply to certain types of travel, such as cruises

- d. Line 24b “Deductible meals and entertainment”
    - 1. Tests to determine deductibility
      - a. Directly-Related Test (biz combined w/ meal or entertainment)
      - b. Associated Test (biz before or after meal or entertainment)
    - 2. Deduction is limited to 50% of the actual cost
    - 3. Option to use GSA per diem for meals while traveling ([www.gsa.gov](http://www.gsa.gov))
  - e. Other expenses – Special rules and limitations
    - 1. Business gifts are deductible only up to \$25 per year per recipient
    - 2. Expenses that are both business and personal must be pro-rated (i.e. internet service)
  - f. Non-deductible expenses
    - 1. The cost of your first landline phone in your house is not deductible regardless of business use
    - 2. Clothing worn to business events
3. Schedule C Line 30 “Expenses for business use of your home” /Form 8829
- a. Home office must be used exclusively for your writing biz
  - b. Deductible expenses:
    - 1. 100% of “Direct expenses” – expenses relating to home office only (i.e. painting the home office only)
    - 2. A pro-rata amount of “Indirect expenses” – expenses relating to the entire home (i.e. utilities, rent, mortgage interest, real estate taxes, homeowners/renters insurance, etc.)
  - c. Each year’s deduction is limited to your net profit but unused expenses can be carried over to later years
4. Schedule SE “Self-Employment Tax”
- a. Self-employment taxes = social security taxes
  - b. Rate is 15.3% of net income (12.4% OASDI and 2.9% Medicare)
  - c. No self-employment tax is due if your net profit is less than \$400
  - d. OASDI portion applies only up to an annual income limit (\$106,800 for 2009)
  - e. One-half of self-employment tax is an adjustment to income on Form 1040 Line 27
  - f. Self-employment tax is added to income tax on Line 57 of Form 1040
5. Form 1040 ES “Estimated Tax for Individuals”
- a. Due dates - April 15, June 15, Sept. 15, and Jan. 15 of the next calendar year
  - b. An underpayment penalty applies if you owe \$1,000 or more with your tax return (use Form 2210 to compute the penalty)
  - c. You can request a waiver of the penalty if you have reasonable cause for your underpayment (the waiver is requested on Form 2210)
  - d. Option to increase withholding at your or your spouse’s day job

### C. Recordkeeping

1. Statute of limitations for IRS assessment
  - a. The IRS can normally go back only three tax years to audit a return
  - b. The IRS can go back more than three years if income has been understated by more than 25%, if a fraudulent return was filed, or if no return was filed
  - c. Keep records for at least three tax years back, six is better
2. IRS requires documentation/substantiation of all expenses – keep receipts, invoices, bank statements, check registers, credit card bills, etc, as well as bills for utilities, proof of rent/mortgage statements, and repair/maintenance receipts if you claim a home office
3. There is no one “right” way to keep books – find a method that works for you
  - a. manual method (see sample manual log in IRS Publication 463, p. 35)
  - b. spreadsheets
  - c. bookkeeping software
4. Keep receipts for assets until three tax years after item is fully depreciated
5. Keep a detailed mileage log
6. Keep your datebook or calendar in your tax records if it contains useful info

### D. Hiring a tax professional

1. Hire one with the credentials that are right for your business and verify the credentials
2. Red Flags – Avoid preparers who: promise a refund before looking at your records; operate on a seasonal basis only; fail to include their identifying information in the “Paid Preparer” section; include questionable items such as excess mileage, overstated medical expenses or charitable contributions, unreimbursed employee business expenses, or odd credits such as the fuel tax credit; or ask you to sign an incomplete return
3. How to minimize tax prep fees
  - a. Organize your documents by form
  - b. Provide summaries/totals of categories of expenses
  - c. Have a list of questions ready so that you can address them all at one time

### E. Useful IRS Publications – Available at [www.IRS.gov](http://www.IRS.gov)

Publication 334	Tax Guide for Small Businesses
Publication 463	Travel, Entertainment, Gift, and Car Expenses
Publication 503	Child and Dependent Care Expenses
Publication 505	Tax Withholding and Estimated Tax
Publication 535	Business Expenses
Publication 552	Recordkeeping for Individuals
Publication 560	Retirement Plans for Small Businesses
Publication 583	Starting a Business and Keeping Records
Publication 587	Business Use of Your Home
Publication 919	How Do I Adjust My Withholding?
Publication 946	How to Depreciate Property
Publication 969	Health Savings Accounts and Other Tax-Favored Health Plans
Publication 970	Tax Benefits for Education

Sign up for my quarterly newsletter with tax tips at [www.DianeObrienKelly.com](http://www.DianeObrienKelly.com).

Check my website’s “Tax Tidbits” page for continuously updated tax tips.

Part Two – How To Survive an Audit

I do NOT agree with your January '02 determination and I have NOT changed my position on the appropriate deductions for a writing business. Please accept this document as my request to **Appeal** this decision based on the following reasons:

As a member of Romance Writers' of America (RWA) a national organization that represents over 9500 published and unpublished members, I follow the guidelines/articles published in our trade magazine. Tax guides are written and published by CPA/tax attorneys who are also authors. Since you are responsible for all types of businesses and deductions, you may not have access to the specifics of fiction writing.

I do not believe the tax doctrine commonly known as the "Hobby Loss Rule prevents me from claiming business expense deductions prior to publication and/or earning a profit because I operate my writing activity as a business. Publication is not the only criteria required to differentiate between a hobby and a business. Substantiated by the enclosed documentation, my writing activity constitutes a business according to the nine factors for IRS consideration.

**1. Writing activity operated in a business-like manner:**

- Detailed records of expenses – submitted to your office on 07/20/07
- Writing time log, manuscript tracker, conference submission log, agent queries and responses – enclosed.

**2. Time and effort indicates my intent to generate revenue.**

- Time log: 756 hours dedicated to the writing business in addition to my day job justifies intent.
- I have 9 completed manuscripts in long and short format with multiple completed versions. Folders are named by heroine due to change of titles and book length to meet publishers' needs at time of submission. See electronic file screen print and Manuscript Tracker.
- Membership in National and local writing chapter
  - Romance Writers of America (RWA)-see dues receipt
  - Georgia Romance Writers of America-see dues receipt
- Attended five conferences and One-Day seminars/special critiques
- The document tracker indicates the number of agents and editors I have contacted and submitted proposals.
- I am also a PRO member of RWA. This is a nationally recognized professional status to differentiate members who have intent to publish.

**3. Do I depend on my writer earnings for a livelihood?**

I do not rely on my writer earnings as a livelihood. However, this should not disqualify me from claiming deductions when the factors listed in this correspondence show I am operating a business.

**4. Losses are due to circumstances beyond my control and are typical of a writing business start-up phase.**

I have enclosed a copy of "First Sales" section from Romance Writers' of America January 08 edition. This article appears on a monthly basis in RWR. As this article demonstrates, it is not unusual for authors to write for many years prior to publication. "First Sales" indicates a

time period from one to nineteen years in only one month of documentation. Multiply this by 12 months and then by four years to cover the time during this audit.

**5. Documented change in operation methods to improve profitability.**

Contests sponsored by RWA chapters provide not only an opportunity to place the entry in front of agents and editors, they also provide feedback forms from the first-round contest judges—professional authors. My expense report shows I entered 4 contests in 2004. Additionally, my electronic file print shows the number of revisions for sample manuscripts.

I have made every effort to improve my profitability. My revision files show my work to improve my manuscript marketability.

**6. Documentation of knowledge needed to carry on a successful writing business.**

I am currently employed and have been employed for the past ten years by a government contractor. Writing and creating educational material and policies is a substantial part of my responsibility. Additionally, I have submitted nonfiction articles in my field of expertise.

**7. Documentation of success in making a profit in similar past activities.**

I have made an average salary for my skills.

**8. Have I made a profit in some years and what is the amount of that profit?**

Again, I have not generated profit from my writing. Although I have won contests, most of our contests offer an opportunity to show work to agents and publishers rather than cash awards. However, this should not disqualify me from claiming deductions when 7 of the 9 factors show I am operating a business.

**9. Expectations to make a future profit from the appreciation of assets used in the activity.**

I have continued to improve my writing craft. In 2007 one of my manuscripts won two contests. I have received requests for submission by one agent and one editor. One manuscript was accepted by an editor and later orphaned. This means the editor received a promotion to a different editorial line during the time I was completing the requested revisions for publication. The editor who replaced the buying editor did not approve her predecessor's revisions and I was not contracted. This is typical of the publishing business. Material reviews and final acceptance depend upon the line editor at the time of contract.

Although I did not include a copy of all manuscripts and revisions, I can generate all in electronic or paper format. Based on the depth of my work, you can see that my expenses are not inflated and are professionally documented.

Since I have documented evidence that I have met seven out of nine considerations of a business activity, I request that you reconsider your determination and allow my business writing expenses.