CHAPTER 21

TAXES: BEYOND SCHEDULE C

Like all US taxpayers, professional writers are affected by special tax issues outside of those presented in income and expense filings. Although they are not addressed neatly in one place as income and expenses are on Schedule C, these issues are important to know about and understand.

SELF-EMPLOYMENT TAX

Virtually all employed Americans (with the exception, ironically, of our federal lawmakers) contribute from their earnings to, and are entitled to the benefits of, Social Security and Medicare. Social Security provides workers with retirement and disability income and dependent benefits in the event of their death or disability. Medicare currently provides guaranteed health care insurance for all citizens beginning at age sixty-five. Payroll taxes are automatically withheld from employees' regular paychecks to cover their mandatory Social Security and Medicare contributions, and employers pay one-half of these taxes. These taxes are not, however, withheld from payments received by the self-employed. Therefore, all self-employed people, including professional writers, must file Schedule SE, Computation of

Social Security Self-Employment Tax, with their Form 1040 and must pay the self-employment tax shown on Schedule SE.

Your self-employment income subject to the self-employment tax is basically your net income from writing as reported on Schedule C, subject to certain adjustments. If you have more than one business, your combined business earnings must be totaled on Schedule SE to calculate your self-employment tax. If you receive wages from an employer from which the payroll tax is withheld, you may subtract the wages from your total taxable income to calculate the tax on your self-employment income. If you and your spouse both earn self-employment income, each must file a separate Schedule SE.

To qualify for Social Security benefits, a worker must have worked and contributed for forty quarters (that is, ten full years) during her working life. The amount of one's Social Security (but not Medicare) benefits is based on the amount she has paid into Social Security. The more one earns, the more one pays into the system, and the larger the amount of monthly benefits from Social Security to which one is entitled.

For all workers, employed and self-employed, there is a ceiling on the amount of annual income on which Social Security taxes are paid. The maximum amount of taxed income has steadily increased over the years—from $14,000 in 1975 to $106,800 in 2011 (there is now no ceiling on the amount of income subject to Medicare tax)—and the rate of taxation has also increased to 15.3 percent in 2010, but was temporarily reduced for 2011 and for part of 2012 to 13.3 percent (10.4 percent for Social Security, plus 2.9 percent on all income for Medicare). Fortunately, a portion of your self-employment taxes is deductible from your gross income on Form 1040.

More information about the computation of self-employment tax can be found in IRS Publication 334, *Tax Guide for Small Business (For Individuals who use Schedule C or Schedule C-EZ)*. Additional information about the benefits available under Social Security is available at the Social Security Administration's website (www.socialsecurity.gov) or through its toll-free number (1-800-772-1213.) The Administration also offers a helpful pamphlet titled *Understanding Social Security* and an information sheet called *If You're Self-Employed*. Once you have paid into the system for the requisite forty quarters, the Administration must send you an annual report that explains your earnings history and your projected benefits based on credits earned. If you do not receive this report, contact the Administration.

ESTIMATED TAX PAYMENTS

The federal government needs funds to operate year-round. Employers withhold (and remit to Uncle Sam) both income and payroll taxes from their employees' regular paychecks on an ongoing basis throughout the year. By the same token, self-employed people must pay their federal income and self-employment taxes in quarterly installments, which are computed on Form 1040-ES, Estimated Tax for Individuals. If you will owe $1,000 or more in taxes in a given tax year from self-employment, you must send your quarterly estimated tax payments for the tax year to the IRS on or before April 15, June 15, September 15, and January 15 (of the year following the tax year). The $1,000 threshold for 2012 is net of any employment income tax withholding and refundable credits from your total tax (but not net of any estimated tax payments). Failure to pay sufficient estimated taxes can expose you to liability for penalties and interest on top of the tax deficiency. To avoid the penalties from underpayment, you may pay as estimated tax in the current year the amount equal to your actual tax bill for the prior year (110 percent of that amount if you will earn more than $150,000). IRS Publication 505, *Tax Withholding and Estimated Tax*, gives more detailed information about estimated tax payments and how to avoid penalties for underpayment.

RETIREMENT PLANS FOR THE SELF-EMPLOYED

Self-employed sole proprietors can use several types of deferred tax savings plans for retirement: a Keogh, or qualified plan, a Simplified Employee Pension ("SEP"), a traditional IRA and/or a Roth IRA. Keogh, SEP, and traditional IRA plan contributions can be deducted from income on Form 1040. For some plans, you might need to file additional forms; check with your plan's administrator.

You should also strongly consider setting up a Health Savings Account, similar in operation to a traditional IRA. If you anticipate medical costs that will not be covered by your insurance, including deductibles, a HSA allows you to set aside pretax money to cover them. See IRS Publication 969, *Health Savings Accounts and other Tax Favored Health Plans*, for more details on this excellent option.

QUALIFIED PLANS

A "qualified" (also called "Keogh") plan permits self-employed people to contribute to a retirement fund and deduct the amount of the contribution from their gross income when computing income taxes. The Keogh deduction is allowed in a given year only if you invest it in one of a specified kind of retirement fund, described in IRS Publication 560, *Retirement Plans for Small Businesses (SEP, SIMPLE and Qualified Plans)*. Even if you are employed by a company with a retirement program, you might still be able to set up a tax deferred Keogh plan covering your writing income. If you have employees, any retirement plan you set up for yourself will also require contributions for the benefit of your employees.

A financial institution can help you set up and administer the Keogh plan. There are several ways to determine the maximum amount of contributions you may make to a Keogh plan, which are limited by certain caps. As with other tax deferred retirement plans, contributions to a Keogh plan must be made before the filing date of the tax return (usually the following April 15), but unlike other plans, the Keogh plan itself must be set up during the tax year for which your deduction is taken. You must pay a tax penalty for withdrawing from the plan prior to age fifty-nine and one-half (unless you become permanently disabled), but no taxes are incurred on the growth of a Keogh fund until the funds are withdrawn. Distributions are taxed when made.

Keoghs are good plans for self-employed people. Your tax bracket upon retirement age could be much lower than it is while you are working and contributing to the fund, so income tax on the distributions would be at a lower rate than you are paying today. Meanwhile, the funds will have grown tax-free. If you create a trust to hold the Keogh, you can act as trustee and administer the investments. One-participant Keogh accounts of less than $250,000 are exempt from annual filings, except in the last year of the plan. More information about Keogh plans can be obtained from the institutions that administer them.

SEPS

A self-employed person may also create a Simplified Employee Pension (SEP), which is simpler and has fewer requirements than a Keogh plan. SEPs do not need to be set up by the end of the year for which the contribution is made and do not have the same annual filing requirements as some Keoghs. If you want to make the largest possible deductible contributions to your retirement funds, however, a Keogh plan is better than a SEP. IRS Publications 560, *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)* and 4334, *Simple IRA Plans for Small Businesses,* explain the various plans in more detail.

TRADITIONAL IRAS

In addition to either a Keogh plan or a SEP, you might be able to open a traditional IRA (Individual Retirement Account). An IRA allows you to contribute up to a certain amount of your pretax income per year (assuming that your wages and professional earnings amount to at least that much) into a retirement fund. To qualify to make deductible contributions to an IRA, either you must not be covered by another retirement plan, such as an employer-sponsored 401(k), Keogh, or SEP, or if you do participate in another retirement plan, you must earn less than a certain amount in adjusted gross income. The custodial fees charged by a plan administrator (but not commissions paid on transactions) may be deducted as investment expenses on Schedule A if these fees are separately billed and paid.

THE ROTH IRA

Even if you participate fully in another retirement plan, you might also qualify to establish and make after-tax (i.e., nondeductible) contributions to an individual retirement plan called a Roth IRA. (You cannot invest in a Roth IRA if you earn more than a specified amount in adjusted gross income.) To qualify as a Roth IRA, the account or annuity must be designated as such when it is set up, but you may convert a traditional IRA (but not a SEP) to a Roth IRA (and back again) if you are willing to pay income tax on your original contributions to it. Roth IRAs are generally subject to the same rules as traditional IRAs, except that you cannot deduct contributions to your Roth IRA. The great benefit of a Roth IRA is that it grows tax-free, *and* qualified distributions from it can be tax-free when they are made. You may withdraw your original contributions to it at anytime without having to pay a tax or penalty (because you have already paid income tax on them). More information may be obtained from the institutions administering Individual Retirement Accounts, as well as IRS Publication 590, *Individual Retirement Arrangements* (IRAs).

OTHER TAX CREDITS AND DEDUCTIONS

Certain tax credits that apply to any individual taxpayer, both those employed by another and the self-employed, are explained below.

CHILD AND DISABLED DEPENDENT CARE

Anyone who maintains a household including either a child under age thirteen or a disabled dependent and who must pay for their care in order to gainfully pursue employment or self-employment might qualify for the child and dependent care tax credit.[136] The credit is 35 percent of what you pay to employ a caretaker in order to be gainfully employed. IRS Publication 503, *Child and Dependent Care Expenses*, describes in greater detail the rules and limitations of this credit.

BAD DEBTS

Although bad debts might be deducted as a loss against business income for those using the accrual method, a party's failure to pay you as agreed for your work may not be deducted as a bad debt. The reason is simple: the unpaid fee is not counted as taxable income. As stated in Publication 334, *Tax Guide for Small Businesses (For Individuals Who Use Schedule C or C-EZ)*, "Cash method taxpayers normally do not report income until they receive payment. Therefore, they cannot take a bad debt deduction for payments they have not received or cannot collect." But cash basis taxpayers can deduct certain types of business or nonbusiness bad debts. A loan to a customer or a friend that is never repaid, for example, qualifies as a bad debt. (Such a loan must be legally enforceable against the borrower.) Nonbusiness bad debt deductions are taken in the year in which the debt becomes worthless, and may be carried forward to subsequent years' returns, if it exceeds the yearly limit ($3,000 in 2011).

NET OPERATING LOSSES

A self-employed person who experiences a business loss as determined on Schedule C may carry the loss to Form 1040, where it is eventually subtracted from gross income to calculate taxable income. If the loss is

[136] Tax credits are subtracted directly from your tax bill. Their impact is much greater than are deductions from income in the same amount.

large enough to wipe out other taxable income for the year, the excess loss may first be carried back to reduce taxable income in up to two to five prior years (depending on the type of income) and then carried forward for future taxable years. This type of loss is likely to arise for a professional writer when they change from salaried employment to full-time writing. One favorable result could be a tax refund for previous years' payments and/or a lower tax bill in future years. IRS Publication 536, *Net Operating Losses*, describes the net operating loss deduction in detail. You will most likely need an accountant's help to compute your losses.

AMERICAN WRITERS LIVING ABROAD

American citizens living abroad are taxed by the United States government on all their income earned from anywhere in the world, but they are entitled to take an exclusion (the "foreign earned income exclusion") for income earned from foreign sources in the amount of up to $92,900 (for 2011). This exclusion can result in substantial tax benefits when the tax rates of the foreign country such as Ireland, where a qualified writer might live tax-free, are lower than the tax rates in the United States. Certain foreign housing costs might also be excluded or deductible from income.

The basic requirements are either a minimum one-year residence or physical presence in a foreign country and income earned from work done in the foreign country. "Residence" is a flexible concept based on the circumstances of each individual. While the residence must be uninterrupted (for example, by owning or renting a home continually), remaining abroad for the entire taxable year is not necessary. Brief trips to other countries do not affect one's tax status as a resident abroad.[137] "Physical presence" requires the taxpayer to be present in a foreign country or countries for at least 330 days during a period of twelve consecutive months. Regardless of which test is met, the foreign earned income to be excluded must be received no later than the year after the year in which it was earned.

137 Some or all of your foreign earned income exclusion might be lost if you travel in countries restricted to US citizens under certain sanctions rules. Check with your local US consulate for more details. Publication 54, *Tax Guide for US Citizens and Resident Aliens Abroad*, explains the guidelines for eligibility for the exclusions.

If you wish to benefit from the exclusion for income earned abroad and foreign housing costs, consult with a tax lawyer or an accountant about your particular situation. If you live abroad, ask the US consulate whether any treaty regarding taxation between the United States and your residence nation affects your tax status.

In addition to the foreign earned income exclusion, some taxes paid to a foreign government on income that is also subject to US taxation might be eligible for a tax credit or deduction on your US return. IRS Publication 514, *Foreign Tax Credit for Individuals*, explains these provisions.

FOREIGN WRITERS IN (OR EARNING IN) THE UNITED STATES

Foreign writers who are residents of the United States are generally taxed in the same way as citizens. Foreign writers who are not residents of the United States are taxed on income earned from US sources under special rules, including a mandatory withholding tax of 30 percent on royalties earned on US sales. A foreigner who is merely visiting or whose stay is limited by immigration laws is usually considered a nonresident. A foreigner who intends, at least temporarily, to establish a home in the United States and has a visa permitting permanent residence, will probably be considered a resident for tax purposes. For a more extensive discussion of their tax status, foreign writers in the US should consult IRS Publication 519, *United States Tax Guide for Aliens*.

Non-US nationals earning royalties from US book sales that are subject to the 30 percent withholding tax might be able to claim a full or partial exemption from that tax. Whether and to what extent a foreign writer is entitled to the exemption depends on her country's tax treaty with the United States.[138] If the withholding rate in your country is 0 percent (as in the United Kingdom), you may claim the full exemption. But note that to the extent you take the exemption, you must declare it as foreign income and pay the tax imposed by your home nation. The downside of trying to qualify for the exemption is the inordinate amount of paperwork and filing time required. First, you must obtain a tax ID number. For an individual, this is the ITIN (Individual Tax Identification Number). Getting an ITIN is

[138] The IRS website lists the countries with which the US has a tax treaty at www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties—A-to-Z

easier said than done.[139] After getting your ITIN, you can send the proper IRS form (W8-BEN) to your US publishers. This form allows them to pay your royalties without withholding the 30 percent tax as your country's tax treaty with the United States provides.

[139] Getting an ITIN takes many weeks and requires that your US publishers write a letter addressed to the IRS on your behalf, and that you submit the letter and other forms and proof of your identity and nationality to the nearest American Embassy. The wait for the ITIN to come from the IRS after you take these steps is several weeks. Your agent or publishers might be willing to help you navigate this process. It is best to start it significantly before royalties might be due, and to ask your publisher to withhold paying you until you have gotten the exemption.