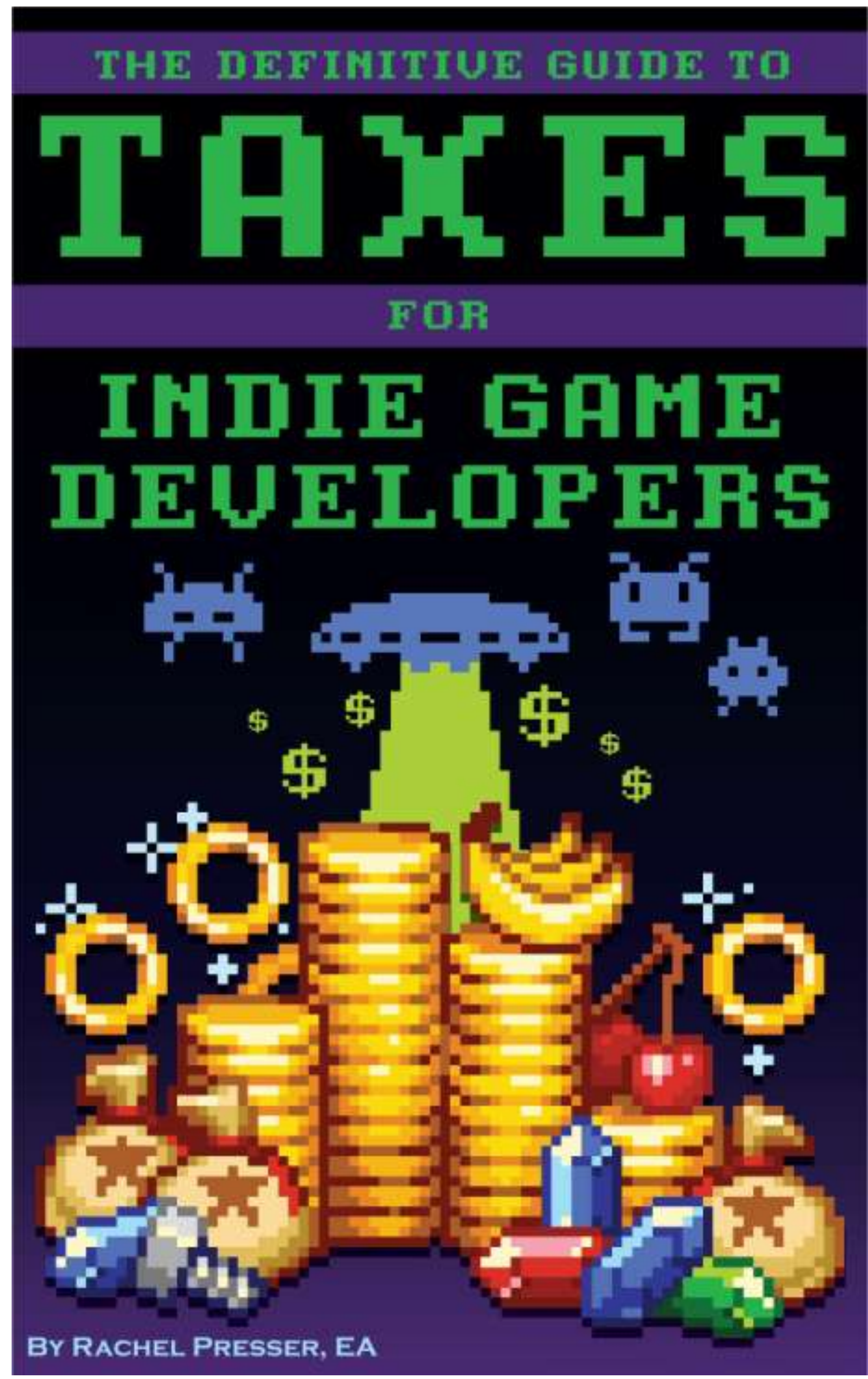

REVIEW COPY

Table of Contents

Level 0: Why Game Developers Need Their Own Tax Guide
Level 1: Types of Taxes
Level 2: Chaotic Neutral Married (Filing Statuses)
Level 3: Deductions, Credits, and Exclusions
Level 4: Keep Records Like Developer Diaries
Level 5: Tax Impacts of Funding a Game
Level 6: Is Game Development Your Livelihood or Just a Hobby?
Level 7: Business Entities, Formalities, and Setting Up
Level 8: The Load Screen, Start-Up & Organizational Costs
Level 9: The Main Event, Business Expenses
Level 10: Lost Levels, Non-Deductible Items
Level 11: Travel, Meals, and Entertainment Expenses (The Bonus Round)
Level 12: Turn-Based Strategy, or Depreciation of Big-Ticket Items
Level 13: Home Offices Are the Turtles That Can't Swim
Level 14: Why Your Fiscal Year is Like Dinosaurs Living With Humans
Level 15: Endless Runners, or Ways to Treat Your Development Costs
Level 16: Rubber Chickens with Pulleys in the Middle (Inventory)
Level 17: Sales Tax: Torment
Level 18: Classification Quest: Do I Issue a W-2 or 1099?
Level 19: Where in the World Are Your International Dev Team Members?
Level 20: How to Choose and Work With a Tax Professional
Index of Citations
Acknowledgements

Level 0: Why Game Developers Need Their Own Tax Guide

Thanks for buying *The Definitive Guide to Taxes for Indie Game Developers*! This introduction isn't going to drag on forever, I promise, but there are some things you should be aware of so I definitely recommend not skipping right to the next chapter. But I won't stop you if you decide to. I can't cause the Kindle app to crash from afar.

If you're an indie developer, you're a person who takes the initiative to read things thoroughly and in full – but you're also busy. So that's going to set the tone of this book: concise and to the point, written in plain English (whenever possible!) and with as much fun as I can possibly pack into a topic that makes ripping out your toenails one by one with a rusty pair of pliers look like a round of *Skyrim*. There were times I had to give figures to explain certain rules and show examples, but otherwise I tried to keep tables, figures, and legalese to a minimum.

But just like with programming, many of the concepts covered are also cumulative, so I would recommend reading this book in order opposed to jumping around, particularly if you're not that familiar with the language of tax. A lot of the references I make in later chapters also go back to stuff that was already covered.

Chances are you might also be an accountant, tax professional, or attorney trying to get some understanding of the gaming industry in an effort to get business from the growing population of indie developers. This book is really aimed at game developers themselves, but I've included citations from authoritative literature if you are in the professional sector and looking for good backup material to share with your clients.

So with all that said, I deserve a proper introduction here. After all, why should you trust this Rachel Presser character with your tax questions, primarily the ones pertinent to making games for a living?

I have both a B.S. and M.S. in accounting and still hold a federal license to represent taxpayers: the Enrolled Agent or EA designation. (Did you just ask yourself, "What's an Enrolled Agent?" Don't worry, we'll be talking plenty about that later.) Between working on my degrees and license, I worked as an independent tax practitioner for most of my time in the field, but I also worked at retail tax outlets and boutique firms. I've done tax returns for everyone from food stamp recipients to people requiring these 2,000-page beasts to account for all their holdings. I wrote about tax law for publications like *Tax Pro Journal*, knowledge bases like Task FM, and private clients. I did my master's thesis on 1099 fraud and abuse, as there is insanely complicated case law regarding whether a worker is an employee or independent contractor. For three years running, I also worked with a large test development company and directors of the IRS' Return Preparer Office to write all three sections of the Enrolled Agent professional exam and determine what the basic minimum competency for Enrolled Agents should be.

Most of all though, I've been co-running Himalaya Studios since 2011 as CFO and Executive Producer and oversaw raising six figures on Kickstarter for our point-and-click adventure/RPG hybrid, *Mage's Initiation: Reign of the Elements*. I'm also designing Himalaya's very first mobile game. I waited my entire life to write and design games. I tried to leave the tax field time

and again, but didn't officially do so until the middle of 2014. After going through various teaching gigs and the vagaries of the Craigslist economy, I started Sonic Toad when I saw the demand for crowdfunding experts and consultancy for game developers that was actually out there. (And proceeded to kick myself for wasting all that time looking for another tax job. But you'll have to read more about that in my upcoming memoir/film analysis/treatise on American workplace values, *The Tao of Gord*.) I decided to take things one step beyond and provide not just consulting services but an ongoing resource to the indie developer and freelancer spaces, particularly in dealing with the tribulations of indie life and entrepreneurialism and how it affects our personal lives.

I was inspired to write this guide upon seeing that there was a real dearth of business resources out there for game developers, taxation being just one of many of those aspects. Having taught a variety of business classes for Playcrafting NYC, an education and business development hub for the tristate area's game development community, I kept getting inundated with requests to show game developers how to do their taxes. Ergo, with the success of *Basics of Business for Indie Developers* and *Best Practices for Crowdfunding,* a class on taxation was born. Then, having facepalmed over many accountants' submissions to Gamasutra where I could tell they clearly didn't have any indie developers as clients, let alone made games or took care of the business end of an indie studio themselves, I figured it was time to let other devs benefit from the years of my life that got sucked away in the tax field.

Moreover, I found that most business and tax books out there are really boring and dry. Sometimes they contain relatable examples, but you can tell they were written for an incredibly general audience – or, worse yet, for other tax professionals – but no less marketed to the everyman. Every industry has its quirks, and games are no exception: we need our own tax guide because despite economists pointing out that video games now eclipse film and music combined, there's very little support from the professional sector. Working in the games industry is still seen as this rare oddity.

Then there's the fact that discussions and breakdowns of tax law are really prone to familiarity blindness. So it really didn't surprise me to find that lots of the books I looked at seemed like they were more or less written for other tax professionals. Or, at best, people who had the basics of tax prep lingo down. I wanted to make a book *for* game developers *by* a game developer. This book is the first of its kind, at least that I'm aware of.

Many of the tax law areas and concepts outlined here could apply to any business type, but let's face it: the Internal Revenue Code is hundreds of thousands of pages long. Looking for just the right code sections if you lack background in tax law can take days. IRS publications and instructions are written in Tax, not English. Throw in some of the complicated aspects of game developers' operations, and it's a recipe for your head feeling worse than waking up after you hit The Fig at E3 and wound up downing a bottle of Jaeger chased with trashcan punch.

Obviously, I can't cover EVERY tax topic and situation out there, and every taxpayer is unique. But this book should give you a solid understanding of how your taxes will change as a result of working for yourself in some capacity, whether you're already a full time dev, trying to transition to just that, or you make games strictly as a side hustle. Game devs also aren't a

monolith; some of you are artists first and entrepreneurs second. I've met devs who really want to grow their businesses and others who want to keep it simple. That's all fine and good, but the law applies to you all the same. Ergo, you should get familiar with it.

The world is rapidly changing. We live, communicate, and create in a world of e-signatures on documents, powerful devices barely bigger than a deck of cards, and virtually never dealing with a human at the bank. But as a whole, America's legislative and business environments are unfortunately stuck in the era of file cabinets, offices being the only place you can possibly get work done, and fax machines that were built before the Eisenhower administration. The IRS is no exception!

Game developers don't just have the concerns any other small business owner or freelancer would; we also have to worry about some of the more nebulous areas of tax and business law that apply to digital nomads, as a majority of us travel that road and wouldn't trade it for that super-rare, solid gold Zelda NES cartridge. Some of us work alone. Others work in teams, whether temporarily or for the long haul, and don't know how to structure them to achieve that sweet spot with the least amount of both hassles and taxes paid. Most indie developers also have to do something else to subsidize their pursuits, such as another job, a sharing economy gig like driving for Uber or renting out your couch on Airbnb, or, if you're like me, yet even more self employment via multiple sources like consulting work and passive royalty income from books or music.

And that's not even getting into the industries the tax code favors and disfavors, because game developers and the numerous professions within the games industry share many aspects of different fields: fine and digital art, technology, software, music, writing, digital media…sometimes there are even retail applications, what with fans loving swag and the rise of crowdfunding for studios of all sizes. This is why indie developers require special attention in their tax planning considerations.

I pinpointed what I felt were the most important issues an indie developer is likely to run into, so you will be aware of what to discuss with your tax professional and the types of records you really need to hold onto, because there are benefits you probably weren't aware of. (There are also pitfalls better hidden than all the Easter eggs in any given Daedalic adventure.)

Just like how engines and operating systems upgrade, so do tax laws. Some items are indexed for inflation, meaning that certain benefits will keep rising every year to keep pace. It's sort of like how processors generally get faster when new computers hit the market. You can still wind up buying one that runs like a snail on Valium waiting for the Second Avenue subway to be built, but chances are a laptop built in 2014 runs faster than one built in 2000. Some items in the tax code stay the same. Some tax provisions expire like Twinkies while others expire like salad.

Also, this book is predominantly about federal US tax law. I'm sorry, international devs; I love you all the same, but you'll benefit more from my other seminars and writings than this book if you do not live and/or work in the US. Still, there is a chapter in here you'll want to pay special attention to if you plan on doing work with any American studios for the long haul and/or a significant timeframe.

State and local taxation is also not covered at length here, because otherwise this thing would wind up longer than the entire *Dreamfall* series.

One last note before we let the fun begin: Unless you also come from a background of doing complex tax returns, I really hope you're working with a tax professional. There's a whole chapter dedicated to finding a good one. Please swear upon your favorite feelie right now that you're going to use this book with them, because I have a whole special index in the back with authoritative literature and Tax Court citations for the harder-to-find topics and discussions of case law.

And now it's time to end this cutscene and let the actual gameplay begin!

Chapter 1: Types of Taxes

In a nutshell, income taxes aren't the only taxes out there, and definitely not the only taxes that will affect you.

There are different kinds of **tax returns** that have to be filed – like your personal tax return, as opposed to the returns your business has to file. Businesses can have income tax returns but also have things called **information returns**, which are tax forms you have to file but you don't send any money with them. I've frequently heard people use the term "tax return" when they get a check from the IRS, but the correct term is **tax refund**. Getting a refund means that you paid in more than you were assessed for the year and chose to have it sent back to you as opposed to allocated to next year's tax bill. The "return" is the actual form you filled out.

But even right on your personal tax return you have to file every year, there are different kinds of taxes. It just doesn't seem like it because you're paying them all in the same place. Think about it: you'd file a different form for a driver's license than for a business license or a marriage license, and you'd pay for all of them through different agency offices or websites. But it's all revenue to the government, regardless. You'll pay certain business taxes in the same place as your personal income tax bill, as you're going to read about. But just like applying for those different licenses, the way you calculate and pay some of these taxes is going to be a bigger pain than others.

Income Taxes

We'll start with income taxes. If you're a TV Tropes fan, income taxes are Exactly What It Says On the Tin: taxes based on how much income you earned during the year, after your applicable loopholes and penalties. Income taxes are paid on wages and salaries you earn when you work for somebody else, and also on profits you earn from self-employment. It can also be assessed on things like royalties and rental income.

But not so fast! If it were THAT simple, why does the average American spend 40-80 hours every year trying to stay compliant with the tax code, 100-120 if an entrepreneur like yourself? Why do some people have income tax returns that are just a couple pages and can be completed in less than fifteen minutes, while other people have these leviathans that outweigh dictionaries and take a team of accountants at least two weeks to prepare? (By the way, that statement isn't an exaggeration. The largest tax return I ever prepared exceeded 5,000 pages.) The tax code is complex, as I said in the intro. But income tax is, first and foremost, the tax all taxpayers have to deal with no matter what they do for a living. You'll pay income tax whether you work a regular salaried job and your employer takes taxes out of your paycheck for you, and you'll also pay income tax on your own if you work for yourself.

Income from a job, your share of profit from a shared business, or solo self-employment is called **earned income**. Even if you don't have any earned income, you likely still have to pay income tax, such as if you're subsidizing game-making by having rental properties, receiving trust payments, and/or earning investment income. That kind of income is called **unearned income**. (I'm not going to focus on unearned income in this book, but felt it was important to point out the difference because the law applies to both types of income differently.) A lot of unearned

income has preferential rates attached to it, such as the rates for **dividends** and **capital gains**, but other kinds of unearned income have more stipulations attached. Most income, including earned income, is taxed at the **ordinary rate**. Ordinary rate is simply the rate you will wind up being taxed at for most of your income and subject to the **statutory rate** you'll fall under, which is often higher than the preferential rates for investment income.

Federal income taxes are **progressive**. Generally, the more taxable income you have, the higher the statutory rate you must pay. However, the statutory rate (or **tax bracket**) you fall into may not tell the whole story because we're going to discuss the different types of tax-reducing moves available to you and how your situation is different depending on how you formalize your game development pursuits.

Income taxes are paid at the federal level, but depending on where you live, it's likely you also pay a state income tax as well. Some cities and counties collect income tax, too, like New York City and Philadelphia.

There are also **personal** income taxes and **business** income taxes. As we get into the different options you have for formalizing your business, I'll talk about the pluses and minuses of each, as the rules for personal and business taxes are quite different. Your personal taxes will be affected by what form your business takes, for better or worse. But even though it doesn't seem that way at first, the rules are different. Think about how C++ and C# have similarities but execute differently. That's basically how business and personal income taxes can be, at a glance.

But the short of it is that income taxes are based on how much income was generated. We're going to spend plenty of time later exploring the numerous ways to cut that number down to pay less income tax, but that's the basic gist.

Payroll Taxes

Payroll taxes, unlike income taxes, are conditional on employment, meaning that these taxes are paid as a result of *being* an employee or *having* employees.

If you work for somebody else, there are taxes that you pay and ones that your employer pays. The most common payroll tax that we all have to contend with is Social Security and Medicare, also called FICA. These taxes have to come out of your paycheck at a total of 15.3%, but your employer pays half of this amount (7.65%) out of their own money.

Payroll taxes are generally **flat**, or **regressive**, unlike the progressive income taxes. If your employer pays you $30,000 per year, both you and the employer are paying at the same exact 7.65% rate as your supervisor who gets $70,000 per year.

However, while the sky's the limit on how much you can pay in income tax, that's not the case for Social Security taxes. Of that 7.65% tax you and your employer have to pay, 1.45% is for Medicare and 6.2% is for Social Security. Medicare taxes have no limit, but at the time of writing, $118,500 is the annual limit for having to pay into Social Security and this amount rises every year. So let's say you now earn a $200,000 salary at your job. You're not paying 7.65% per year; you're actually paying in at 5.12%. ($118,500 × 6.2% = $7,347, 1.45% of $200,000 is

$2,900. $10,247 is 5.12% of $200,000.) The boss is also paying an identical $7,347 out of the company's money for their share of payroll tax.

And this cap applies for the entire year, so if you switch employers or work a second job and you already hit the cap, you will get the excess Social Security taxes refunded to you when you file your tax return.

Payroll taxes don't start and stop at Social Security and Medicare, though. Unemployment insurance is paid at the federal level (FUTA) and state level (SUTA). FUTA is always paid by the employer, never by the employee. There are some heavy calculations with FUTA which I'm not going to delve into, based on wages paid and how many hours the employee is putting in, but it's usually 6% of the gross pay. SUTA can be an even denser topic, based on the variegated state unemployment insurance laws out there. Some states also require the employee to pay into the unemployment fund, such as New Jersey.

If you have employees, you will need to factor payroll taxes in. If you're hiring a full-time programmer at a base salary of $80,000 per year, you'll need to account for your share of FICA and FUTA alone, plus SUTA and payroll administration costs. Just like how you definitely wouldn't receive a flat $80,000 if you were that employee, as an employer you would be paying at least 15% more than that $80,000, depending on administrative costs and state/local payroll taxes.

Payroll taxes are onerous not just to pay, but also in terms of administrative burden. Federal payroll tax returns have to be filed quarterly and diligent records must be kept. You may be a ways off from hiring employees just yet, or decide not to altogether, but this is a peek at what you'll be in store for if you do.

Self-Employment Tax

Self-employment tax is likely the tax you will be the most concerned with.

To sum it up, this is the 15.3% FICA tax, just like you'd have to pay if you were still getting a regular paycheck, but it's not quite calculated the same way, and you're also going to pay this 15.3% by yourself. After all, what would the phrase "self-employed" be without you yourself being seen as your own employer in the eyes of the law?

The FICA cap applies to self-employment tax just like it would if you were an employee. But while your and your employer's shares of FICA are determined by gross pay, self-employment tax is determined by your self-employment income *after expenses*.

Because of this, self-employment tax can be harder to beat down than income taxes, as you'll see in later chapters. But the biggest determinants in how much self-employment tax you'll have to pay will be how much you made and how much you spent. Then, how those expenses will come out on paper. This is a tax that can sneak up on you if you're not careful, so it's important to know what expenses you are allowed to deduct.

Corporate Income Tax

We touched upon the concept of income taxes earlier. Corporate income taxes get their own discussion because different rules apply.

There are two types of corporations, S corporations and C corporations. S corporations have a lot of limitations but can present a lot of opportunities for tax savings. C corporations offer more leeway and, depending on your circumstances, can either result in crippling taxes or saving a great deal of money.
Both require their own tax returns in addition to your personal ones.

The concept of **entity level taxes** will be discussed later, but regardless of the level, these guys need their own tax returns, regardless of what your personal tax return will look like. Basically, S corporations don't pay taxes at the entity level like C corporations do; your personal tax rate will apply to profits you make from them. Whereas C corps have their own tax brackets just like personal taxes do except your personal life (e.g. if you have kids, own your home, and other tax-cutting situations) will not weigh in whatsoever on how much corporate income tax gets assessed.

Sound confusing? We're going to spend more time on corporations and how you treat income from them later. But the short of it is that corporate income taxes can be entity level or personal level.

Franchise Tax
Franchise taxes are charged on the state/local level. Typically, they're based on your company's right to exist or on the **capital structure**. By capital structure, this can mean how many owners of your business there are, or, if you have a corporation how many shares you currently have issued regardless of who owns them. If those things don't change year to year, you shouldn't face an exorbitant franchise tax increase. But if you issue more shares to accommodate an investor coming into the picture, that bill will usually go up. Some states and cities charge an annual franchise tax just for the business to exist, no matter what entity it is or how many owners there are.

Be careful that you pay your franchise tax bill on time and file the right forms for it. Many small businesses often forget about it and end up thinking everything is fine so long as they take care of the *income* tax filings. If you forget to pay franchise taxes, the state can revoke your permission to do business. The world needs to play your games, so set reminders in a calendar or your phone, or hire a service to have this on autopilot.

Sales Tax
Sales taxes are the bane of customers and businesses alike. The burden is on the customer to pay the tax when they buy something, but then it's on you, the business owner, to make sure it's being correctly collected on taxable items and then reported and remitted to the correct jurisdictions.

As game developers, most of you might not have to worry about this out of the gate. But if you plan on selling swag on your website or at conventions, or boxed editions of your games, you definitely have to worry about it. Even digital downloads are becoming taxable items in some states and cities, and the digital distribution platforms you sell your games on may or may not

collect sales tax for you. Nebulous rulings on digital downloads are cause for alarm: you MUST be aware of this because revenue-starved state and local governments aren't going to buy "I didn't know I had to charge sales tax" if you get audited. (Even if you actually didn't know.)

There are over 9,600 sales tax jurisdictions throughout the United States. There is no universal sales tax referendum. Subsequently, making sense of sales tax administration is like having a never-ending list of bugs you can't get out of the game even if you put my toad in the mainframe when she's hungry.

Poor handling of sales tax frequently causes small businesses to shutter at worst and face heavy fines at best. I give sales taxes their own chapter because I think it's information you should have. While a more traditional business that sells locally is more apt to run into sales tax problems, there is a lot of rapid legal and administrative change taking effect in the digital realm that is harder to apply than a purely brick-and-mortar business.

Transfer Tax

The most well-known **transfer taxes** are estate and gift taxes. Estate tax, or the death tax, is paid when you die. Federal gift taxes are paid if you give someone a gift of more than $14,000 per year per recipient as of 2015. This amount indexes every year. State gift taxes vary.

If the donor doesn't file a gift tax return and pay the tax, the government will go after the recipient if they become aware of a large taxable gift. (Fun fact: gifts given for medical and educational expenses are tax-free provided that the institutions are paid directly, such as colleges and textbook sellers, and doctors and hospitals.)

Transfer taxes, as well as transfer benefits and exclusions, can also apply to businesses. That's a heavy-handed topic a bit out of this book's scope. But to give the *5 Second Movie* version of it, if you already have a business and want to start a new one, such as if you get an investor or otherwise change/divest ownership, but there's things like IP and cash to transfer, you may be in store for transfer taxes if you're not careful.

However, gift taxes deserve a mention because they have been brought up both in legal and taxation discussions on crowdfunding. When we get into the methods of funding a game, there's a chance you might be dealing with gift tax avoidance to some extent, which will be covered in the next chapter. I'm not going to discuss estate tax, as it's too morbid even for my taste, only affects about two percent of American taxpayers, and if you inherit money, there's no tax on it.

*　　*　　*

So while that's not every single tax type under the sun, these are the types you should be aware of in having your own business. (Which you do, even if you're just coding for hire or making games as a one-person show.) You'll be picking up other pieces of tax lingo throughout the book, too, but it's important to make the distinction between these different tax types because you'll have to deal with each type differently. Some, you won't be able to avoid getting burned on, but you can successfully avoid others. Contending with taxes is just what you have to do when you work for yourself.

But just like the greatest strategy games of our time, you can devise a method that will get you the most points or the least damage taken. Because, unfortunately, you can’t ragequit – unless you’d like to make games from a jail cell.

Level 2: Chaotic Neutral Married (Filing Statuses)

Your **filing status** is a box that you check off on your personal tax return that indicates your marital status and/or household composition or family status.

Since this book deals primarily with issues pertaining to having your own business in the digital realm (read: strictly business taxation), depending on how you set yourself up, personal tax issues can certainly bleed into your concerns. So while I'm not going to write something about filing statuses and dependents that could rival *The Last of Us*, I'm going to do a basic overview here because regardless of what you do for a living, people frequently use the wrong filing status, which can have a massive impact on your tax bill.

Putting on our programmer hats for a second, think of filing status as declaring a global variable in a script. The filing status selected will define several local variables, some of which will be Booleans (yes or no answers) and others that will be integers. The primary local variable that the filing status affects is how much the **standard deduction** will be worth. (More on deductions in Level 5.) The next variable it affects is the number of **exemptions** you can take for yourself and your dependents. If you aren't sure who is allowed to be your dependent or which filing status is correct, you should consult a tax professional. You can also check out the IRS publications I noted in the citation section.

For simplicity's sake, I'll assume that you are filing as single for most of the scenarios. Most of the rules and concepts covered are irrelevant to filing status, but it may still come up, so I think you should know this.

Single

Unattached, no kids? Or you're unattached and older but your kids have long moved out? Your filing status is likely to be single. This is what you'll check off whether you live by yourself, with roommates, or your parents providing that you're unmarried and have no dependents.

But even if you're not actually single, the IRS doesn't recognize long-term relationships whether or not you live together. If you're not officially or common-law married, you can't file using a married status and have to keep your taxation matters separate. You are single for tax purposes.

Married Filing Jointly (MFJ)

If you are officially or common-law married, you can choose to file your taxes jointly. This causes the IRS to treat you like you're one taxpayer instead of two separate ones: your income and deductions get merged. This can have serious benefits – or downfalls.

Contrary to popular belief, it's not just higher income couples who have to worry about this. If you and your spouse both have low incomes, you might lose your eligibility for aid like the Earned Income Tax Credit even if you and your partner otherwise qualified when you filed as singles.

As a self-employed person, joint filing has both advantages and pitfalls, depending on how your spouse makes money and how much both your incomes are. If you racked up a business loss,

your spouse can essentially use that loss to offset their income, assuming they work a regular job and/or have other income surpassing the amount of the loss.

Does your spouse also make games with you? There are special rules for qualified joint ventures that you'll need to pay attention to. Normally, two spouses would be partners in a business just like two unmarried people can be. But if you choose not form a business entity, run your studio as a married couple, and you file your taxes jointly, you can do something called a qualified joint venture. There's a little more on this in Level 7.

Newlywed? Congrats. You're also treated as married for the entire year, even if your wedding was on New Year's Eve.

Married Filing Separately (MFS)
Basically, MFS is often the least beneficial filing status, but you must use it if you are separated but still legally married, or if you and your spouse voluntarily keep your finances separate. (If you are unsure of your marital status, it's prudent to ask an attorney who practices in your home state.) Some benefits are lost completely using MFS status, like the Earned Income Tax Credit, and it doesn't take much extra income to get little or none of a credit or deduction you previously had no trouble claiming under single or MFJ status.

Head of Household
Are you a single parent or guardian and the family's primary breadwinner? Don't lose out on the benefits of filing as a head of household, which is the correct status to use if you are unmarried and have at least one dependent child who lives with you most of the year. If you don't have children and are unmarried but you have a parent as your dependent, even if they don't live with you, so long as you're providing/maintaining a household for them, you can also use head of household status.

Qualifying Widow/Widower
If you were married and had at least one dependent child before your spouse died, you can use this status for up to two years after their death, depending on the age of the child or children.

* * *

That should cover the basics. I'm going to assume we're dealing mostly with single filers, but this should give a good idea of what you should research further if you're still stumped over what status to use. And remember, just because someone is eligible to be your dependent, it doesn't mean you'll necessarily be able to use a more beneficial *status* like head of household or qualifying widow.

Level 3: Deductions, Credits, and Exclusions

As we begin the game, it's time to roll some dice and figure out which benefits and shortcomings our character will wind up with!

The main tax benefits at your disposal are deductions, credits, and exclusions. You've likely heard these terms before in doing your taxes but weren't sure what the differences were. If you take a look at a blank 1040 tax form, there's a reason why it's laid out the way it is. Even though I'm putting exclusions last in this chapter, they come first on the tax form. But deductions come before credits for a reason, as you're about to find out.

Deductions

Simply put, a deduction reduces your taxable income. At the most basic level, if your income is $50,000 and you have $10,000 of deductions, you'd be taxed on $40,000. But there are two types of deductions: **above the line** and **below the line.**

Generally, an **above the line** deduction will be more beneficial to you, for a couple of reasons. First, you don't have to **itemize** deductions to take one above the line. (More on itemizing in a bit.) You just have to meet the conditions to take that particular deduction. As a self-employed person, the one you automatically get is 50% of your self-employment tax, which is based on the grand total of all your self-employment profits. If you have self-employment income and you are paying for health insurance for yourself or your family out of your pocket, you also get a valuable deduction for this.

Some other common above the line deductions include student loan interest, traditional IRA and other retirement plan contributions, and moving expenses if you've moved a substantial distance for a job.

All of these above the line deductions are also called **adjustments.** Adjustments get subtracted from your **gross income**, and this result is your **adjusted gross income,** or **AGI.** (I'm going to make quite a few references to AGI from here on out, so I'd definitely bookmark this chapter just in case.) So, adjustments are your friend.

There are many calculations in the tax code that hinge on your AGI, as you're about to see. To help illustrate this with a more detailed example, let's say that you netted $30,000 in self-employment profits and that was your only income. You are uninsured. Your self-employment tax comes out to $4,590 and you can adjust by half ($2,295.) You also paid $700 in student loan interest. Your AGI is $27,005.

Below the line deductions are calculated after your AGI. There is the **standard deduction**, then the **itemized deduction.** The standard deduction is a flat, pre-calculated amount based on your filing status but can be higher if you and/or your spouse are 65 or older. The legally blind also get a boost to the standard deduction. If you are married and file taxes separately, your standard deduction is zero if your spouse itemizes.

Itemized deductions are filed on the Schedule A form and comprise a variety of deductions that may or may not be based on your AGI. Medical and dental expenses (including health insurance premiums) are subject to 10% of your AGI, but state and local income taxes don't have an AGI limitation. If you live in a state that doesn't have an income tax, you can take the general sales tax deduction based on your state instead. But going back to our example where you have $27,005 AGI, if your total deductible medical and dental expenses for the year were $2,000? You wouldn't have enough for the deduction. That 10% is a threshold. However, if those expenses were $3,000, 10% becomes $2,701 rounded up and $299 of your medical expenses would be deductible.

But just because you qualified for the medical deduction doesn't mean it'll benefit you to itemize. The majority of people who itemize do so because they own their homes and have mortgage interest and real estate taxes to deduct in full. Secondary to homeowners, the other group of people most likely to itemize are those who have higher incomes and live in a state with a high income tax.

If you donated money or things like clothes, books, and household items to charity, you have to itemize to be able to deduct it. You should still totally support causes you care about, even if you don't get a tax benefit, and if you're moving or fed up with clutter a trip to Goodwill is inevitable. But even if you donate profusely, there's a chance that depending on what your other deductions come out to, that taking the standard deduction would still be more beneficial to you.

There are also countless little oddball deductions hidden away in Schedule A. Some of them are never claimed because virtually no one ever qualifies, but others are just plain obscure, such as the fact that if you sue an employer for lost wages or back pay, or appeal an unemployment board's decision, you can deduct your attorney's fees. It doesn't even have to be just wages or unemployment comp; so long as the income is taxable, it would count. This is common knowledge to tax professionals, but a deduction the average person rarely takes advantage of.

According to IRS.gov, two-thirds of American taxpayers took the standard deduction instead of itemizing. If you don't own your home and pay little or no state/local income tax, it's highly likely you'll take the standard deduction.

Credits

A credit is more powerful than a deduction because it is a dollar-for-dollar reduction of your tax bill. Just like how there are two kinds of deductions, with one being more beneficial than the other, it's the same for credits.

Tax credits come in two flavors: **refundable** and **non-refundable**. The credits that most people, particularly most game developers, will qualify for are of the **non-refundable** variety. This means that the credit can only be used to the extent that you are assessed income tax. Common non-refundable credits include the child tax credit if you have dependent children, and the lifetime learning credit for college and grad school tuition. So let's say your AGI is $30,000 and you take the standard deduction. With one exemption for using single status with no dependents, your taxable income is $19,850. You're assessed $2,528 per the tax table, and you have a $200 lifetime learning credit from paying for grad school. Your tax bill is now $2,328.

If we change the scenario a bit and you're qualified for other non-refundable credits that are more than $2,528, unfortunately, the remaining amount doesn't get refunded to you. So, if you had other credits totaling $3,000, you couldn't get back the $472 difference. However, depending on what the credit is, you might be able to carry it over to the next tax year like the R&D credit so it isn't entirely lost.

This means you can't use non-refundable credits against that dreaded self-employment tax even if they beat your *income* tax to a pulp. This includes the oft-discussed R&D credit. It's non-refundable, so don't get starry-eyed at the prospect of funding a game with it.

Refundable credits, on the other hand, are a huge boon. These guys will get you money back even if you aren't assessed any income tax, and can be used to offset other taxes reported on the return, like self-employment tax. The most common refundable tax credits are the Earned Income Tax Credit (EITC) and the additional child tax credit, which is claimed when you either have three or more dependent children or the regular child tax credit wiped out what you owed in income tax and the rest gets refunded to you.

It's important to know the distinction between deductions and credits because, as you can see, the ways they're applied have drastically different impacts on your tax bill. You can think of deductions as getting a promo code and seeing a reduced price at checkout, while credits are like getting a merchandise credit or gift card.

Exclusions

The best way to describe an **exclusion** is like using a Game Genie before firing up an NES game: it comes *before* you figure out credits and deductions, just as the Game Genie activates its magic before you press Start to make the gameplay easier from the get-go. Exclusions determine your *gross income* after figuring out all your sources of reportable income. After gross income, the above the line deductions determine adjusted gross income and below the line deductions determine taxable income. To gamify all that, gross income is like popping in a cartridge (plus a Game Genie if applicable) then adjusted gross income is like grabbing bonuses while taxable income is uses something of an inverse score multiplier based on those bonuses you picked up.

Despite its rank in the pecking order of figuring out how much taxes you're assessed, there's a reason I saved exclusions for last, and it's because exclusions aren't as clear-cut as credits and deductions. Some require documentation and/or may involve receiving a tax form like a 1099, while others don't. For instance, in most cases receiving a gift is not taxable income you'd need to report on your tax return. You won't get a 1099 or anything, either. This exclusion wouldn't need to be documented on your tax return or require additional forms. Whereas, if you owned your home and sold it, there are certain conditions to meet in order to exclude $250,000 of the profit resulting from appreciation in value. You'd have to report the sales proceeds, which get reported to you on a 1099 from the broker, even if you broke even or sold at a loss, but you wouldn't be taxed on the proceeds. If you did profit more than $250,000, you'd only have to pay tax on the amount over it, and this would require extra paperwork to properly claim the exclusion.

Just because something is *reported* doesn't mean it will be taxed. But there are a wide variety of exclusions that can be murky to figure out because they're not neatly listed in order for you to

plainly see on a tax form the way deductions and credits are. Some of them could apply to anyone, while others only benefit certain groups of taxpayers.

* * *

In this book, we won't be dealing with exclusions much. The emphasis will mostly be on deductions since they're easier to come up with, and with the exception of the R&D Credit, there aren't many credits that jump out specifically to game developers. But there are some exclusions here and there, which I'll show you for their pure strangeness.

So, to recap: the goal of the game is to get the lowest score possible. Deductions reduce your taxable income, which your score is based on. It's a little like the scoring mechanism in *Oregon Trail*. You know, the shorter the journey and the less resources you started the game with, the higher your final score was. (Or, like golf where you hope to get a hole in one or as few swings as possible.) Above the line deductions are more powerful because they reduce the next tier of your score base, adjusted gross income. Then, your base score is determined by below the line deductions and attacked by non-refundable credits first. After that, your self-employment tax is added to your score, but because it dodged the non-refundable credits, it's now harder to get a low score. Lastly, refundable credits take out whatever they can of your score.

Going by *Oregon Trail* score multipliers, does your score resemble that of the teacher or the banker? How many members of your party got dysentery along the way?

Level 4: Keep Records Like Developer Diaries

Exactly What It Says in the Title, to reference TV Tropes once again.

Keeping concise records is going to make your life easier – and, more often than not, your financial professional's fees lower. Any dollar that comes in or out, you want to keep track of it! Anything concerning what you spend or earn, or getting traditional or alternative financing, **record it.** Be able to dig it up easily if you have to reference it.

My old tax business was called Tax Solutions for Real People. I chose that name out of annoyance with all the small business guides out there that virtually never discussed the utter necessity of good recordkeeping and record sorting, or how being able to find things readily makes your life easier. And let's face it: real people generally aren't accountants or tax professionals who've had recordkeeping requirements and techniques drilled into their skulls for years on end.

If you have poor recordkeeping habits, now is the time to improve them. Anything pertinent to your taxes is important, but if you're self-employed and starting a formal business entity, you're going to be held to a higher standard than when the only papers you had to hold onto were paystubs and W-2s that you could usually always get a duplicate of from your employer or payroll provider if you lost them. As a self-employed person or a business owner, losing records is going to cost you more dearly. As you dive deeper into this tome, you're going to see all the ways to save money and why it's important to properly document these things and maintain good records after you've developed a solid system.

Think of all the numerous lists you have to make when you design a game: animations and sprite lists, rooms, audio assets, then the bugs you'll feed to my toad. Let's apply that skill here. Here are the kinds of records you'll need to track:

- Any expenses for making the game
- Day-to-day expenses related to running your business
- Expenses for getting and looking for work and sales
- Travel and convention/expo expenses plus things like number of days, origins and destinations, and layovers
- Major investments, such as equipment and new computers
- Amounts you pay yourself
- Amounts you pay other people
- Money earned from game sales, services rendered, etc.
- Sales of equipment used in your business, such as computers, consoles, audio equipment, etc.
- Sales of intellectual property rights and other intangibles
- Any changes in the ownership of your company
- Tax forms you've filled out or previously filed **(the last three years' worth for personal taxes, six years for business)**

But not all records are equal. Some transactions require only a receipt or maybe your charge statement to back them up, while others have a higher burden of proof and require very strong documentation. Travel and entertainment expenses immediately come to most tax pros' minds for high burden of proof because those items frequently have personal elements that cause the deduction to be reduced or totally disallowed. Compare that to, say, your internet and hosting expenses, which are more straightforward because you pretty much need to have a website and internet access to make a living in the digital sphere.

If you sell swag and have to keep track of the purchase and sale of inventory items, diligent recordkeeping is extremely important. Selling inventory is also treated differently than if you sell something you've used in the course of business, like a computer or console, which you'd also need to keep tabs on.

But before we plumb the depths of how all these different transactions get treated, it's important to keep the following recordkeeping principles in mind.

Keep Business and Personal Expenses Separate

First and foremost, keep your business transactions separate from your personal ones. If you do something as a side hustle and don't make a significant amount of money from it, this part isn't as crucial. But if you are doing a significant amount of business and want to make it your primary source of income or a major secondary source, separating business from personal finances is a must.

This means separate bank accounts, PayPal accounts, and credit/debit cards. Think about the numerous things you'd have to dig through when scanning your bank statements for business expenses: how do you know if those two transactions at Staples were for personal supplies, or which one was a business expense? If you eat outside the home a lot, which one of those restaurant or bar tabs was for a business purpose, like meeting with a fellow indie for advice or prospective client? Which one of those really high charges was indicative of buying dinner for your dev team, or a night totally unrelated to doing business where you don't remember buying shots for an entire graduating class? Sounds like a migraine to sort out!

This is why it's integral to have separate accounts for your business activity once you've reached the point that you have so many transactions, it becomes a headache to weed out business from personal.

Using your business checks, PayPal account, and debit cards instead of your personal funds means there's no headaches in separating out page after page of commingled expenses. And in the ungodly event you are audited, you can make a much stronger defense if your income and expenses are neatly kept separate. Commingled assets are frowned upon by the tax authorities and can even be treated as totally personal assets, depending on the auditor you wind up talking to.

Also? If you get smacked with bank charges and credit card fees, you can deduct them if they're solely for business accounts. You can't write them off if it's for a mixed-use account.

It's also a good idea to have separate email accounts so that you can find things more easily and build up your professional image at the same time. Your personal account has so much more to muck through; wouldn't it be a pain to look up a very common search term and find yourself digging through 5,000 results trying to find your deductible expenses?

Go Digital Whenever Humanly Possible, and If It's Paper, Try to Make it Digital
As a given, due to the primarily digital nature of our industry, most game devs don't have to worry about this as much as people in other lines of work, but enough indies use cash or wind up with paper trails to the point that it was worth mentioning.

Paper is annoying and terrible for the environment. Do your best to keep everything digital. Go paperless for your bank and charge statements, and pay most of your main business expenses online if you can. This way, you can easily search them in your email as well as the financial institution's site. Make separate folders in your business email for your different kinds of receipts, notices, and records.

But we still sometimes have to deal with paper in some capacity, such as when you have to use cash instead of a card. Some government agencies will only let you use a money order to pay for certain expenses instead of a check or credit card like it's the 21st century and this creates a more annoying paper trail to keep track of compared to pulling up a check register from your digital bank statements. If you have a lot of receipts where you had to pay cash, or documents that aren't digital by default, it's a good idea to invest in a system like PaperPort or a similar turbo-scanner device so you don't have to spend days hunched over a manual scanner. If you can't afford a system like that yet, or you don't have that many paper receipts, simply taking very clear pictures of the documents with your phone or tablet and storing the pictures in a cloud service like Google Drive or Dropbox will also do wonderfully. Receipt paper and handwritten slips fade over time, and it's also a pain digging them up; scans and photos are just fine.

Digital records are just easier to pull up and search and will save you so much time and mental anguish. We've come a long way from having to excavate filing cabinets to figure out how much we're allowed to write off. But there's still an annoying paper presence, whether we like it or not. Formulate a system that makes sense for you in how you'll deal with it. Too much paper lying around has an aggravating effect both on your business and your mental health, presents a fire hazard, and, if you're a fellow New Yorker…roaches love paper. GET RID OF IT IF YOU CAN.

When to Write Yourself an Expense Report
Keeping personal and business finances separate is paramount. But, well, real life happens: you leave your business credit card at home. Or you have to entertain an influential Let's Player and their production team, and your personal credit card is offering bonus cash-back on restaurants this month while your business credit card offers zero benefits, and you really don't want to miss out on the rewards. Then you go out for drinks afterward, and the bar's card machine is broken so you have to use cash. What to do?

Write yourself an expense report, then reimburse yourself. There are many free expense report templates floating around online that you can easily work with in Excel or Google Sheets. Label

the expenses with dates, payment method, and purpose. Then, reimburse yourself from the business funds. I myself have frequently done this when I've had store credit cards that gave discounts or I left the corporate card at home. I make a memo on the check or PayPal payment with the expense report – in the notes section if it was short, or if the report was long and has a number/name, match them up: GDC 2015, (Game Name) June Summit, and so on.

Keep this expense report handy. If you set your business up as a corporation, the IRS actually *requires* you to do this. I recommend doing it no matter what type of entity you select. So long as you have separate bank accounts, PayPal accounts, and/or charge cards, this is a best practice if you use cash or a personal card for anything business-related.

For expenses that have both a personal and business element, such as phone and internet, a simple allocation is fine without needing an expense report every billing cycle. It's pretty much accepted by the IRS to take half of your phone and internet/data package because it's become so vital to making a living in an increasingly digital world. However, if you establish a separate phone line or data plan specifically for your business, then you can deduct all of it.

Keep Multiple Hustles Separate

Just like generally keeping business transactions separate from personal ones, if you're a hustler, as most game devs are wont to be? You also have to keep the income and expenses for your multiple lines of work separate.

It need not be super granular, where you're filing multiple business forms when you're getting a few small royalty checks, or forming a new company for each line of work. But if you're making games, driving for Uber, and doing additional writing for hire, these activities are different enough from each other that you'll need to keep your income and expenses separate for all of them. In other words, don't commingle your personal gas bills with the ones you racked up on duty for Uber and driving to a convention.

Use a Recordkeeping Method That Fits Your Studio's Complexity

Think about how you code scoring mechanisms in games. You have an integer or long value used to measure the player's score. A story-driven, point-and-click adventure game is likely to have a simple mechanism with an integer value, and the score doesn't change a lot save for picking up an item or talking to an NPC. Then take a platformer that has randomly-generated levels with multipliers; the score would be a long value that is frequently changing. Follow me?

The same thing goes for *how* you keep records: is your mechanism for keeping score going to be complex or is it relatively simple?

Let's take someone who is employed as a narrative designer for a studio. They do writing on the side, getting a few gigs a year, and therefore have infrequent, sporadic transactions to keep track of. Someone fitting that description likely doesn't have to place priority on formally starting a business and opening a separate bank account. Noting expenses and income on an Excel sheet is fine if there's just not a whole lot there. They'd have the point-and-click scoring mechanism: you pick up an object or use the right object on something and you get a point.

Then, take a studio like my own, which has a corporate form and more than one owner. We not only successfully crowdfunded, we also have multiple income streams and capital sources, and several repeat and one-time payees to keep track of. This equals having a sizable amount of transactions every month. Our scoring mechanism would be something really complex, like *Heroes of Might and Magic IV.* Subsequently, we use professional accounting software for recordkeeping because an Excel sheet or two really wouldn't cut it.

…But Make Sure You're Using That Method Correctly

If you're at the point where you need a more sophisticated recordkeeping system or plan to need one soon enough, be warned that you may or may not have the right skills along with the time and energy to handle it. When it gets beyond the point of recording "I made this amount of royalties this month" or "I spent X on this conference," you might wish to take on a system that has a learning curve, such as QuickBooks.

I've had so many utterly mangled QuickBooks files wind up on my desk that if I see one more, I could give Kratos from *God of War* a run for his money with the rage storm that would ensue. Please swear upon your favorite old-school big box RIGHT NOW that if you do not have a background in accounting, or at the very least a high level of financial literacy that would lend itself to learning accounting terminology and having it drilled into your skull, you will NOT attempt to use something like QuickBooks or Peachtree yourself.

I recognize that this statement may get me some flak. If you worship Intuit, fine, come at me and tell me how awful I am for beating up on QuickBooks. But I've facepalmed over so many a FUBAR file that I feel I can't stress this enough to the average small business owner, who likely doesn't have an accounting background and is too afraid to part with their money to pay someone who knows what they're doing to help them with it, whether it's an ongoing basis or just to at least get started.

If you lack an accounting background, please don't pretend to have one in order to save money once you're at the point that you need a more robust recordkeeping system. If you start having more and more transactions as your studio grows, it's a sign that you need to get the right people involved to help you. If you (or anyone else on the dev team) has no idea what to do with the interface and attempts using it in a way that makes sense to you guys but without any idea whether it follows accounting protocol, *it's going to cause you more grief in the long run*, along with higher bills from your tax professional at filing time, because improperly-entered records are insanely time-consuming to fix. And errors mount up faster than Sonic after an eight-ball soaked in espresso.

To give some examples of what I'm talking about: if you put your own money into your business, it's not income – but I've seen it labeled that way on the files I've received. If you get a royalty check, it increases the cash account, but it IS income, not a reduction of expenses. I've also seen that error, along with some truly bizarre entries like negative receivables and recording computer upgrades as inventory, and I had to wonder how this happened.

And, once again: *Don't pay personal expenses out of the business accounts*, even if QuickBooks makes it look like you can do so neatly. This is where I'd stick that "You make bunny cry"

meme upon recalling the most garbled file I ever received, which had things like paying an Ann Taylor store credit card out of the company checking account, along with the owner's personal electric bill. No less, this is what I mean: QuickBooks files resembling the uncut version of *Caligula.* **Please don't have yours be one of them if you choose QuickBooks – or any other system, for that matter.**

Some of you may be able to properly pick it up. Some of you may not, and there is no shame in it. There are many professional bookkeepers out there, a lot of who are QuickBooks Pro Advisors. They must pass a rigorous licensing exam by Intuit and are well versed both in accounting and these programs. These fine people will happily help you for a reasonable fee for ensuring your books are done properly. Especially if you will need them on an ongoing basis.

You'll give them all of your records, like receipts, information on people you paid and how much they got, bank statements, etc., and it will be correctly entered for you, which not only saves time so you can focus on making an awesome game, but then you also won't have to answer an additional fifty questions at tax time from some poor underpaid tax professional relating to breaking down an indecipherable file, who's been working seven days a week for almost a whole fiscal quarter and just wants to lock herself in her apartment with *Magicka* and not look at another file for a very, very long time.

Yeah, don't be that person. PLEASE.

Just Because You Didn't Get a Tax Form Doesn't Mean You're Off the Hook

If you're receiving royalties from one of the major digital distribution platforms, like Steam, Amazon, Apple, Big Fish, and so on, you'll likely get a 1099 tax form. Smaller publishers and bundle organizers may neglect to issue you a form even if they should've, or if you received small amounts that went under the radar. Foreign publishers aren't likely to bother sending you anything beyond your payment. In any event, you have to keep track of these earnings and report them. It's also just a good idea to keep track of royalties that you're paid and owed in the event you get an incorrect 1099 or don't receive a royalty check you were due.

But just because you don't get a 1099 doesn't mean you don't have to report the income. Nope, you still do.

Cash Income and Payments

Cash is more common with expenses rather than income in our case. Being in a primarily digital realm, game development is a relatively cashless line of work. Most of your transactions will be digital and thus easily traceable. But there's still a lot of potential for cash transactions, like having to pay for a coffee meeting where you didn't meet the minimum to use a card, or when you're heading to a convention and end up dealing in cash with the people you're traveling with to share the costs of gas and tolls.

Past office jobs might have kept a petty cash drawer for things like food delivery and similar transactions. It can be a real annoyance to keep track of your own petty cash drawer, as it requires making a separate account in your recordkeeping system and going back to the receipts you had on hand or handwritten records. Keeping track of your own cash with the company cash

in the same wallet is a migraine waiting to happen. Don’t accidentally design a shell game out of your cash management!

Going back to the expense report advice, the best way to handle cash expenses is to use your own personal cash, make a report using receipts as backup, and then reimburse yourself. In the event you don’t get a receipt, such as if you’re on the road and leaving cash tips for hotel staff, keep a log of your cash expenses and things like gas and lodging that people frequently split. It’s easy to do this right from your phone with Google Sheets or your app of choice. Paper receipt and sales-slip books are also good for keeping written records as they occur; you can always scan them or take a picture with your phone.

My favorite method of recording cash expenses, both with and without receipts, is to pay myself out of PayPal. Once you have your business bank account set up, start a PayPal one and link the two. You can then pay your personal account from it using the no-fee option to send money to family/friends. This way is less cumbersome than writing a check and creates a digital trail that you can track down more easily than a written record.

As for cash income, it’s likely to be less frequent, but in the event you have it, you still have to report it just like your income you earn through digital means. Cash gets messy, both literally and figuratively. It’s a pain to count and deposit. And there’s a reason why cash-heavy businesses like coffee shops and laundromats are the most likely to get audited: the ever-present temptation to claim you’re making less than you really are to skimp on both your income tax bill and sales tax tally because everything is done in cash.

It’s hard to make good games from a jail cell. Don’t try it.

Level 5: Tax Impacts of Funding a Game

There's a good reason I gave an overview of the different tax types earlier: you can wind up being affected by these rules depending on how you fund your game development pursuits.

Money has to come from somewhere. Where is it coming from? Who is providing it, and what is their relationship to you? How will you be affected? I feel these are questions that should be answered before we dig into what you can and can't write off. All money is green, but the tax law affects all of these ways to fund a project.

Me, Myself, and My Money: Self-Funding, Part 1
This is the most straightforward method tax-wise. If you pull money from your checking or savings account, as far as your business is concerned, it's tax-free money, or **capital**. You own the business; putting your own money in as capital doesn't incur any taxes.

Same goes if you have multiple owners and you each put in your own money: it isn't considered income. It's capital. Doesn't matter whether it's a buck or several million.

Friends, Family, and Fools: Is it a Loan or a Gift?
If you're lucky to have financial support from friends and family, it's typically the next step in growing a business after you've put your own money in. After all, if you don't believe in your own project to put up your own funds, why would other people?

But it does raise a question: are you getting a loan, or a gift from a family member or friend? And who are they writing the check to? You, or your company?

Let's say that you formed a corporation and one of your parents wants to help out. If they write the *business* a check for $5,000 and it's meant to be a gift, the business would have to pay tax on that money if neither of your parents own any part of your company. Despite the *McCutcheon* ruling saying that corporations are people, businesses can't get gifts without ponying up taxes on them. But if your folks write that check to *you*, there's no tax because it's a personal gift and $5,000 falls below the gift tax threshold of $14,000. By *gift*, it means that there is donative intent. Read: no expectation of repayment. Having donative intent implies that it's done with the kindness of the giver's heart and aren't seeking out an unwritten revenue share, or principal plus interest (or even repayment with no interest), or that they're getting something of equal or greater value in handing over that $5,000. (The satisfaction of helping a game get made doesn't count.)

If your parents want to *loan* your business $5,000 with a clear intent for you to pay them back, you'd need to have a loan agreement and at bare minimum what's referred to as the **federal applicable interest rate**, which changes every year. Repayment terms would have to be clear, and you'd have to issue your parents a 1099 for the interest paid every year if it's more than $10. The loan proceeds are not taxable, and you'd be able to deduct the interest payments.

But because of the informal nature of friends and family helping each other out, it's important to make the distinction between whether you/your business has to pay the money back or not, and who the check is being written to. Once again, if there's supposed to be any hope of paying the

money back in some fashion, even "interest-free," or via revenue share, then it's a loan, not a gift. The gift tax rules and limits wouldn't apply.

Supportive Spouses
Hand in hand with friend and family funding, spousal support also comes into play, because there's two important considerations with the gift tax that you should be aware of: gift-splitting, and unlimited spousal transfers.

Going back to the example with your parents, let's say one of your parents looks down upon game development and doesn't want to give or loan you one red cent but the other wants to help you however they can. You're the only one who has ownership of the business. Going back to the $14,000 per-donee limit per year that I mentioned earlier, even though one parent doesn't want to give you anything, the other parent can give up to $28,000 during the year without incurring the gift tax because of the gift-splitting election. Since married taxpayers are treated as one taxpaying unit, it's basically as if both parents gave that money despite one parent not giving any at all.

It doesn't need to be parents, either. If you're lucky to have some independently wealthy friends who want to help fund you, and they happen to be a married couple, the same rules would apply.

But when it comes to your own spouse, you can make unlimited gifts to each other and never incur gift tax. Even if you file your taxes separately and otherwise keep your finances separate. If your spouse wants to give you well past the yearly limit of $14,000, they can do so and not pay one penny in gift tax or have to file a gift tax return.

Loans and Credit Cards
If you take out a loan from a bank, credit union, or alternative lender to fund a game, you don't have to pay taxes on the proceeds and can deduct the interest paid. This is relatively cut and dry.

If you put business expenses on a personal credit card and don't pay the balance, you can also deduct the interest, but only to the extent they're for business expenses. If you have $5,000 of business expenses racking up interest on the card and $2,000 in personal expenses, you could only deduct the interest applicable to the business portion. For cash advances drawn from credit cards, the same principle also applies. This is why it's recommended to have separate cards: fees and interest will always be deductible if they're solely used for business. But while commingling is looked down upon, people frequently can't get credit cards in their company's name without running it through their personal credit, so this is allowed.

However, something to be careful with regarding these borrowing options is that while you don't pay taxes on the money received and deduct the interest paid, proceeds CAN become taxable income in the event that you are unable to pay the debts and they get cancelled/forgiven. You'll get a 1099-C tax form for the amount that was forgiven.

There's ways to legally get around paying taxes on forgiven debts that are beyond the scope of this book, but I figured you should be aware of this in the unfortunate event that your game gets

trapped in Development Hell and you have no choice but to arrange debt settlement to avoid total financial ruin.

Investors
Just like with putting your own money into your business, if an investor decides to help you expand and they now own part of your company, any funds they put in will not be taxable because they're capital, not income.

Existing Royalties and Other Income: Self-Funding, Part 2
If your studio is up and running and you've already got games making royalties, or have a system going like ad revenue and affiliate marketing bringing in income to help with your expenses, it's taxable income in the year it's earned. It won't get taxed again when you set aside funds to go directly into a game.

Publisher Funding
If a publisher is paying you to make a game, it's considered payment for services and is therefore taxable as you receive the payments and any royalties/residuals after the game has been released. Even if the production gets cancelled, you still have to pay tax on the money the publisher paid to you and deduct the related expenses you had.

Business and Student Grants
With game development slowly gaining legitimacy as a medium, and video game programs cropping up in academia, there has been a significant rise in indie developers receiving grants to make games. It has led to a slew of tax implications depending on the conditions of the grant program and who the recipient is.

Generally speaking, if you're in the business of making games and you get grant funding from a private foundation, you would have to pay tax on it. But there are sometimes hidden stipulations in grant programs if you run your studio as a corporation where depending on the purpose of that grant (such as if the grant is purposely for public art or spurring entrepreneurship in low-income areas) where it can become partially or fully tax-free. The grant could also be taxable at the federal level but tax-free to an extent at the state/local level depending on who issues the grant and what it's for.

If you are a game design student and receive grant funds from your university's department to make a game primarily to contribute to the field or research new development methods, you will have to pay taxes on the income received because you are providing services to your school. There are rules surrounding the treatment of taxable fellowship grants that are beyond the basic scope of this book, but the basic gist is that more often than not you have to pay taxes unless you are using the grant funds to pay tuition, fees, and required equipment and supplies for your coursework. For example, if you received a $10,000 grant for the semester and it cost you $8,000 for tuition, you'd have to pay taxes on the $2,000 remainder even if it went directly to development costs for a department-sanctioned project.

Going back to general business grants, since game development often bleeds into technology as far as the tax code is concerned, there can be a legislative exception for your studio to not pay tax

on the grant regardless of how your company is set up. But interestingly, you will have a lot more leeway as a corporation than you would with any other business setup if you plan on getting grant funding. There are multiple complex regulations and steps involved in not having to pay taxes on a business grant that fall outside the scope of this book, but there are specific exceptions in the tax code that would make grant funding tax-free.

Incubator Funds

Incubator funding has become a popular method of funding businesses, game developers being no exception, in recent years. Depending on the terms of the program, you may or may not have to pay taxes on the funds.

Y-Combinator and similar accelerator programs that entail having some ownership in your company would basically be like having an investor; they have some equity in the company, so any cash they put in won't be taxed. But then you have programs that will give you funding in exchange for your services, some ownership of the IP, or perhaps a cut of your future royalties.

If an incubator program gives you or your business money in exchange for doing things like teaching or lending talent to the program, then it's going to be taxable. After all, going to a job is getting paid for services, and it's not that different of a concept. But if you're getting funding with an expectation of a royalty share and/or residuals from the copyright, it's a little more nebulous. Is any ownership of the company changing as a result of that revenue share? If the ownership of the business doesn't change, are there clauses in the agreement in the event of the game not making it to its release date? This goes back to the "is it a gift or a loan" debate, though generally speaking, if there is no change in the ownership, you would likely have to pay tax on the funding, but then you can deduct any future royalties paid just like you would the interest on a loan.

Crowdfunding

Crowdfunding has paved the way for so many games to come to fruition that otherwise may not have been made. Millions of dollars have been pumped into Kickstarter, Indiegogo, FundRazr, Patreon, and other platforms to fuel many game developers' dreams.

There have been a lot of interesting debates in the tax and legal communities regarding crowdfunding, such as whether pledges constitute sales or gifts. At the time of writing, there has not been any formal legislation on rewards-based crowdfunding in terms of how you have to treat pledges and how the timing of the campaign and your expenses factors in.

Basically, it's going to be taxable. You can deduct the fees paid, rewards, and other expenses incurred in running the campaign, as well as the actual expenses of the project that you're funding. Be careful in the timing of your campaign and when you plan to incur most of these expenses as opposed to when the campaign will end as well as when you can reasonably expect to deliver. All of these will heavily factor into how your taxes will be impacted by a successful campaign.

There's been debate about people pledging a few dollars or several to a campaign and asking for no rewards in return. Does that fit the donative intent of being a gift? Until legislation otherwise

says crowdfunding pledges aren't taxed, better safe than sorry: assume it will be taxable. A crowdfunding pledge is more likely to be a tax-free gift if you are raising funds for a personal cause like needing help with your rent on a platform like GoFundMe, or setting up a page in lieu of a wedding registry and not giving anything to the backers in return. If you're providing them some kind of promise, like services or handmade goods – or, in our case, a game – you're going to owe taxes.

* * *

That should cover the most common ways an indie developer is likely to get funded. There may be even more ways by the time this book is published, but those have been the most common methods that I have seen in my time in the industry and experienced myself.

In a nutshell, when in doubt, it's likely going to be taxable. But it's also important to make the distinction of whether your or company is receiving the money, and what the *intent* of that transaction is: because they want to help you, or want to get something in return?

A lot of tax law applications and audit defenses really boil down to intent, as you're going to see. But even the most plausible intents don't always mean the law is straightforward – for better or worse.

Level 6: Is Game Development Your Livelihood or Just a Hobby?

So we've covered some basic tax lingo so far, as well as how the common methods of funding projects constitute taxable income or not. But taxes aren't strictly just about filing forms and crunching numbers. There is a whole separate court just for tax matters, and upholding and appealing decisions made by the IRS merits entire libraries. This practice area is also referred to as **tax controversy**, and there are numerous firms that solely specialize in it.

There are tomes full of case law that apply. Not just for being able to properly claim credits and deductions, but also debating the intents, facts, and circumstances behind the taxpayers' decisions and how they framed their arguments. Typical courts of law have plaintiffs, defendants, and appellants. Federal Tax Court has petitioners (you, the taxpayers) and the respondent, which is the Commissioner of the IRS, then the United States if the case gets argued beyond the IRS. There are going to be many references to these cases in the upcoming chapters and the citations, in addition to Supreme Court cases and other jurisdictions for the more nebulous areas of the law that are relevant to us.

Before we dive real deep into the nitty-gritty of business entities and formalizing things as though this were a riveting dungeon map in any given *Avernum* installment – complete with stat-grinding – this chapter is devoted to a super-important distinction I feel needs to be touched upon first: the authorities stepping in and trying to figure out if this is just a fun and expensive hobby, or if you have a legit business.

Most game developers should be lucky enough to avoid needing a tax controversy expert, though it certainly couldn't help to have one in your network. I hope that no one reading this ever winds up getting a hobby loss smackdown. But it happens. And due to the extreme financial volatility the average indie developer experiences, along with many people being undecided on whether they should make games just for fun or if they want to seriously pursue it for a living, it's a good idea to familiarize yourself with the hobby-versus-business rules.

Breathe deep. Imagine it's an incredibly bushy adventure game puzzle with many layers, and that this particular game designer was such a masochist that they totally should've written *Fifty Shades of Gray* instead. (At least for better writing quality, if nothing else.) Ready?

Do You Make Games as a Hobby or for a Living? (Or Attempting to Make It Your Livelihood)

Lots of people have fun, challenging, and engaging hobbies that can frequently be expensive. Game development is no exception, even though there are lots of free and low-cost dev tools lying around these days that have made game development more accessible than it used to be. People also band together on passion projects; that's actually how my studio was formed.

Unfortunately, pricey passion projects that get drawn out for a super long time also lead a lot of people into some sticky situations with the tax authorities when trying to claim a huge amount of expenses for doing something out of love rather than the *intent to make a profit*. Since it is very

easy to rack up a substantial loss if you've got little to no income, many years of doing this and reporting it on your tax return winds up making you a stationary target for an audit, and this is something that should be of concern to every indie developer.

While there is slowly more legitimacy creeping into making games for a living, it's still not seen as real, actual work by a lot of people. You likely already know this, given the derision you probably get upon stating you're a game developer and getting the same looks people give five-year-olds when they say they want to be mermaids or cowboy-astronauts when they grow up. And unfortunately, the IRS is no exception!

Even though anyone who picked up this book knows how much eyesocket-grating labor goes into game development, to the taxman, you're just pushing pixels for the hell of it. Especially if you're not making any money yet, and even more so if you have a pretty big game in the works and it will be a *long* time before you start getting any income from it.

So now, you have to ask yourself, "Why do I make games?" And let's snap out of the more artistic and existential reasons, such as what I've written about on Gamasutra.

Do you just make games for fun and take whatever money you make from it, if any, as a nice bonus?

Is it something you do for fun but want to turn into a side business? Or is it your main source of income?

It's All in the Intent
To make a profit, that is.

Even if you make games that put artistic expression first and profit second, proving that you're in the *business* of game development is going to go a long way in case you keep racking up losses consistently and wind up being selected for an audit as a result. Does this mean that you need to give up on making the kind of games you want to make, just because another genre or monetization method is more profitable? No. But you still need to show you have the intent of doing this for money to some extent, whether you're a starving digital artist or the next Notch. If you *don't* have the intent to really make a profit, and you also have other sources of income such as a job or another business, it's going to be harder to defend your stance that any losses you rack up should be treated as business losses than hobby losses.

Business expenses themselves, as we'll be delving into later, virtually always require having a profit motive to pass the smell test with the IRS, and then with Tax Court if it gets to that point. This right here is why the need to keep good records is so dire. Expenses that catastrophically outweigh your income are common with just about every new business, but especially so with game development, since it can be fraught with protracted periods of little to no income. If it goes on like that for several years, it raises a red flag.

In examining your overall intent, there is a nine-factor test involved. These nine concepts are not of equal weight, and each has been applied to every Tax Court case differently depending on the facts and circumstances.

1. Are You Operating in a Business-Like Manner?
This doesn't mean getting up at 5AM every day and putting on a suit to design levels. But this part does mean that you don't treat making games as something you don't have to put a lot of thought and effort into aside from just making the game. You're keeping actual books and records or hiring someone to help you with that. You got a separate bank account when it got to the point that you needed one, and are doing a lot of the same things other game developers do to build up their names and get noticed. And if you're making little or no money, you're also looking at successful indies and making efforts to adopt their methods.

If you're seriously just treating game development like something you do on the side for fun, this factor will hurt you. It's best to get things formalized with a business entity and an employer ID number, have business cards and other promotional materials made, and get separate email and social media accounts, plus a website. All of these show you're not just doing this because you like making games. Putting actual branding together and separating your business from your personal social media and means of contact shows you're serious about being a game dev and want to make money off your creations. You don't have to prove that you want to make *Call of Duty* money, but just that you want to make *a* profit.

2. Expertise and Consultation
Are you invested in learning about the business environment of game development, particularly for indie games?

Zidar v. Commissioner is an oft-cited case that established simply knowing a lot about your industry and passionately being involved to some degree for many years isn't enough to prove that your venture is a business and not a hobby. Even if you've been playing games for multiple decades, worked for large and small studios, and frequently speak about games at conventions, you need to have made attempts to get to know the business end of things.

Zidar was passionate about racing cars and had been doing so since he was very young. He was an expert on racecars, and so he tried going about racing on his own and attempted to get some sponsorships. But he didn't invest any time or money into learning about the actual business side of professional racing, and it ultimately struck down his ability to absorb the consistent losses from his racing endeavor against his other income.

While it's important to know how to make good games and improve your skills in all areas of game development, it's equally important to understand the economic aspects of how to make a living as a game developer and the financial realities of indie life. Are you taking business courses, whether they're industry-specific or not? Buying books and constantly combing Gamasutra for reading material about running a business, and how to succeed as an indie? (This book counts! No one reads about how to do their industry-specific taxes for fun.) Going to conventions where these matters are discussed, like GDC and Indiecade? Are you working with

consultants who are well versed in the gaming industry? How well you understand the business practices and environment of your chosen industry also factors into defending your business loss.

And even if you don't understand the business aspects too well in real life and just want to concentrate on making a game, you still have to show that you *made some effort* to get business-like, whether it was taking classes, retaining a consultant, or buying books. Proof of making that effort works in your favor if you ever wind up fighting this issue out in Tax Court.

3. Time and Effort Investment
How much time have you put into forming a studio and making a game?

Tax Court frequently looks at whether you've quit your job to substantially work on your new business or if you still depend on other income. It's insanely hard to make a living in this business, and a vast majority of indie developers frequently need another job (or series of jobs and/or other freelance gigs) to subsidize their efforts if they lack a spouse or family member who can subsidize them. (I beg of you, if you're ever audited? Point out how common this is. Tell your tax professional so they know what strategy to take with the auditor. This factor virtually always ties in with the financial situation factor, of whether or not you were also in a position to quit your job, or perhaps had been fired and had no choice but to take on self-employment.)

Did your personal relationships suffer as a result of still having to work an outside job while you worked on your game and building your following? This is also a good defense against this factor. It's an unfortunate reality we all have to deal with sometimes; the effects that starting a business of any kind will have on your interpersonal relationships is a topic for a whole other book. But showing that your friendships or spousal relationship suffered as a result has been a valid defense.

Whether you quit your job or not, or your relationships suffered or didn't, have an idea of how many hours per year you put into the games and building up your community. Those hours are indicative of building your business plus working on the game.

4. Expectation That Assets Will Appreciate in Value
So you've made your games, and in some cases franchises, and built up your community. Do you expect them to make you money in the future upon protecting your intellectual property with copyrights and trademarks?

We all know that game sales tend to taper off after the first few months post-release. So this part hurts you. But a game can wind up having a resurgence or going viral, finding an audience long after it's been released. Suddenly, your copyright is worth a great deal of money particularly if you can milk sequels. Or if you utilize your intellectual property in other ways that consistently make you money, such as merchandising, it's a given that your intangible assets have increased in value.

But if you're not being formal about carrying on your development pursuits as a business and therefore don't bother to protect your intellectual property, it's hard to say if the value would appreciate, and this factor would rule against you if you wound up in Tax Court. Filing

copyrights, and trademarks if applicable, also goes back to the first factor, proving you have a business-like interest in protecting your intellectual property.

5. Your Success in Other Activities

Is this your first foray into indie dev life, or have you done this before with another dev team as a principal or as an employee? Have you ever gone into business for yourself period, like having a side hustle in addition to a job? And were you profitable, even if you didn't earn much?

Then, to get specific, if you've made games before, have you made games for publishers and other studios that sold well?

Fortunately, this factor is often neutral in a lot of Tax Court proceedings because a lot of people start only one business in their lifetime. But it's still on the books, so if you've had previous success, it will help your case.

6. History of Profits and Losses (3 out of 5 Year Rule)

The IRS looks at how your activity is doing in five-year intervals. If you made a profit, even just a few dollars, in three out of those five years, then your loss is less likely to get the book thrown at it.

Industrial norms are also factored in, and though game development isn't understood well by the professional sector, there is more than enough authoritative literature from IGDA, local game developer collectives, Gamasutra, and the like to prove that it can definitely take more than three years for an indie developer to turn a profit. Even the IRS has frequently cited the start-up phase as being between five to ten years or even exceeding that. If development timeframes and costs wind up spiraling out of control, defend your loss by proving it resulted from an exceedingly long start-up phase, not because you're doing this as a hobby.

Going back to the first factor, operating in a business-like manner also means you chose to abandon unprofitable methods. This really gets factored in if you have a long history. I'll even use my own studio for an example. We've decided to go in a different direction after *Mage's Initiation* by designing smaller games. Trust me, this decision was not made to make the IRS happy but to make our own bank accounts happy. We wanted to work on multiple projects at the same time that we could push out a lot faster than huge epic games that take years to finish. No less, this move would satisfy both tests. Consistent losses over a five-year period can represent just finishing up one large project before moving onto smaller projects and other more profitable methods. So, if you didn't profit in three out of five years you've been around? You'll have to prove the potential is there and that this is an industrial norm.

Once again, you don't have to prove you'll make *Angry Birds* kind of profit: just *a* profit.

7. Amount and Frequency of Incidental Profits Earned (If Any)

A bit Kafkaesque, I know. Or like one of those sliding puzzles where the piece you need is all the way on the other side of the board and there's no reset button.

The best way to prove you have the intent to make profit is to…actually, well, make a profit. Even if it's just $5. But the overall picture is looked at here, plus the five-year intervals, in determining if you have a real business or just a very expensive hobby.

But to sidestep the obvious, I looked at a couple different cases and went back to Zidar v. Commissioner. Zidar got walloped by Tax Court because his car-racing activity was seen as "highly speculative" in terms of having any ability to make a profit whatsoever. In other words, if the Court deems that there is no *opportunity* to ever make a profit, either just for you or for your activity in general, that's where you'll get a smackdown.

Fortunately, you have plenty of proof all around you that games are a viable industry and indie developers can indeed be profitable. Games in general have an extremely high potential for profit and are not speculative at all. Risky, but not speculative: look at how many six-figure and seven-figure crowdfunding campaigns for games are out there. AAA and indie development mashed up together have a larger economic output than film and music COMBINED, likely to exceed $100B by 2020. Despite the stigma we deal with? If you ever find yourself mired in Tax Court, you shouldn't to have to worry about this part.

But some studios just aren't meant to be profitable despite their best efforts. And if you're randomly selected for an audit, this factor is going to have more weight against you if the Court thinks you'll simply never be profitable, even if the intent was there.

8. Your Financial Status
This somewhat goes back to the time and money investment and whether you're going to have what the Court refers to as a "detrimental reliance" on this income.

If you're not relying on your royalties and payments for development services, how many sources of income do you have? It's a good idea to have multiple sources, but the idea behind that is you're making money off them. But if your spread is really disproportionate, it's going to hurt you if you're consistently racking up losses in making games, particularly since it's got that element of enjoyment/recreation.

Moreover, is the loss from your game development activities providing you a massive tax benefit against these other sources of income? The Court's seen it happen time and again where people try to deduct what amounts to very expensive hobbies and use them against income like a high-paying job and other forms of income that are harder to liberally take expenses against. Going back to Zidar for a second, he was making over $600,000 a year from one of his ventures, $50,000 from another. Racing cars was a fun hobby that not only lacked opportunity to make a profit, but there was no detrimental reliance on the income. The personal pleasure element was the last nail in that coffin.

Whereas in M.T. Shane v. Commissioner, Shane was of fairly modest means and didn't have a lot to lose by investing in his businesses. He earned $35,000 a year from a full-time job with occasional bursts of cash from a part-time job. The Court decided that it was highly unlikely he'd engage in time-consuming hobbies that literally cost thousands of dollars if he didn't want to make a profit.

Just like the tax clients I once served, indie developers span everyone from welfare recipients to the independently wealthy who live off inheritances or well-to-do spouses, and many in between who subsidize their efforts with jobs or other businesses. So this part varies case by case, depending on your other sources of income and/or if you have the financial backing of anyone else.

9. Recreation/Personal Pleasure Element

Okay, that sounded like one of those laughable full-motion video 3DO titles from the '90s that were only in the very back of select Electronic Boutiques. But this part is ultimately what causes a lot of petitioners to lose their appeals, either by itself or in conjunction with one of the other factors in the test: is your activity seen as a fun thing, rather than endless toil? And game development definitely is, by mere perception.

It'd be easy enough to prove to the Court that while you're passionate about making games and love working on them, you're not sitting there playing *Fallout* for twelve hours a day. The whitepapers about crunch time and the countless dev logs out there about mainlining espresso and ramen to just finally have a palpable release date will help prove this.

It's only human nature to gravitate to things you like. Hey, I like making games, ranting about indie dev life, writing from the bus, and talking at panels and game developer collectives about both of those things. I like these things a hell whole lot more than I liked being sealed in a fluorescent-lit box all day with tax forms and fax machines that predated the Louisiana Purchase. It's reasonable to expect someone is going to enjoy blogging, crafting, hang-gliding, or making games more than the average soul-sucking job.

But if you haven't formalized things, haven't decided if you really intend to make a profit, *and* game development happens to be something you enjoy? This factor will really won't curry you much favor.

How to Safeguard Yourself in the Event of a Hobby vs. Business Audit

For most of you, this should hopefully not be an issue, as you're going to get your businesses in order correctly as well as *make an effort* to make money. There's the whole act of formalizing your business, which is something a lot of creatives need to be VERY careful with, since folks like us can become easy targets without even realizing it. But if you're coming up short year after year, you need to be mindful about your intents as well as getting all the correct paperwork in order.

I'll be frank: going back to the financial status factor, higher-income singles and couples need to worry about this more than the poverty-stricken indie living hand to mouth or subsidizing their efforts with a lower middle class job. However, going by cases like Shane and the dismal success rate for fighting the power on hobby vs. business cases? Everyone is fair game to get smacked with an audit.

Here's what you can do to minimize your risk and get it together.

- *Formalize your business.* Form an actual entity and get a tax ID for it, open a separate bank account, figure out a recordkeeping mechanism, and have something of a business plan even if it's just some scribblings in a sketchbook or a Google Doc and not a high-level, multi-page document from a consultant. We're going to cover entities and formalities in depth in the next chapter to get this part under control.
- *Get a website.* A nice-looking one with a slick design that fits your studio's style. It's a good idea to do so anyway for the sake of building up your brand, showcasing your work, and giving your fans a place to go, but it also shows you've made an investment in yourself. While lots of hobbyists have websites, having a very professional-looking one helps prove you are serious about making games for a living.
- *Keep good records.* There are so many reasons for this, and proving you have an actual trade/business is one of them. Hobbyists keep minimal or no records. Are you a hobbyist or a serious indie developer? (Hobbyists trying to transition count as "serious indie developers.") For the records beyond receipts, mileage logs, and so forth, this is why it's a good idea to have a separate email address for your studio if you don't already get one through your website. Being able to pull up proof of industry communications and all the time you're putting in can be done simply through a comprehensive email search. Spreadsheets also help to keep track of your activities, such as meetings you had with other people in the business and what you did or tried to accomplish. One of my colleagues even has a whole spreadsheet where he inputs the information from business cards he collects at every event he attends, along with what he remembers discussing with that person. Not only is that a great way to build up business relationships and collect emails for your mailing list, but it's also perfect proof you do this for business and not as a hobby!
- *Make efforts to learn more about the business environment of being an indie developer.* If you don't live in an area that offers good indie dev culture or appreciation for the games industry and therefore don't have something like a local IGDA chapter or a collective like Playcrafting, there's plenty of consultants like myself who will happily work with you over the phone or Skype, Hangouts, et al. There's also lots of free articles, blogs, and postmortems about the business side of game development available on Gamasutra. Bookmarking them always helps.

So What if Game Development IS Just a Hobby to You?

You still have to report the income. However, there's two sides to this.

One upside is that you won't have to pay self-employment tax on the income, like you do when you have business income as an owner, principal, partner, or what I refer to as solo-preneur.

But you can't easily deduct your expenses. You need to:

A) Take the itemized deduction, but you can only deduct expenses to the extent that they pass 2% of your adjusted gross income, and
B) The expenses can't exceed your hobby income.

Let's say that you have a full-time job that pays $60,000 per year, and that is your only income aside from your game development hobby. You make games for fun and don't intend on making a business out of it. Working by yourself in a free engine, you incurred zero dev costs. A

sponsored game jam a few states away is giving out cash prizes to the coolest and most innovative attendee. Your game wins! You get a $1,000 prize and spent $400 in travel and lodging to attend the event and submit your game.

Had you officially been in the trade, your $600 profit would be subject to self-employment tax of $85. Then, 50% of it ($43) would reduce your adjusted gross income (AGI): $60,000 + $600 - $43 = $60,557.

But as a hobbyist, you have to add the full $1,000 into your AGI: $60,000 + $1,000 = $61,000, so 2% of your AGI is $122. If you took the standard deduction, you're screwed, as it makes no difference whether you had hobby expenses or not. If you itemized, you could only write off $278 ($400 hobby expenses - $122 threshold = $278). The higher your AGI, the less you're able to write off for most items with the itemized deduction.

Now imagine if you had just pushed your game onto any of the major platforms after the success of the game jam, and it winds up becoming the next *Flappy Bird.* Your royalties suddenly eclipse what you make at your job, or come close to it. It opens a lot more debate between Tax Court arbitrators and controversy experts for whether amount of money that large is really just an expensive and shockingly lucrative hobby, or if it's a business – or perhaps the start of one. But despite the pain of self-employment tax you'd have with that amount? So many beneficial deductions and credits hinge on the adjusted gross income, which business expenses help knock down while you can wind up dead in the water on hobby expenses.

*   *   *

I think that most people who picked up this book are serious about making game development into a business and have plans to rely on it to some extent. But just in case you change your mind or wind up consistently racking up losses, it's important to know the distinction the IRS makes about hobbies compared to businesses.

Now, we're going to discuss entities and how to get those pesky formalities out of the way.

Level 7: Business Entities, Formalities, and Setting Up

When you're starting a new business, or have been doing something for a long time like working on games but never formalized it, one of the most pressing issues in deciding how to proceed is deciding what **business entity** is right for you.

A business entity is the structure that your endeavor will take. It's set by a binding document that is sort of like your company's birth certificate – it determines how it will appear on official documents and also how it will be taxed and regulated.

Most entities are what are called **flow-through entities**, meaning that whatever income the entity earns will flow right to you, the taxpayer, so you have to pay taxes at the *individual* level. The same goes for racking up losses and, depending on what type of entity you have, items like gifts to charity and nondeductible business expenses, and capital gains and losses, which get different treatment than normal business income.

Indie Developers Are Primarily Non-Employers
This is actually a distinction that the Small Business Administration (SBA) makes, not the IRS. Most indie developers fall into the **non-employer** category of small businesses; it means that you generate at least $1,000 in revenue per year and have no employees, regardless of how many principals/owners there are and how many contractors you pay.

While not a formal entity type, you should definitely become familiar with this term because I'm going to use it a few more times throughout this book and the SBA estimates that about 75% of *all* small businesses in America are non-employers regardless of what entity type they've chosen. This would encompass *anyone* who has some self-employment income or loss that they're reporting so long as they had at least $1,000 in receipts/1099s and never bothered to set up a formal entity because it's a side hustle to them. So the statistic about 75% of all small businesses is honestly a little misleading on their part.

Still, this is an important term for you to know. All business entities can choose to be non-employers, and if you want to work by yourself and never need to file employee or contractor payroll forms, you have the option of not bothering to create an entity. But if you want to join the 25% and hire at least one employee in the future or right out of the gate, forming an entity beforehand is going to save you a lot of headaches.

Whether you're going to hire employees may also factor into which entity to set up – not so much for tax concerns, but for liability reasons: you the employer are held liable for the actions of your employees, so an entity that provides more shield from liability like an LLC or C corporation would be preferable.

However, your tax situation will still drastically change when and if you hire employees. You will have increased tax obligations resulting from payroll taxes – primarily your share of FICA as well as 6% in federal unemployment insurance, and this isn't counting state and local taxes – as well as additional administrative burden on both the federal and state (and possibly local)

levels, like the filing of quarterly payroll tax statements. Your life will look like *Papers, Please* if you don't have the right professionals in your corner helping you out with this.

Also, you can always kill off your current entity and start a new one down the road if need be. Depending on how many years you've been in operation and what income, expenses, activities, and how many employees you have, doing so can be a cumbersome and expensive process. But many companies do this to reflect changes in ownership or in personal finances, either or both of which have made a different entity type more favorable. Switching from being a non-employer to an employer or the other way around are also valid reasons for winding down and starting up again.

Most of us are non-employers and plan on staying that way, from what I've seen. It's very common for indie developers to have strong relationships with the people they make games with, but on paper you have a payer-contractor relationship and satisfy the requirements we'll be touching upon later. Non-employer or not, though, having employees is merely one factor that goes into choosing the best entity for your operation.

Sole Proprietorship (No Formal Entity)

If you are self-employed and never set up a formal entity, you would be what's called a **sole proprietor.** It's just you who owns the ship and runs it, even if you have employees. You report your income and expenses on a form called Schedule C that goes with your personal federal tax return, and your profits are subject to self-employment tax.

If your operations are still pretty small, you don't have many transactions yet and don't plan to in the near future, or you don't want a whole lot of administrative burden to deal with, sole proprietorships are frequently the way to go. When you're starting to make more money, other entities become more preferable because self-employment tax can take a massive bite out of your earnings.

Self-employment tax won't be your only concern, though. Most of us indies are reinvestment sorts. A game that sells well easily self-funds the next game, either in whole or part. Because you are taxed *entirely* on whatever profit you netted, this means that if you didn't pay yourself all of it, you'll be in for some disappointment. For instance, if you operate solo and your studio makes a $200,000 profit off a game that goes viral, but you only drew a $40,000 salary, you still have to pay taxes – both income and self-employment taxes – on the full $200,000. You can't deduct the amount you pay yourself under a sole proprietorship. That could put a serious damper on your plans to self-fund your next title.

Just as I mentioned in the hobby loss rules, racking up a **net operating loss** means that you can use the loss against your other income, thus reducing your adjusted gross income, which can provide significant tax savings but also put a target on your head for an audit depending on the size and frequency of the loss(es). These losses are often racked up through a sole proprietorship on Schedule C.

Qualified Joint Venture (Married Couples Who Don't Form an Entity)

I briefly touched upon qualified joint ventures (QJV) early in the book when discussing filing statuses. Having known many husband-wife dev teams, I figured this topic was worth bringing up.

A QJV is basically the exact same thing as a sole proprietorship except that the only condition you can use this status is if you have two spouses co-owning the business and filing a joint tax return, but don't form an actual entity. Married couples working on the same business frequently make the mistake of filing a Schedule C where only one spouse is reporting the profit and therefore getting credit for the FICA taxes paid. By doing a QJV, you simply tick off a box and both spouses will be credited for those taxes without having to form a partnership.

But you're not allowed to have an entity at all. Since you can't even have an LLC as a QJV, the only advantage to doing this would be if you are really not making any money from your studio yet and need to cling to every penny because this will save a married couple's business a lot of administrative burden.

Limited Liability Company (LLC) and Default Rules

LLCs have some blessings and curses. For business formality purposes, it's a great way to get something going with pretty minimal formality in most states. Many people opt for LLCs because they have less administrative burden than a corporation or partnership, but more flexibility than having no entity at all.

But in terms of taxation, LLCs are fairly amorphous. They are what the IRS calls a **disregarded entity**, in that they do not recognize LLC status. Most states don't, either. When you form the LLC, you must choose how it's going to be treated for *tax purposes*. Under the default rule, a single-member LLC is taxed as a sole proprietorship unless you choose to be taxed as an S or C corporation. LLCs with two or more members are taxed as partnerships under the default rule and also must make an election if the members wish otherwise.

If you want to be taxed as a sole proprietor, then you don't need to do anything after forming the LLC. But if you want to be taxed as one of the other entity types, you will need to file an entity selection form. You'd get the same tax treatment as an S or C corporation. Depending on your situation, this might be beneficial, as it wouldn't have the additional administrative and formality burdens of having an actual corporation. But it can also wind up not saving you that much money or hassle, so you definitely want to be careful when it comes to bucking the default rule.

Depending on what your concerns are with shielding yourself from liability and what your state's rules are, LLCs might not provide many benefits or elimination of much administrative burden. But for federal tax purposes, they're not recognized, and you have to choose how you'll be taxed.

Partnerships: Structure, Basis, and Limits

Partnerships are formed between two or more individuals or other business entities. Pure partnerships are pretty rare in the gaming industry: LLCs and corporations provide more fluidity in case ownership changes, and they present many complex taxation issues that make people gravitate to S and C corporations because while also being complex, they frequently offer more

benefits than partnerships. Partnerships also have to dissolve in the event a partner dies or wants out, or one or more new partners enter the picture. A whole new partnership must then be formed. However, many studios are formed as LLCs then taxed as partnerships if there's more than one owner, so the following certainly does come up if you choose an LLC.

Each partner (or member, if an LLC) reports income or loss according to their ownership percentage, referred to as partnership (or LLC) interest. ***(For simplicity's sake, I'm using "partner" from this point onwards.)*** Unlike a sole proprietor who will report all of their expenses right on their personal tax return on Schedule C, the partnership will report all income and expenses at the entity level on an information return form for partnerships or LLCs taxed as such. Then, you receive a form called a K-1 that explains how much your share of all of the partnership's activities is worth.

Partners also have to deal with the concept of **basis**, which comes up in several practice areas of tax law but in this case refers to how much cash and/or other property the partners have invested into the business. Partner basis must be recalculated at the end of every tax year, as well as before sale or disposition of the interest. **Basis should be noted on your K-1 every year.** Think of it like a cumulative score that carries over from one level to another perpetually.

So let's take this year. At the beginning, you put $10,000 of your own cash into the partnership's bank account upon starting up. This increases your basis by $10,000. Basis also increases whenever there's a profit, by whatever your share is. So if you own 50% of the partnership and it makes $5,000 in profit, your share is worth $2,500. This increases your total basis to $12,500 by year-end.

Conversely, losses decrease your basis. So if that $5,000 was a loss instead, your basis is now $7,500 after your share of the loss.

Remember what I said above about drawing your own money and having to be taxed on the profit even if it majorly exceeds the amount you withdrew for personal use? It's pretty similar for partnership interest. Going back to the first example, with your studio posting a $5,000 profit, you'll still have to report the full $2,500 on your tax return. Since expenses are reported at the entity level, you can't take anything else off and must pay self-employment tax on this amount. Even if you didn't withdraw anything! But if you had a loss, that would be weighed against your other income just like a sole proprietorship loss would.

However, if you have a sole proprietorship, then you have the advantage of being allowed to withdraw however much cash you'd like, because you're always taxed on whatever profit you earn regardless of how much you pay yourself and how much you initially invested. If you take out more than what you earned this year, it doesn't trigger anything. On the other hand, partners have consequences for taking too much money out, depending on what their basis is. These withdrawals are called **distributions** and they reduce basis. If you have a positive basis both at the beginning and the end of the tax year, this isn't that big of a deal. Assuming our $5,000 profit and 50% ownership once again that leads to a $12,500 basis, let's say that you receive a $6,000 distribution for living expenses. Your new basis becomes $6,500.

While the $6,000 distribution is reported on your tax return and happily sitting in your bank account, only $2,500 was taxed. Unfortunately, the same would also rule true if you took out absolutely nothing: partnership income is taxed *as it's generated*, just like a sole proprietorship, except that you now have the annoyance of basis to deal with.

Now, we're going to up your distribution to $15,000, since you found the home of your dreams and need a down payment. This distribution completely wipes out your $12,500 basis and actually leaves you with a negative basis to the tune of $2,500. That $2,500 in the red is now a taxable gain, so you'd have to report not only your $2,500 profit share but an additional $2,500 as capital gain income.

And these are just the simplest and most common basis issues you're likely to deal with. This is barely the tip of the iceberg!

There are other things that affect basis, so if you want to do an LLC taxed as a partnership? Grill your prospective tax professional on how well they understand partnership taxation and request that they do a basis calculation for each partner at tax filing time every year. Whether you stay with the same firm or eventually switch professionals, you're going to be very glad you did this.

There are also **general** and **limited partners** when it comes to partnerships. Most of you would be general partners, in that you spend a considerable amount of time on the studio and have an active role in its operations. Limited partners would be investors who don't **materially participate,** which is IRS lingo for that preceding sentence. Limited partners can be friends or family members who put up funds to help you, or professional investors. This brings in the **at-risk limitations** for partners like these because a business you don't have an active role in is considered **passive activity** and deducting losses is extremely limited if not completely disallowed. Limited partners generally can only take a loss to the extent of their investment (basis) in the partnership, while general partners can take their share of losses in full.

I wasn't kidding when I said partnerships are killer. They'd make Guiles weep and probably not proud to be an American.

S Corporations: Benefits, Limitations, Reasonable Compensation Rules

S corps have become a very popular form of business in recent years because while they're flow-through entities just like partnerships and sole proprietorships, they have the unique aspect of profits being totally exempt from self-employment tax.

Don't get too excited yet, though. S corps also frequently come under scrutiny because of the reasonable compensation rules and having to open a payroll account to pay yourself and the other officers with, because corporate officers are treated as employees. This means dealing with payroll taxes and the administrative burden of having employees, including having to buy workers comp insurance. **Yes, even if it's just you. Even if you want to remain a non-employer.**

The reasonable compensation rule states that you have to pay yourself a salary similar to what someone doing comparable work and holding comparable credentials would be earning, further shaped by facts and circumstances of your business environment.

To exemplify that in English, a full-time programmer where I live would easily receive $80,000 a year, along with another $20,000 worth of benefits. So, if you have a comp sci or game design degree and do most or a significant amount of the coding, your reasonable compensation would be $100,000.

In my partnership example, a $5,000 profit is exciting news for that particular dev. I think it'd be reasonable to expect that you wouldn't draw a salary period, let alone a $100,000 salary, if we looked at the profit alone. Going by indie norms, the general consensus is that you pay yourself whatever you can afford. But many of us frequently opt to hold onto most of our profits in good times to self-fund future games. That means paying ourselves a modest salary relative to our credentials and what a decent local employer would pay, like $30,000-$50,000, in comparison to that $100,000 estimate. Holding funds for reinvestment would constitute a reasonable circumstance for giving yourself a low or non-existent salary.

Reinvestment aside, you should have an idea of how S corporation profits get taxed.

Let's give our S corp dev happier circumstances than our partnership example: two people with 50/50 ownership make a game that winds up becoming a major hit, posting a $400,000 profit before officer compensation is considered. You pay yourself $100,000 and your CFO gets $80,000, leaving a $220,000 profit.

The S corporation paid the employer's share of payroll taxes of your salary and you pay the employee's share. Your $110,000 share of the profit is NOT subject to self-employment tax, but when combined with your $100,000 salary, it can still bump you to a fairly high tax bracket. Avoiding self-employment tax is frequently why people choose S status, which makes drawing a very low salary appealing, but you'll be taxed on your share of the profit regardless of how much is made.

If you have a net operating loss, the loss will also go in your favor, just like it would if you had a sole proprietorship. But depending on how it comes out on paper, you might still be subject to reasonable compensation requirements, especially since being able to rack up a loss may also give you more incentive to give yourself a salary, depending on what the corporation's income and the rest of its expenses were like. There is a sharp contrast with C corporations when it comes to choosing how to pay yourself in this regard.

S corps also have restrictions as to who is allowed to start one. Only US citizens are permitted to be S corp shareholders and you can't have more than 100 shareholders. (You also can't form a dummy corporation or LLC and buy S corp shares with it.) The 100 shareholder limit might be not be of concern to most indie developers unless you plan on getting an investor and/or going the equity crowdfunding route, but if you have offshore team members this is definitely of concern to you. You'd have to go with a partnership or an LLC taxed as one, or a C corporation.

Something else you might want to be aware of is whether your state or locality recognizes S status. Where I live, in New York City, New York State recognizes it but the City does not, meaning that the City will tax it as if it were a C corporation.

C Corporations: The Truth About Double Taxation, Benefits, and Pitfalls

C corps get a lot of hate in the tax world. You yourself may have been scared out of starting one if you've already this discussion with a lawyer or accountant.

C corps do have some disadvantages, such as having a higher administrative burden overall than the other forms of business organization. But the biggest and most profitable companies in the country are C corporations. If you have the right people and planning on your side, C corporations can be an enormous boon to you, but this type also comes with more pitfalls than *Dark Castle* if you're not careful.

C corps might also be your only option if you plan on starting a bigger company and you can't meet the S status criteria, such as if you have a dev team member who is not a US citizen. If you plan on growing your business and would like to get an investor on board or do equity crowdfunding, C status is definitely more attractive than S. Directors must be appointed when you have a corporation to decentralize the management, but if you have a **closely-held corporation**, which I think is the case for a vast majority of indies, so long as at least 50% of the stock is held by five or fewer individuals you don't need to have a board involved.

Unlike all the flow-through entities we just went over, C corps are their own entity, meaning that whatever happens with them stays on their own tax returns. If you take out any salary, you are only taxed on what you withdraw. What the C corp earns will only affect your tax bill if you receive income from it. If you take nothing out, your personal tax bill is unaffected even if it posted a massive profit.

Going back to our successful developer example, where two people have 50/50 ownership and post a $220,000 profit after expenses and salaries, all you would be taxed on is your $100,000 salary, assuming you received nothing else from the corporation. However, the corporation does have to pay tax at its own rate on the $220,000 profit. This is the infamous double taxation aspect of C corps that makes people run like they just saw a copy of *E.T.* for Atari.

On the flipside, though, unlike an S corp, if the C corp racks up a loss you can't write it off your personal taxes because once again, the income and loss doesn't directly flow through to you. You'd still owe taxes on that $100,000 salary you received whether the corp was running in the red or making money hand over fist.

Officers of the corporation also have to be treated as employees for tax purposes. This means you still have to buy worker's comp and pay into unemployment even if you live in a state where you will be straight up denied unemployment for owning a business. But if you stay a non-employer and/or your business income is relatively sporadic, you can declare yourself 1099 so long as the pertinent payroll taxes (read: self-employment tax) get paid in full.

Eventually, when things pick up, it may be time to open a payroll account, depending on how much you'll be paying yourself. One advantage C status has over S status is that the reasonable compensation rules don't come into play, so if you want to pay yourself a low salary for reinvestment purposes, or you have a reason for reporting low income such as trying to retain eligibility for housing or developer grants, C status might be the way to go. You have a lot more leeway when it comes to financial planning both for your studio and for your personal finances to figure out which tax bracket you'd fall into for both.

Dividend payments also come into play with both S and C corps. Dividends are earnings that you receive when you own stocks; as the owner of your business, you might own 100% of the shares in your C corp or a certain share of them. If you have a brokerage account or retirement investments, you've probably seen dividend payments on the statements. Dividends are based on profits, so when you set up your articles of incorporation, you need to define your dividend policy, such as that dividends will only be paid if the company posts X in profits. (Fun fact: dividends and capital gains have a 0% tax rate at the federal level if you fall into the lowest two tax brackets. Keep this in mind if you'd like to throw money in the market, or how you plan on setting your dividend policy.) Dividend income is also not subject to self-employment tax.

As I mentioned way at the beginning, dividends are taxed at a lower rate than what you'd earn from wages or 1099 payments. But unfortunately, you can't deduct dividend payments from the corporation's tax return like you can with the salaries. And while there's no reasonable compensation rule with C corps, they have the inverse problem of the IRS determining if the officers get paid *too much* for the sole purpose of being able to write the salaries off the corporate tax bill, because personal statutory rates are often lower than the corporate ones. So the IRS will recharacterize some of your pay as a dividend, which means that you'll pay a lower personal tax rate on that portion, but then the corp can't deduct the payment. Going back to the same example of the successful indie with the $220,000 profit, assuming that no dividend policy has been set or it has a relatively low threshold such as it must reach $100,000 in profit before dividends are paid to the shareholders, the profit would be split 50% between you and your partner, so you'd both have to report a $110,000 dividend on your personal tax returns.

It's important to keep track of your dividend policy because refusal to pay dividends out over a protracted timeframe can wind up getting you smacked with the **accumulated earnings tax**, a 15% flat rate tax on accumulated cash that only applies to C corps. Don't worry about it too much though. Not only are we the types who reinvest significant sums into new games and IPs, but if you've been consistently paying yourself a modest salary every year and manage to save up a six-figure reserve, you're not that likely to get an accumulated earnings audit.

A disadvantage that C corps have when compared to S corps is also that income will lose its **character.** Dividends, capital gains, earned income – doesn't matter when it's a corporation. It's all going to be taxed at the same ordinary rate. For game developers, this isn't that big of a deal, since we are not a very capital-intensive business with hundreds of thousands tied up in equipment and buildings that constantly get bought and sold. If you're a console developer, or perhaps in the audio track, this bit may be of more concern to you than to the majority of us who flit in and out of coffee shops and co-working spaces with laptops and tablets. If you also plan on buying and selling IPs, you'll want to bear this in mind. If you're a solo developer and buy a

copyright for $5,000, and it then winds up fueling a viral game so a publisher offers to buy it from you for $100,000, with most of the entities the $95,000 capital gain would pass onto you and be paid at the preferential rate on your personal tax return. With a C corp though, it would just get reported like any other kind of income that the business earns. The only exception to this is dividend income: if the corp buys into other corps: it gets a *deduction* for the income!

But remember those pesky hobby loss rules that cause massive headaches and thousands in penalties and lawyer fees? They don't come into play when you have a C corporation. Part of this is because corporations are harder to navigate, bureaucratically speaking, and someone who's just doing it for fun is really not at all likely to subject himself or herself to the barrage of paperwork involved. But moreover, it's because when a C corp racks up a loss, it doesn't transfer directly to your federal tax return. You can choose to carry the loss forward, or carry it back. So if you anticipate a good year the coming year, carryforwards are great. Carrybacks would be more convenient if last year was your good year and this year tanked. While you couldn't use that loss against your other personal income, at least you won't have to pay any corporate income tax.

Formalities

Depending on the state where you set up your business and what entity it is, you're going to be subject to some kind of formality. We went over a lot of the basic formalities, such as keeping good records and forming an entity, as well as establishing a presence with separate bank accounts, emails, and a website.

Tax code formality means that you are observing those mundane little rituals such as having meetings and keeping minutes. Corporations have the largest formality burden because if you fail to observe certain formalities, you can have your corporate status (and thus all the relevant benefits) revoked.

If you've set up a corporation, you've likely seen all these different appointments to be made: treasurer, secretary, chairman, and the like. Since most indies are closely-held corps and don't need to worry about this, you'd just need to appoint the person who is primarily responsible for handling the business side of the studio. (Or yourself, if you're a one-person operation.) But depending on the state you set up in, you might have to hold an annual meeting where you discuss the state of affairs and have the secretary keep minutes. This could easily be done over beer and nachos at the local pub, using a napkin then snapping a picture with the phone, if you've got nothing important to discuss and think it's pointless and taking away from development time. But if you plan on making some serious changes to the company, like giving shares to a new team member, changing appointees, resetting your dividend policy, and so forth, then you'll need to keep better record of it on something that can actually be read and easily found again and referenced. If your studio is starting to make good money and you want to raise the dividend policy so that you don't automatically pay all the money back out, you'd note in the minutes how much money you plan to allocate to a new game or project to keep the accumulated earnings tax monkey off your back.

Obviously, keep good records, no matter what! But you'll want to bear this in mind if you go for a corporation, because they can provide you some significant benefits, but this is one of the

downsides. Hey, is a meeting over good food and beer or maybe Hangouts really that bad of a price to pay for being able to decide when and how much to pay yourself?

Employer Identification Numbers (EIN)

After you've applied for your incorporation papers or operating agreements, you need to get an EIN.

Most incorporation platforms will offer to get you an EIN as part of your startup package for anywhere from $35-200. Don't do this! Once those papers are in your hands, go to irs.gov and simply choose what kind of entity you have. There's a few other questions to answer, but you should have an EIN in less than five minutes. There are plenty of other times you'll need to hire professionals for your tax matters, but getting an EIN is easier than a hidden object game with halos on all the items.

You not only need an EIN to hire employees and issue 1099s to contractors, but even if you're a non-employer it's just going to make your life a lot easier to have things like your new bank account and publisher accounts, plus 1099s for royalties and work for hire payments, routed to the EIN instead of your Social Security number.

Industry Codes

Despite how much video games now eclipse film and music combined, we don't even have our own industry code!

When you go to file your business returns, you have to use a code that best describes your business activity. This doesn't sound like a big deal at first, but it would be nice if game developers could actually have their own industry code for statistical tracking, such as how much the average game developer spends on things like meals and entertainment and general supplies, and how sharp income and loss swings are year-over-year. Also, certain creative safe harbors in the tax code disallow certain industry codes which include the one I'm about to recommend because it fits game devs best so this bit is still pretty important.

But we don't get a special code that would help with this. Nope. We're lumped in with every other software publisher, regardless of if you are fully indie or rely on publishers. Or what kind of software you actually make. Our spending and earning habits differ so much! It's not fair, but it is what it is.

So when you're sorting through that massive list trying to figure out what code we fall under, 511210 for software publishing is usually a good catchall. This is the same code Activision and EA use, even though we don't just make software; we make cinematic software, which could fall under film and art! Why DON'T we have our own code?

I can't believe the IRS makes a distinction between whether laundromats are coin-op or not, and still has active codes for blank videotape manufacturers, but game developers don't even get their own code.

*　　*　　*

This should give you enough of an idea of how the different entities work, at least at the federal level. Whether you decide on your own or with the guidance of an accountant, lawyer, or consultant, pick the entity that seems like it’d be the best for your current and near-future needs. Don’t think TOO far into the future, because if something changes you can always wind down the business and start a new entity.

There’s a learning curve to starting a business, but once you do it at least once, starting a new one isn’t as difficult. So long as you keep good records and have a strong information system in place, you should be fine.

Level 8: The Load Screen, Start-Up & Organizational Costs

Before we get to the meat and potatoes of your business expenses, there's the whole shebang of start-up costs. These can either be like a fantastic leveling-up bonus or a piece of utterly masochistic design like that boss battle in *Heroine's Quest*. And it requires a slightly different hat than the one you'll be wearing for thinking about your regular business expenses.

This? Is the load screen. This is what goes down before the game actually begins. You have opened it, but not actually played it. Though I know you want to play.

Let's press Start.

Recovering Start-Up Costs

Think of a game that has fighting mechanics where you and/or an enemy can regenerate health or hit points. Preferably something turn-based like *Heroes of Might and Magic IV*, or perhaps *Adventure Quest*. We're going to get more into **cost recovery** methods in the oncoming chapters since there's different rules of varying complexity that will apply to you depending on what you buy for your business, but there's a cost recovery move with some stipulations that you need to be aware of first.

The term **capital expenditure** also gets bandied about if you're talking to tax professionals or trying to decipher IRS publications. A capital expenditure is something subject to cost recovery rules and methods, in that you can't just write it off all in one fell swoop. This would cover big-ticket items like equipment and vehicles, or things like patents and other assets that are expected to have a pretty long life. So for most of us indies, this is stuff like computers, tablets, peripherals, consoles, and other such equipment we need to make games. We're going to discuss the treatment of these later on, but the short version is that you can recover the costs of equipment in full either by electing to expense it if you're qualified to, taking the depreciation deduction every year for its life, or if you sell it.

Your start-up costs are also considered a capital expenditure because you might not be able to write them all off in one shot (depending on the amount) and you can only recover them in full if you sell your business, go out of business, or take the deduction for it for 15 years.

Using *Heroes of Might and Magic IV* as an example, if you cast the Poison spell on enemy parties, they would be afflicted with X points of damage every turn based on the Hero's skill level until they died or the spell wore off. Let's say you have a Hero with very strong Death Magic skills, so their Poison spell lasts ten turns, and an enemy army only needs seven turns to die, assuming that they stay on their side of the map and nothing else happens to them. That's pretty much how amortization works. Then, for the army closer to you on the map, you strike a devastating melee or ranged blow, or perhaps cast a spell like Ice Bolt or Magic Fist, which is one large amount of damage done in just one turn. And that's how expensing is. Expensing is done in one turn. Amortization is done in several turns. One tax year is a turn.

So what constitutes a start-up cost?

Start-Up and Organizational Costs

If you have not earned a single dollar yet but have a whole bunch of expenses, like buying office supplies, renting co-working space, a new website, and so on, these expenses are referred to as your **start-up costs**. Expenses in forming your actual business entity are called **organizational costs**. This would primarily be legal expenses and incorporation fees, whatever you paid to actually "give birth" to your business entity as opposed to expenses that could've happened before or after you formed it.

You can expense up to $5,000 of these costs, meaning that you'll get an immediate deduction for them. Whatever exceeds $5,000 would have to be amortized over a 180-month (15-year) period. You can elect to amortize all or most of your start-up costs. Depending on how long it will be until you make that first dollar, let alone a profit, you will need to assess how long you think it will be until you'll get the game released and/or making money with your studio in another way to determine whether it's more beneficial to just expense the first $5,000 or fully amortize it, since you'll have such a long recovery period.

And let's be frank: you don't know if you'll barely earn back your dev costs and other expenses, where it'd benefit you more to have that consistent deduction there to pad you for several years down the road, or if you'll have a *Minecraft* kind of hit and expensing that first $5,000 would help you more. Any other income you will have in the year will also factor in, as well as what you reasonably expect it to be in the near future. There is honestly no one-size-fits-all solution for this part. You have the option to take that first $5,000 upfront (Magic Fist one-turn spell) or recover it over 15 years (Poison multiple-turn spell). You'll have to judge how long you think it'll take and what you reasonably expect your income for the next few years to be.

If you expect many turns/tax years to be of more benefit to you, you'll want to pay close attention to what's allowed to be amortized rather than expensed.

Most of the expenses you rack up prior to that very first dollar in income count as a start-up cost. Because game developers frequently have very protracted timeframes of no income, though, this is *definitely* a concern for you. But so long as you've made that first dollar doing something with your business entity – whether it's from ad revenue or perhaps an affiliate program, maybe some contract work reported through the same entity – that's when the start-up costs would be considered over and you can start expensing things normally.

Let's say you started your studio in January of this year and commenced development right after that. You spent $800 on travel and attendance fees to go to a convention to learn new techniques and grow your following, $100 on office supplies, and $500 on a gaming industry consultant. Monthly recurring costs are $15 for web hosting, $50 for your business portion of phone and internet, and $150 for co-working space. It took four months of work before you made your first dollar in May, getting affiliate and ad network income since the game is nowhere near ready yet. With $1,400 in fixed expenses and $860 for four months worth of monthly expenses, your total business expenses that must be treated as start-up costs come out to $2,260. Everything you spend after that day (let's say it's May 1) can get treated as a regular business expense. So your ongoing bills after this point would not be amortizable.

You also paid $450 to an attorney to draw up an operating agreement and formation papers for your new studio. A mandatory $100 filing fee was also paid to your state and $25 to your local newspaper to make the announcement that your business was born. (This is mandated in some states and counties; be on the lookout for it when starting your company. It can also be far, far more than $25.) This makes for $575 in organizational costs.

You can combine these costs for a total of $2,835. Since you're well under the $5,000 threshold, you can write this off in full to recover it all now, or deduct $15.75/month rounded up to $16 ($192 per year) to recover it over 15 years.

Recovering Start-Up Costs Greater Than $50,000
Did you have very high start-up costs? Over $50,000 kind of high? Your $5,000 deduction becomes limited, then completely phased out if you're past $55,000 in start-up costs. You have no choice but to amortize all of it over 15 years.

The reason for this is that the $5,000 you could immediately deduct has to get reduced by the amount of start-up costs exceeding $50,000. So to make it easy on you, start-up costs that are $55,000 or greater lose out on that choice to take the deduction or not. Let's say your qualified start-up costs were $60,000. You'd just have to amortize the entire amount. But if they were $52,000, you'd still be able to expense $3,000 if you wanted to, because $2,000 is the amount by which it exceeds $50,000 ($5,000 – $2,000 = $3,000.)

Actual Game Development Costs: Are They Experimental or Proven?
There's an entire chapter dedicated to research and development, or R&D, matters. Special attention has to be paid to dev costs when you are a brand spanking new business that has not yet earned its first dollar.

You MUST separate out certain costs for game development when compared to your other start-up costs. You may have noticed that when I gave the example for the start-up costs, I didn't give any development costs. There was a reason for that. It could be considered research and experimental costs, which don't get lumped in with the startup costs.

Unlike the start-up costs, which have an option for you to expense up to $5,000 then amortize the rest over 15 years, for dev costs, you can choose to expense them in their entirety, or recover them over five years if they are not experimental. If they *are* considered experimental, then you can amortize over 10 years separate of your start-up costs with no expensing. This option is there for you for projects further down the road, but has a unique aspect in that it has to get treated this way whether your business is brand new or long established. It's got a shorter term than the start-up costs and is all-or-nothing in that sense. **You cannot lump your development costs in with your start-up costs, even if you have a brand new company.** You have to expense them in full when they occur, or amortize them over five years, 10 years if experimental.

The R&D chapter goes over this in more detail, but in short, you have to separate your dev costs out even if you plan to amortize over 15 years.

Is It a Start-up Cost or a Speculation Cost?

Let’s not think about dev costs right now. We’re going to put our start-up costs hat back on. Given that this industry is a thug in a cocktail dress, some people decide to bow out before they even get their game done. So you have to worry about whether your expenses would be considered speculative.

Speculation costs would entail hiring consultants, research, and if you plan on having physical office space, any expenses involved in surveying areas for such a thing. Normally, these are part of your start-up costs or general business expenses, depending on when you made your first dollar in income. So if you also bought a Unity license, attended classes, and whatnot, those would also count as speculative costs.

Think of it as buying a strategy guide instead of actually playing the game. Even if you buy THE BEST strategy guide ever written and come up with all these ways to hack your characters’ stats and get the best score, if you don’t actually go through with the game, it was pretty pointless and all for naught. And that is *exactly* how the IRS sees business research/speculation costs. **It has to result in actually starting a business to be deductible as a business loss, even if you had no income.**

And sadly, game development is often rife with this. Some would-be indies do make a significant investment in licenses, assets, lawyers and consultants, paying fees for workshops and classes, just to decide that being a professional game developer in any capacity really isn’t for them. (Or that they’d rather work for a studio than own one.) Due to the protracted timeframes of no income that we frequently experience, proving your expenses were not speculative might be difficult. But I’d hazard a guess that if you bought this book, you’re in this for the long haul and not going to give up before you even have a chance to get a royalty check. Still, you never know.

To make matters more nebulous, the regulations that normally force you to be very conscientious of your transaction dates and amounts are pretty fuzzy here. If you wind up *not* going into the business of game development at all but still incurred these expenses, they fall into two categories: the expenses prior to considering starting an actual business, then the expenses after you decide whether to go through with it.

I know you’re probably scratching your head right now. It feels like a classic Sierra puzzle where you have no idea if you just dead-ended yourself by not picking up the old boot in the desert. So let’s say you started throwing around the idea of going indie in January. You paid $100 for some classes in February to meet people and spent $15 on books, followed by $1,000 to attend GDC in March. What you see there inspires you so much that you decide to give indie development a go when you come home a week later. In April and May, you spend about $800 paying people to help you and another $600 in non-development expenses like lawyers and workshops. Come November, you give up when you get offered a job at a studio and decide you’d prefer employment to the indie life.

Because you didn’t decide until *after* GDC to go into the business, the $1,115 for the conference, classes, and books are considered non-deductible personal expenses. Because you didn’t actually go into business, development costs don’t need to be separated out from start-up costs so the $1,400 you paid after the decision to go indie would be considered a loss.

However, it’s not a business loss: it’s a capital loss. You must net your capital losses against capital gains properly. You might have capital gain income from selling stocks and the like. Assuming you have no capital gains to net it with, you are limited to deducting $3,000 per year.

* * *

Basically, once you’ve decided for sure that you’re going into business and you’ve made that first dollar in income, that’s when the real fun begins with what you’re allowed to write off. Load screen’s done; moving onto the actual game now!

Level 9: The Main Event, Business Expenses

Now we're at the part I know you were all waiting for: what am I allowed to write off, aside from my development costs? Before you start bouncing like Q*bert over what kind of tax hacks are in store, we need to have The Talk about business expenses as a generality first.

If you recall from all those hobby loss court cases, the thing that killed most of the petitioners' defenses was that there was no profit motive to what they were doing. That same core concept is going to apply here again: is there a profit motive behind *what you're spending money on*? Especially behind the most major audit targets, like extensive travel, good meals you don't have to cook, and having a home office?

Do you think that by incurring these expenses, you'll be able to make money more easily right now or in the future? If your answer is yes, you might have no problem defending that deduction. (Emphasis on the
"might.") If not, you'll have a harder time defending it if you wind up getting audited.

Trust me, there's a lot of stuff out there that you probably had no idea was deductible, and I simply can't wait to show you. But people do unfortunately go overboard sometimes, or flagrantly try to claim something as a business expense when it's clearly not. To keep digging in even further, like a round of *Spelunky*, this is why it's really imperative to keep your business expenses separate from your personal ones.

The Cohan Rule
While I already gave you a good breakdown of how to keep records more intricately than a '90s JRPG, I want to touch upon what is known as the Cohan Rule. Good recordkeeping needs to apply to all transaction areas, but this rule has strictly to do with business expenses. Cohan v. Commissioner was a 1930 Tax Court case that established that in the absence of an actual receipt or other record where you wind up having to make a case, the Court can make a reasonable estimate for how much something was. However, there still has to be enough evidence on hand for the Court to make an estimate. For a quick example, if you completely lost access to your email and charge bills and had to prove how much you paid for web hosting every month, you could reasonably estimate your expense by pulling up the rates from your provider's website.

Granted, this case was in 1930 before you had email, Excel, Drive, and camera phones making all of this easier on you! But obviously, if vast amounts of people didn't keep poor records, this rule wouldn't still be constantly cited in Tax Court over 80 years later. Don't have the Court make estimates for you. Keep track of what you're spending and make sure you can substantiate it.

How To Substantiate a Business Expense
I need you to imagine a building puzzle in a point-and-click adventure game right now. Think of the multiple rounds of errands and goodie-fetching to assemble a crew in the *Monkey Island* games, or the escapist antics of Rufus in *Deponia*; either way, a complex, step-by-step building puzzle. That is basically the logic you have to employ in substantiating a business expense. Here's what you need to keep track of:

- How much you paid and/or how much you use what you purchased
- Time and place of the use or expense
- The business purpose of this expense
- For meals and entertainment, business relationship to the person/people getting dinner/show/etc., how many people were there, what you discussed

Think of this as the Melee Forest treasure hunt puzzle in the first *Monkey Island* game, except you'll get something even better than a stupid t-shirt: saving your own shirt in Tax Court. This is particularly important for the expenses that could be hard to prove are business-related, like travel.

Ordinary and Necessary

A business expense is deemed "ordinary" if it's something that is common for your chosen profession. Know that exhaustive list of NAICS industry codes that miraculously does not represent game developers? The code you pick get gets looked at. If you picked the wrong code, you might get flagged for an audit if your figures look very off compared to what normally gets entered for that code relative to your zip code and revenue level. But looking at things we spend money on, it's perfectly ordinary for game developers to buy other games. We need reference materials to see how a mechanic was implemented, why something sold the way it did, tear apart a resource file, and see what we would or would not want to put in a future game. For companies that aren't in the games industry, buying games would likely be frowned upon. It's also common for us to claim little or no rent expense; that wouldn't be the case for a manufacturing business or retail store.

And it's "necessary" if it's either helpful in terms of helping you make a profit or simply a necessity to get things done, like your phone and internet. It's got a personal element, but I write off 50% of my package to account for both business and personal use. Simply put, I need an internet connection to make a living, as do all of you. If you can't access email and write back to people, text them, call them, respond to offers, write content and work on the games that will make you money? Then you can't make a living for the authorities to go tax. Speaking of which, you need to file business returns and other forms; it's the law. Tax preparation is definitely a necessary expense, as are filing fees, postage, and any other costs related to filing your business taxes and researching them.

Expenses are also deductible if they're simply helpful. The faster and more efficiently you can get games released, the faster you'll make money to get taxed. If the expense was similarly helpful to you in terms of getting more work done or overall making your professional life easier, it's deductible.

The Obvious Expenses: Internet and Website

You need a place for your fans to go, as well as to show off what you've done. Your web-related expenses are definitely deductible. How can you make money if no one can see your games and what you're up to?

Site-building expenses for your main site and any additional sites like ones you make for a particular game are deductible, along with your ongoing hosting bills and things like domain transfers and back-end maintenance. Whether you hire a professional or do it yourself, the expenses incurred are all allowable. And to do all these things, you need an internet connection.

As I mentioned a few times before, because phone and internet packages have both personal and business elements and you're likely to just have it in your name instead of your studio's, the easiest thing to do is just allocate 50% of the bills to your taxes if you're a digital nomad, as most of us are wont to be. If you purposely start a phone line or separate internet account in the studio's name and use it just for business, then you can deduct all of it. This is more apt to happen if your studio has physical space and wifi isn't included in the rent, or you have a couple people on your dev team all in the same country where it will make sense to split a phone plan.

Administrative Expenses
Have you gotten to the point that you need a virtual assistant to help you field emails and update your mailing list? It's definitely deductible, along with those other costs of doing business like publication affidavits when you start a new LLC, registered agent services, mail forwarding and the like.

Other basic office and admin expenses like postage, faxes, notary fees, bank charges and PayPal fees, check printing, and the like can also be deducted. If it's something you need to keep the studio up and running, it can be written off.

Business Taxes
As I mentioned early on going over the different tax types, there are all kinds of different taxes out there and you can deduct some of them on your business tax return.

If you paid state/local corporate income taxes, you can deduct them and the same goes for any local business taxes such as New York's unincorporated business tax and Delaware's corporate franchise tax. However, you can't deduct *personal* state/local income taxes, only state/local level corporate taxes, franchise taxes, and other business-related taxes.

When it comes to sales tax, it doesn't get a special deduction when it comes to things that you buy. Whatever sales tax gets tacked onto the purchase, you treat it as part of the total price.

Supplies
Game developers don't tend to have "hard" supplies that we use in our day-to-day work like a nurse or handyman might. But we buy office supplies to some extent: binder clips and paper clips for those sprawling game design documents, and envelopes for the mailing of official documents. (Speaking of which, mailing supplies also count: stamps, labels, and packing materials.) If you're doing any kind of art for your games that involves physical supplies like sketchbooks, pencils, markers, and so on, you can deduct them because they constantly have to be replenished.

Paper for your printer counts, too. Just like with the internet and phone expenses, you may have to allocate both your printer and paper for business and personal use, since it's pretty inevitable

in home office settings. The paper would get expensed, but the printer gets depreciated (written off over a longer timeframe). This is true even if you buy a massive carton of paper that takes over a year to go through.

Big-ticket items will be discussed in more depth, as you'll have to differentiate what gets depreciated opposed to what counts as a supply. But typically, if it's something you'll use up easily opposed to a large or small piece of gear you'll expect to use for far longer than a year, then it's considered a supply and not a fixed asset like a car or piece of equipment.

Rent

Do you pay for co-working space? It's a deductible rent expense. Same goes for if you rent a storage unit for holding swag and gear for events, or office space on your own.

Rental of a PO Box to keep your business mail separate and your address private is also deductible, and if you rent any equipment such as furniture or TV screens for conventions, you can also deduct it. Indies as a whole don't tend to deal with long-term equipment leasing which is treated a little differently, so leases are beyond the scope of this book, but providing that you pay your rent as it's due on both space and equipment, you can deduct this expense normally. Then, if you have an actual office, rent on this is also deductible whether it's ongoing or you're just renting a room for a day for your team to have a brainstorming session.

How you can deduct your residential rent if you work from home is discussed later, because home-based businesses have enough craziness with regulations and case law to merit their own chapter.

Networking, Fanbase Growth, and Looking for Income

You know that you have to network to grow a business. You have to make efforts to meet people and follow up with them in order to get gigs as well as engage with people in person to get them into your games and your other endeavors.

Are you an IGDA member or plan on becoming one? Membership is deductible, along with any other professional societies, trade organizations, and developer collectives. If you don't have a local IGDA chapter in your area, joining is still a good idea for getting into events like E3 and trying to find other people near you who also want to establish more indie developer presence.

Getting into conventions is a biggie for finding fans as well as other game developers and publishers who can give you opportunities and make you better at your craft. If you're paying for a booth and admission, you can deduct it. Same goes for shorter events where you don't have to do extensive travel. We're going to talk about conventions and travel in the next chapter in more depth, but the basic gist is that you can write these events off.

If you're trying to get gigs from publishers or other developers, any expenses you have for looking for work also counts, such as signing up for platforms that charge monthly fees, hiring a professional resume/CV writer – pretty much any expenses you have in marketing yourself and your studio. Even if your efforts are unsuccessful, you can still deduct it! You had the intent to get gigs and make money.

Marketing and Advertising
While there are plenty of differences between the two, for tax purposes, we treat marketing and advertising as one and the same: deductible. Things like promotional materials, business cards, banners, online ads, hiring a social media manager, and anything else you pay for to get your name out all count. How can you make a profit if no one's heard of you?

Just like with the networking expenses, a marketing expense doesn't have to be successful to be deductible. After all, you'll want to try different methods of growing your presence, and for game developers in particular, there's no magic bullet solution for this. Whether you hire a professional or take a DIY approach, it's deductible because you have a profit motive.

Swag that you don't plan on having for sale is deductible as a marketing expense, such as promotional t-shirts, keychains, USB cables, and other interesting goodies I've seen game developers use over the years to help sell their games and raise awareness of their studios. If you do plan on selling these items along with other swag, check out the chapter on inventories.

Now, of course, lots of stuff can be applied as a marketing expense aside from the just the obvious placed ads, promo materials, t-shirts, and the like. Do you have a REALLY off-the-wall idea for how you want to sell your game, such as going up to people in a public space in costume (or hiring someone to do this) or using props? So long as you can prove it was part of a guerrilla marketing effort, you should have no problem deducting it!

Deductible marketing expenses also include getting headshots and other professional photos taken of you and your dev team as part of your image. Retouching fees are also deductible. But unfortunately, stylist/makeup artist fees aren't deductible unless you're having some really extreme makeup and/or hair styling done that was clearly related to marketing your games. Simply wanting to look your best using normal makeup and/or styling tools for the shoot doesn't count.

Business Gifts
Many of us foster business relationships through gift giving. You'll get your business partner a gift card for their favorite restaurant to show your appreciation, or give your accountant a bag of coffee to tell them you're thinking of them during tax season. Unfortunately, there's a limit on this deduction of $25 per recipient per year, but you can have as many recipients as you like. For instance, if you buy a case of ten Amiibos and each one cost $35 apiece, if you give them to ten different people, you don't have a $350 deduction. You only have a $250 deduction, $25 per person for ten recipients. Then, if you decided to be really generous to these hardcore collectors and make it two Amiibos for five people, your deduction is limited even more: it's now worth $125, as your limit is $25 *per person*. While you could still buy someone something costing more than $25 to foster a relationship or curry favor, just be aware that the portion above $25 per person won't be deductible. Whereas if you bought two $10 gifts and gave them to the same person throughout the year, you'd fall under the $25 per person per year limit.

The exceptions to the $25 per person rule are small items like pens, keychains, and other tchotchkes primarily meant to promote your business. If you give a colleague a t-shirt with your

game's logo on it, it wouldn't be considered a gift and you'd just write off however much the t-shirt cost you to print. But if you went out and bought them a t-shirt that doesn't promote your work, you couldn't deduct more than $25 per person.

Professional Services

Lawyers, accountants, consultants, and business service firms…you can deduct the amounts you pay to these professionals throughout the year.

Most of the time, particularly for indie devs who are just starting out, you will get billed for each service and simply pay as you go, which means you deduct as you go. This is usually the case for tax prep and consulting services. But when you work with a lawyer, you often have to pay a retainer. You need to keep track of how much is in the retainer and how much you're being billed for each transaction, as deducting it isn't as simple as when you pay as you go.

Let's say that your lawyer requests a $2,000 retainer in January. You are billed $500 in February, $750 in June, and $250 in November. Summing up these bills, you can deduct $1,500 for the year, not the $2,000 retainer. This is because you can request release of the retainer at any time, so that $2,000 initially becomes an *asset*, not an expense. The amounts you get billed then wear that asset down. We're going to explore this topic a little further later, where we'll go over the timing of income and expenses.

Insurance

General business insurance is deductible, as is gadget insurance for your electronics and travel insurance for business trips. If you receive any payments from your insurer that exceed what you paid for that item or trip, then the excess amount is taxable. This doesn't happen a lot, but it's happened enough that the IRS codified it. You can also deduct any expenses associated with filing a claim, like postage, notary fees, and the like.

Health insurance is discussed separately at the end of this chapter.

Education and Skill-Building

These expenses need to be differentiated a little because figuring out which educational tax benefit is best depends on whether the expense is for classes or a degree program at an accredited college or university, or something more informal, like classes at game developer collectives or other places that aren't certified by the Department of Education. If the classes are taught by a private company or nonprofit fitting that description, you can simply deduct it. Workshops, seminars, classes, or hiring private tutors to help you with various aspects of game development are deducted normally. The same goes for continuing education courses related to game development and running a studio, such as project management, marketing, and general business. But if you went to an accredited institution, it could be a different story depending on who paid for it.

If you're buying subscriptions to game-related magazines and sites to keep up with the latest development techniques and market data, these are also deductible as a skills-building expense. Same goes for buying books (including this one!)

As for collegiate game design and business education, the details of the Lifetime Learning and American Opportunity Credits are beyond the scope of this book as they're predominantly a personal tax issue rather than a business one. However, you need to weigh if it's more beneficial to deduct your educational expenses as a business expense or just take them on your personal taxes if you took college-level courses instead of ones offered by private companies. While the Lifetime Learning Credit applies to most indie developers, since you don't need to be a degree candidate and can claim it at any age and timeline in your educational pursuits, it doesn't net much back in most cases, although there could be state-level benefits that piggyback on it that would make it worth not taking it as a business expense.

Health Insurance

Health insurance is treated differently than your normal deductible insurance expenses or any medical expense that you may or may not be able to take as an itemized deduction. If self-employed people ever received a cheat code, this is it!

Unlike those other insurance expenses that would get deducted normally, there is an above the line deduction for this. Now, of course, if you are being treated as an employee by your own corporation, then it can deduct health insurance payments as business expenses and they'd be included in your income on your W-2. (S Corp shareholders need to be particularly mindful about this.) But if you pay for your health insurance yourself and file Schedule C because you're a single-member LLC or sole proprietor, then you can take an above-the-line deduction based on half of your self-employment tax and the amount you paid for health insurance for both yourself and your spouse and/or dependent children.

Your deduction will be the lesser of what you paid for insurance or your profit after you take away half your self-employment tax and contributions to self-employed pensions like SEP and SIMPLE plans. It was designed this way to also cover people who have self-employment income in *any* capacity, so you can take this deduction even if you just do some freelancing on top of a regular job. So let's say that you're single and bought a self-only plan for $450/month ($5,400 for the year). Your only income was from a single-member LLC, and it was a profit of $40,000. Your self-employment tax would be $5,652, so half of that is $2,826. After deducting the $2,826 from $40,000 in profit, you get $37,174, so your self-employment health insurance deduction is the full $5,400.

Assuming you just do some freelancing instead and thus have a smaller profit, then you have a smaller deduction. If your profit was $2,000 instead of $40,000, then your self-employment tax is $283 and half that is $142. Taking $142 away from $2,000 comes out to $1,858, which is a lot less than $5,400. Your deduction is $1,858 while the remaining $3,542 could then be taken as an itemized deduction along with your other medical expenses. If you're still working for someone else and have no health coverage, this deduction can provide you some relief because you don't have to itemize. At least you get something of a cheat code with having to pay for your own insurance.

But if you work for someone else, have no self-employment income at all, and have to buy your own insurance, then you'd have to itemize for all of the premiums. Depending on your income, you might not get any benefit.

Now, that example I gave assumes that you didn't buy an exchange plan to receive Advance Premium Tax Credit (APTC). In the event that you bought an exchange plan and your family status and income level put you within the limits to receive a full subsidy, you need to subtract any APTC payments from the total amount paid. At the time of writing, this subsidy is $3,000 max. Assuming you had the full $3,000 credit paid to you in advance, you'd use $2,400 for the premiums paid instead of $5,400 to calculate your deduction.

One last pitfall to keep in mind: if you were working for someone else in all this time, or perhaps eligible for a spouse's or parent's employer-sponsored health insurance, you have to snip off the months you were eligible for those plans from your deduction. If your spouse is also supporting you and has you on their health insurance, they can't take this deduction unless they too are self-employed in some capacity.

Paying in Kind (Trading Services and Stuff)

Moving on from expenses themselves, let's take a look at how you pay someone. It could be with time instead of money. Most of the time, you'll be paying your business expenses out of your (separate and strictly for business) bank and PayPal accounts or credit/debit card. Cash, in some form.

But indies are a community-oriented bunch. We're sympathetic to one another regarding dev costs and will help each other out by sharing knowledge bases, since a majority of us left other fields or are trying to leave them to pursue our common dream of making digital toys in pantsless bliss. The IRS calls this **payment in kind.**

If you're making a payment in kind to someone whose help you want, either in working on the game or by helping your studio out with something else like business services or website design, be advised that you can only deduct your expenses related to the service. You can't deduct the value of the time you normally would've charged someone.

For instance, an artist agrees to help with your art assets if you help him with some back-end technical work that you charge $100/hour for. The job takes five hours. You don't get a $500 deduction for your time. However, you spend $50 buying a template and $100 subcontracting bug fixes to finish the job faster. You could write off the $150.

The same concept holds true of game keys you give colleagues, beta testers, press, Let's Players, and so on. While game keys might represent payment to someone, you can't deduct what you would've earned had those copies been sold on Steam, your own site, and so on. There's no deduction for what would've been, only what is.

*   *   *

These are some of the more common deductions, some of which you might've already figured could be written off. You have many more, of course, but I felt they deserved their own chapters because there is a lot to take in, particularly when it comes to travel, meals, and entertainment, as well as taking deductions for a home office.

Level 10: Lost Levels, Non-Deductible Items

As you can see so far, most expenses are deductible when they are helpful, ordinary and necessary in some capacity, or are incurred to help you make a profit. You can't make a game for free, right? Most of these deductions are bonus rounds. But this isn't without a few baddies. Where's the challenge in the game without them?

In going over business entities, I gave an overview of how you would go about deducting your own pay. In some cases you can't, such as with a sole proprietorship or receiving dividends instead of a salary. So your own pay is often the first non-deductible item you'll have to deal with. But there are plenty of others.

Federal Income Taxes
Whether they are for a corporation or your personal federal income taxes, you can't write off federal income taxes that you pay. We'd have no infrastructure and probably no space programs if people could do that.

Fines and Penalties
No matter what the penalty is, no matter the jurisdiction, whether it's a $20,000 federal fine for copyright infringement or a $50 parking ticket, you can't deduct these fines.

The only penalties and fines you can deduct are those set by a private company as part of doing business, such as if you have to pay late fees on an overdue hosting bill or if you're renting office space and break the lease so you have to pay penalties to the landlord. But if any level of government hits you with it, no deduction.

Expenses That Lack Commercial Substance
This pretty much goes hand in hand with the ordinary and necessary clauses I went over in the last chapter: if you can't demonstrate there was actual business use of something that you paid for and you tried to deduct it, it won't stand.

In the 2014 Tax Court case Peppers v. Commissioner, Peppers was an accountant with the Securities and Exchange Commission who did some freelancing work for a travel agency. She had expenses that seemed totally ordinary – extensive travel plus phone and bank charges – but she couldn't prove they had commercial substance. Part of this was poor recordkeeping, and the other part was that she didn't really *need* to incur some of these expenses that she did in order to get her work done. It was really the nature of the activity itself that lacked commercial substance, but this is still an area you could easily fall into.

Expenses That Are Obviously Personal
You're sure to hit some gray areas in travel and entertainment, as well as the device you use to make games with and games purchased for review and reference. But there is still commercial substance to these costs. You need an internet connection to make a living. You can't make games without a computer or tablet. Going to events is how you network and get a fanbase, even though you're having fun going to them.

But I've seen some really absurd things come up in peoples' files that made me think they belonged in a game, like the partner in a law firm whose QuickBooks files revealed that she spent an ungodly sum on her daughter's prom dress out of the company's account. Her justification when I inquired? Buttering up a client. Yeah, that's not going to fly. That's just made of more fail than trying to get past those vulturous magpies in *Dark Castle* on a keyboard lacking arrow keys that was dipped in olive oil.

If you invite your entire development team and all your colleagues to your or your child's wedding? Also not deductible! I've seen this so many times despite the fact that literally every single case has been thrown out whenever this happened. If it's not ordinary/necessary or helping you make a profit in some way? Not going to be a write-off.

Political, Electioneering, and Lobbying Expenses

Despite all the legislation that gets bought today, you can't deduct any efforts to advertise or endorse a political candidate. Nor can you get a write-off for getting people to vote on an initiative.

Illegal Purchases

I've seen people try to claim things that are more outrageous than a prom dress or wedding caterers. If you "entertain" an associate with an escort service, it's not going to be deductible. Same goes for that wonderful strain of indica you just picked up, even if it's going to inspire the greatest game imaginable.

This raises a bit of a gray area with both legality in certain states as well as what would constitute a personal expense, per R.L. Vitale Jr. v. Commissioner, where he claimed to be visiting prostitutes for book research and the deduction was axed. Stick with this simple guideline: if you saw it on *The Wolf of Wall Street*, you probably can't write it off.

* * *

It's rarely as black and white as this. We're going to be moving into pretty nebulous territory with the different travel deductions as well as the home office deduction, where it can wind up becoming obliquely personal.

Level 11: Travel, Meals, and Entertainment Expenses (The Bonus Round)

Remember those bonus rooms from *Donkey Kong Country* that opened whenever you collected three identical animal statues? You'd have a limited amount of time to grab all the golden rhinos, ostriches, and sundry you could to get extra lives. Then the screen would blink in semblance of shock before you went postal trying to snap up all those tiny rhinos before the time ran out?

That is how people react when I tell them about the ensuing deductions. And just like those enormous frog and ostrich statues that would double your points, these tax breaks can be just as deviously hidden.

But instead of a time limit, you have some sneaky baddies that can throw you off the swordfish and into a chasm quite easily, for these expenses are frequently audit risks. A lot of people fail to properly document these expenses in the first place, and/or fail to find the right defenses them upon petitioning the IRS. Travel often easily becomes a personal expense if you bring family members along and/or you don't have enough of a business reason to make the trip in the first place. People tend to flat-out misuse travel and meal deductions simply by not keeping good records or not having a profit motive for what's often a very large expense.

You also can't use the Cohan Rule for travel, meals, and entertainment. So you need to keep very militant records for travel, meals, and entertainment expenses – not just the actual cost, but the *purpose* per the substantiation building puzzle I showed you earlier. In order to take a deduction, it has to be what you actually spent. Then, it must meet certain rules, or else there are no gold ostrich statues to accumulate.

You must carefully note the purpose of your jaunts and what you're doing with the people involved. A *Red Dead Redemption*–sized account of the trip, dinner, or coffee run isn't necessary. One to three sentences on a spreadsheet or in the notes section of a PayPal payment/reimbursement should be sufficient. (Or on the receipt itself, if using a system like Paperport.) "Chatted with Ms. Jones over coffee. I critiqued her game and she gave me insight on my marketing strategy. It was just the two of us." If you're with a large group, something like this would also work: "Post game jam beer and nachos; event was packed and I gave out several business cards and I told everyone about my game then directed them to my website to buy it. About 50 people were at the jam and 20 came to the after party and most received my card."

We're going to start with relatively local travel that doesn't involve overnight stays. One of the greatest things about the indie life is that it's ultimately up to you how much local and faraway travel you want to do. More travel means higher burden of proof and better recordkeeping than you engaged in before, but it can be like an endless bonus round in terms of writing related expenses off your taxes. It's like hurling a barrel on the ground and finding a golden rhino statue!

Travel By Car and the Business Percentage

Busy, self-employed people like us frequently have to travel, whether that means constantly running around to conventions and game jams, meeting up with your dev team to work on the game, or meeting with professionals like consultants and publishers to help you grow your business. If you don't live in a major urban area where you have your choice of taxis and public transportation, you're more than likely driving to and from these places, and you are not Activision or EA – you don't have a company car!

You need to figure out a business percentage for use of your own car. While it's pretty simple to figure out a business allocation for things like your internet expenses, it's definitely not for your car, because almost no one in the gaming industry buys or leases a car solely for business reasons like one would in a more physical job like landscaping or plumbing.

To help figure out your percentage, look at the total miles you drive in a typical year of living the indie life. Relative to those total miles, how often are you driving to events, workshops, and business-related meetings? Are you frequently on the road for conventions, game jams and so on, or do you keep things primarily digital and remote, therefore not driving a whole lot? Out of all the out-of-town trips you take, how many are for your game development career and how many are for personal purposes? Asking yourself these questions will help determine what your business percent should be.

Also, just because you deck out your car with stickers and a paint job that blatantly advertises your studio or next game doesn't mean it makes your car-related expenses 100% deductible. No, you still have to use a percentage based on how much you drive for business reasons.

Standard Mileage vs. Actual Cost

Whether you are traveling locally or farther away and travel by car, you must use <u>ONE</u> of these methods: the standard mileage method, or the actual cost method. At the time of writing in 2015, standard mileage is $0.56/mile, and you'd apply this rate to the total business miles you drove in the year.

Actual cost refers to the actual expenses based on the business percent. Here are the car expenses you can claim so long as you subject them to the business percent:

- Gas and oil
- Tires
- Interest on car note
- Insurance
- Repairs
- Maintenance (inspections, washing, etc.)
- License and registration
- Wear and tear (depreciation, discussed at length in the next chapter)

If you take standard mileage, then you can't write off any of those things. *The only exceptions to this are parking, tolls, and personal property taxes.* If you have to pay a property tax on your car, such as the vehicle tax in Connecticut, you can also deduct the business percent of this tax regardless of which method you use.

While it’s a good idea to keep records using both methods to figure out which one nets you a bigger deduction, you can’t claim both mileage and actual car expenses in the same year. You must pick one and stay with that method, making a note on your tax return if you switch methods the following year. Going back to that tricky building puzzle, if you use the standard mileage method to deduct your car use, then you don’t have to substantiate receipts because the IRS already set the rate for you. But you still have to solve the other components of the building puzzle in that you have a very strong burden of proof to correctly record your mileage, how much you use your car for business reasons, and what the purpose of each trip was. Just because you use standard mileage instead of keeping records of your actual cost doesn’t free you from this.

As for which method is better, actual cost tends to be more beneficial but requires more burden of proof and greater diligence in how you approach the business percentage for your car. But burden of proof aside, it really boils down to how much things like gas, repairs, and insurance cost where you live. Compare this to the total number of business miles that you drive during the year and how often you use the car for business reasons, and figure out which method is the best for the present and foreseeable future. If you live in an area with higher car maintenance costs, like one of the coasts, and/or you foresee a lot more use of your car for business reasons, it would make sense to consistently stay with actual costs.

Let’s say that you go to a demo and play night once a month and make other sporadic trips to local events and game jams. The trip to where the events are held is 20 miles each way, and you keep a mileage log that shows you drove a total of 2,000 miles for all the other local and faraway events you attended. For the 12 demo nights with 40 miles round trip, that comes out to 480 miles, plus the other 2,000 for 2,480 total business miles driven throughout the year. Taking the $0.56/mile standard rate, you’d have a $1,389 mileage deduction.

If we take the actual cost method, let’s say that you use your car 30% for business reasons like driving to events and dev team meetups. Using national averages, you pay $1,500 for car insurance and spend $375 each month on gas ($4,500/year). You also had to pay $1,700 for repairs, inspections, and vehicle registration. The grand total of your yearly car expenses is $7,700. Taking 30% of actual costs comes out to $2,310. It definitely pulls a sonic boom on the standard mileage method. But if you move to an area with lower cost of living, it runs you $200/month ($2,400/year) for gas, insurance is $800, and repairs and maintenance cost $900. Here, standard mileage benefits you more, as 30% of $4,100 in car expenses for the year comes out to $1,230.

So, the substantiation part is all the same. You might as well keep very accurate and detailed records of the actual costs to see which method comes up in your favor.

Leasing a Car

There are situations where you can’t use the standard mileage method, and leasing a car is one of them. If you’ve already deducted actual costs in a prior year, then you can’t make the switch to standard mileage if you’re using a leased car. But you can allocate the business percent to the lease along with your other car expenses.

But whichever method you choose, if you lease your car, then you must use that same method for the duration of the lease. You could only switch methods the following year if you're not leasing.

Parking and Tolls

For both local and faraway travel, when it comes to car expenses, you can always deduct parking and tolls for business trips regardless of whether you use the standard mileage or actual cost method. (But remember, you can't deduct parking tickets under any circumstance.)

If you use a system like EZ Pass for cashless toll payments, the statements can help keep track of your personal and business tolls by date and time but you'd have to use your business percent on the purchase of the device and any set-up or maintenance fees.

Car Rental, Taxis, and Public Transportation

These expenses are more straightforward than using your own car: you simply deduct the actual costs. Whether you're taking a local bus or Greyhound, the subway, taxi, or Amtrak, you just deduct what you actually paid. It's pretty simple unless you're buying a weekly or monthly transit pass, which you'd have to allocate between personal and business use. There's otherwise no mileage record required. If you take a taxi, the deduction is just as simple.

As you can see, expensing your own car is like a bullet hell shooter. Expensing taxis and public transit is like a point-and-click adventure. In terms of mechanics, at least.

If you're renting a car to go to a business event to transport things like expo supplies and equipment, deducting the rent is pretty simple, as you're clearly doing a rental only for that event. But if you're renting a car during extended travel, like a convention, you'd need to allocate the rental cost between business and personal use. Whereas for public transit and cabs, it's a little more straightforward.

Using my own E3 travels as an example, I deducted the subway fare to and from the convention center and hotel every morning, and the taxi I took back at night from the developer parties where there was a ton of boozy networking taking place. But I couldn't deduct the fares for personal things like searching for old punk scene landmarks when I had a few hours to kill before my flight home, and I had a lot more non-deductible bus fare when I tried to give myself a *Ghost World* tour. (I did a tour of all the places from *The Room* at my first GDC; it was a blast, and I'm sad most of those places are gone!)

Then, back home, sometimes I'm doing a lot of local travel in a given month for events, classes, and gigs. Easily 50-60% of a monthly Metrocard is deductible for that month.

It's the personal car use that's the real boss battle here. I wouldn't worry about it too much if you're just coming for the convention, don't have too much time for sightseeing, and aren't staying that many extra days. When you're mostly getting between the train station or airport, the hotel, the convention site (if separate), and offshoot events that involve networking, most, if not all, of your car rental should be deductible.

Meals, Coffee, Bars, and Entertainment

We're going to dive real deep into overnight travel shortly, but I wanted to address meals and entertainment while we're between the breakdowns on local and faraway/overnight travel. I'm mostly going to be discussing meals and drinks, because for tax purposes they are considered "entertainment" when they are not part of overnight business travel. (Entertainment itself is pretty self-explanatory: concert and theater tickets, sporting events, and even pretty out-there things like scuba diving.)

You are limited to 50% for meals and entertainment. Once upon a time, you could deduct all of it, but then the taxpayers got sick of subsidizing corporate executives' three-martini lunches, so it got phased out over the years until it stayed at 50%. So, you're limited to 50% of the actual costs, whether it's $100 for burgers and a movie with your dev team or $2 for a cup of coffee at a meeting.

There has to be some kind of business relationship with the person or group of people involved. Are they one of the following?

- Publisher
- Investor
- Customer/client/fan
- Colleague/fellow developer
- Employee
- Contractor
- Press, reviewer, Let's Player
- Influencer in the games industry
- Members of your dev team/business partners
- Professionals who serve you in a non-dev capacity (lawyer, accountant, etc.)
- Someone who is going to give you work and/or a speaker slot

And, was this get-together primarily for business? Did you actively try to conduct business in some manner, with the expectation that you would benefit in some way afterward? Or, if you were the one providing the benefit to the other person/people, did this breaking of Doritos and Mountain Dew result in solidifying your business relationship in any fashion such as sharing development and workflow techniques? "Benefit" doesn't necessarily mean that that person will pay you sometime soon. But it can mean that they teach you a new skill, offer input on your game so you can be more profitable, actually be working on the game or helping you with finding someone who can, or provide something like a review or social media boost that helps get your name out and thus make money.

Whether you're going out for beers with hundreds of other developers after a game jam or having a more intimate coffee talk with an animator you're hoping to work with, those three key business elements need to be present to defend your deduction: **WHO** you're dining with and your relationship to them, **WHY** you are dining with them, and **WHAT** the business purpose/benefit was.

Even if that person is in a non-dev capacity, such as your lawyer or a printer in charge of your promotional materials, you could get anything from useful information about legal concerns you have to a substantial discount on your next order by taking them out to dinner or maybe a baseball game. Information and discounts? Those are certainly benefits!

On the flipside, if you bought an investor a round of drinks or tickets to a show because they expressed interest in you but they never give you a cent? You can still deduct it; there was a business reason for that treat. Just because you weren't successful in getting money out of them doesn't mean you didn't have the reasonable expectation to benefit in some way, even if that benefit was merely telling you how to improve your company and getting a lesson in what gaming industry investors want out of their seedlings.

The Dutch Rule

The "Dutch rule" basically means that you're covered if you pay for the entire meal, drink, or event. Whether you pay only for yourself, treat the person or group, or pay for both, you can deduct it. So even if you and the person you're with each pay your own tab, you still get a deduction!

But don't confuse being able to deduct paying just your own tab with also deducting personal meals and drinks. If you go out by yourself a lot to coffee shops, as indie developers are wont to do to get inspired and avoid cabin fever, you unfortunately don't get any deduction. Even though as creatives we could argue the merits of needing the social interaction and change of scene to work more efficiently, or even seeing something that winds up going in a game later, in the eyes of the law there is no commercial substance to the expense.

But it's a different story if you happen to meet someone helpful in your coffee run that day, like another indie developer or perhaps a consultant, and you offer to buy them a drink in order to get some insight on a business matter or perhaps get some other benefit or useful information.

Food and Coffee at Home and the Office

Do you keep up actual office space somewhere? You have some oblique deductions that can quickly add up.

Think of all the things you have to buy for your home: toilet paper, paper towels, hand soap, and most of all, somewhat shelf-stable food and drinks. Snacks, fruit, coffee, tea, bottled water. Then, of course, things like a microwave and coffee maker. A mini-fridge, if you have really fancy digs!

If you buy those things for your home, you can't deduct them even if you want to argue that a coffee IV drip means you'll get the game out faster. (Even if you're taking the home office deduction.) But you can write them off in full if you have an *external* office – even the snacks and drinks!

If you're bringing takeout or ordering prepared food and drinks for the office, though, the rules about meals and entertainment apply. Same with catering; it needs to have a business purpose of some kind.

In order to qualify for snack and store-bought coffee and tea deductions, you need a traditional rented office or a private suite with a co-working space where you can receive mail and regularly work there. The key is really that A) it's not in your home, and B) you regularly have this space. Because long-term and/or higher-tier subscribers to co-working space usually get benefits like storage lockers and being able to use that location as a mailing address, using co-working space instead of a leased office doesn't necessarily disqualify you from being able to deduct these extra office expenses. But since a lot of developers tend to be nomadic, and co-working spaces tend to also provide a lot of the things you'd have to purchase on your own like bottled water and coffee makers, it's easy enough for the office snacks to become a personal expense. But the subscription fee to said co-working space is still deductible.

Planes, Trains, and Automobiles: Overnight Business Travel

Overnight business travel is your freaking Hadouken. Sure, you're probably surprised at some of the car expenses you can deduct, which really add up even with a percentage, but this is where things *really* get cranked up.

I'm mostly going to discuss conventions because the vast majority of us primarily travel for conventions as attendees, exhibitors, and/or speakers. However, other domestic business trip types will still be discussed, because overnight travel also has more loopholes than local travel.

The "For Only" Test

No, it's not the Bikini Kill song, unfortunately. This test means that you need to ask yourself whether a rational businessperson would be taking this trip or if it wouldn't make sense without your personal reasons for going.

If you're flying out to San Francisco for GDC and only going for the conference, it's pretty cut and dry. But if you always wanted to go to Disney World and one of your team members happens to live in Orlando, so you want to find a way to make the trip tax-deductible? You'll have to come up with a way to really substantiate it as a business trip to write off dinners at Epcot. Going out to the Midwest to see your parents, with only the off chance of dropping by a marketing guru a town over? You'll have a very hard time meeting the "for only" test.

Hey, I didn't say this bonus round was going to be easy to get to! There are many, many people who did not get past this particular boss battle, and you can read all about them in the Tax Court annals. I'd like to point out some specific cases where the "for only" test was miserably failed: Danville Plywood v. Commissioner and Blackshear v. Commissioner, and then revisiting Peppers v. Commissioner.

- The owner of Danville Plywood lost his deductions because he took a whole bunch of his customers on a four-day trip to the Super Bowl in Louisiana. He put them up in a posh French Quarter hotel and they all had a riverboat cruise. A nice gesture, but the trip didn't make sense to the Court. There was no real business purpose for it, so they ruled it out as being purely recreational. There's no reason he couldn't have had a Super Bowl party at home as an effort to bond with his customers and try to get local business. No profit motive to be found there.

- Blackshear was a Baptist pastor who took about twenty people to Greece, Rome, and Palestine for a religious tour. Some of the people happened to be his relatives. Very similarly to Danville Plywood, no real profit motive was found for the tour, and bringing family members is a quick route to a gray area of mixing business with personal travel – a shade of gray that really isn't favorable to you. We're going to get into the inner workings of mixing personal and business travel together, as well as the harsher rules for international travel, but the Court found that Blackshear couldn't substantiate a business purpose for the tour.

- Revisiting Peppers v. Commissioner, she lost her deductions because while she had a shaky but present profit motive in the trips she took, there was no real way to prove that they weren't personal trips. Her family went with her every time, so it was hard to prove the trips were necessary for her to make money. Read: like Danville, it didn't make sense without the personal elements.

The "for only" test goes hand-in-hand with the fact that you need a profit motive to make the trip and justify the expense. Most major conventions provide justification letters on their websites; employees are meant to show them to their employers to get them to pay for their attendance, but they can also help a self-employed person mount a good defense. For trips that aren't conventions, you have a much higher burden of proof to prove that you had a real business purpose for travel.

What You Must Have in Every Overnight Travel Record

Local travel still has high burden of proof, as you just saw with being able to account for car expenses. But there is a specific statutory requirement, another building puzzle if you will, for trips that involve you going away for <u>at least one night</u>.

- The amounts for each separate expenditure for traveling away from home. This means individual transactions and receipts. This is why it's a good idea to make detailed expense reports and keep it digital!
- The departure and return dates for each trip, and the number of days during each trip that you spent on business.
- The name of the city or town you visited.
- The business reason for traveling or the kind of benefit you expected to the gain from the trip.

You need to do all this whether you are going to a convention or not. In particular, you need to identify which days were travel days and which were business days, then which were personal days, because this makes a huge difference in figuring out which expenses that are deductible.

Travel Days, Business Days, and Deducting Life-Sustaining Costs

Let's say GDC starts March 10 and ends March 17, so you decide to make a vacation out of it and come earlier and leave later than the convention dates. Taking note of your departure and arrival dates, you arrive March 7 and depart March 19, making for a 13-day trip.

If you had no other plans to meet dev team members, publishers, associates, or otherwise conduct business outside of GDC, then your only business days would be the days of the convention. Eight days out of the 13 count as business days. You have two travel days as well, so it's 10 out of 13 days that you can take some deductions, which add up extremely fast.

You can deduct your airfare, train fare, and so on, plus ground transportation (cabs, shuttles, public transportation) in getting to and from the airport or train station on both those days. If you used frequent flier miles, Amtrak points, and whatnot, you only get to deduct what you actually paid, not what the ticket price otherwise would've been. But even if you shell out for business or first class seats, so long as the trip had a bona fide business purpose, you can deduct it.

But the critical hit you can make on your tax bill is your life-sustaining costs: meals and lodging. You still have a 50% limit on meals, but this time it doesn't matter if you eat them by yourself or have a business purpose or not! Even your airport snacks are deductible, as is that $10 cup of Starbucks you grabbed once you rolled off the plane to wake up. Just remember though: **you can only do this if you are going away for at least one night.** If you have a very long drive or train ride from another game developer event but are going straight home, and you definitely aren't going to wait until you get home to eat, you can't deduct the meal unless you were sharing it with someone you have a business relationship with and that fostered the relationship.

But meals add up fast even if you're trying to stay on a budget, especially if you're going to a high-cost city like San Francisco or Los Angeles for a major event where all the restaurants adjacent to the convention centers tend to gouge attendees. Even with the 50% limit, meals, snacks, bar tabs, and coffee can make for significant deductions because they add up so fast and unless you're a cyborg you need to eat and drink. There is a limitation on what constitutes "lavish" meals, although the average indie developer who lives on free pizza from monthly collective meetings tends to consider a diner lavish, so I wouldn't fret about that limit too much. You won't automatically get the deduction disallowed based on dollar amount. Once again, if you didn't see it in *The Wolf of Wall Street*, you can likely write it off as an ordinary life-sustaining cost.

Keep in mind, you can't do this on your non-travel and non-business days. So in our GDC sojourn example, we have just three days where there's no deduction for meals. Save the splurging at nicer restaurants for the travel and convention days!

Now, of course, the standard meals and entertainment rules do apply on your non-business days. So, if you want to fit in a fun excursion you can write off? Invite a dev team member or other associate! Try to have a meal or two with them as well and use it as a time to critique each other's games or talk about working together. Because if you're dining solo, there's no write-off on those non-business days.

Standard Meals Allowance

Just like the standard mileage rates, there's a separate rate for travel meals. Using these standard rates means you're relieved from having to document every meal, but the trip itself still needs to meet the tests described earlier just like how the standard mileage method doesn't relieve you from having to properly document that you use your car for business. Using the standard

allowance could benefit you if you're a budget diner who has spent far below the standard allowance for the day and region.

However, this alternate gameplay path is twistier than the direct route of taking actual expenses. Depending on how often you do overnight travel, you might want to stick to that route because tallying up your food receipts from the trip can wind up causing less mental stress than the following:

- Consulting General Service Administration (GSA) tables linked below to find the correct local rates for standard meals allowance, as opposed to mileage, which is a universal rate no matter where you travel.
- Then you still have to take 50% of whatever the rate from that table is.
- Having to prorate the amount on your departure and return dates.
- Just like the standard mileage method that applies to how you claim car expenses all year, you must use standard meals allowance for <u>all</u> of your overnight business trips throughout the year.
- Federal agencies operate on a fiscal year that starts every October, so most people have to choose which fiscal year to use based on which one has the better rates by location.
- You can only use this method for overnight trips; local business meals still use 50% of actual cost.

Sounds like it would bring Ganondorf Dragmire to tears! But depending on how much you travel and your spending habits, this method could wind up netting you a bigger deduction and making the headache worth it. Otherwise, I wouldn't have mentioned it here.

So, the GSA sets these amounts every year, not the IRS. Check out their per diem rates for the daily allowance based on the zip code of where you will be. It will be the M&IE columns, and you can disregard the information on splitting out amounts for meals and incidentals because that is meant for federal employees. Just like with using the actual costs for meals, the meal allowance has a 50% limit. Entering my NYC zip code resulted in $74 per day for the 2016 fiscal year. The actual deduction would be half of that, $37 per day.

If you're going to be in more than one zip code on a travel day, like taking a road trip to a convention that spans across a few states, use the rate for where you will be sleeping that night. This could help you if you leave a low-cost area and sleep in a high-cost one but hurt you if it's the other way around. How much you'll benefit from this method also depends on your taste in dining establishments and beverages and what is available nearby, of course.

You also have to prorate for your departure and return dates using one of two methods. Regardless of which one you use, the area that you are departing from to go home is the regional per diem rate that you'd apply. So, if you're staying in New York for four days and three nights before going back to Chicago, you'd still be using New York rates on that last day. The first way to prorate is the simple federal employee method, which is just to take ¾ of the regional rate for that day. The other method is pretty vague, in that you prorate based on a "reasonable business practice and applied consistently." So under the simplified method, you'd have two ¾ days and two full days, for three and a half days to use New York's rate. Three-quarters of $74 is $56 and

half of that is $28, so two ¾ days and two full days comes out to a total deduction of $130. Looking at the harder proration method, if you look at your arrival and return times on both those days, you could prorate a full day depending on when you arrived or got home. If you arrived in New York midday but didn't get back to Chicago until well after 9PM, it'd be easy enough to say you had four days instead of three and a half, for a $148 deduction.

This hack is pretty difficult, but one that could prove to be worth taking nonetheless. But aren't you having fun?

If you travel outside the contiguous 48, like going to Alaska, Hawaii, or a US territory, the Department of Defense sets the rates for those and you'd have to consult their tables. The Department of State sets the per diem rates for foreign travel if you're doing international business, and you'll have to go by the closest region or city on their chart. Some countries, even ones with notoriously lower living costs like Thailand, have extremely high per diem rates that could make this headache worth it even after the 50% limit.

So just like with standard mileage rates for drivers, you might want to keep track of both the per diem rates and the actual costs for your travel meals to see which one is better for you. Like the mileage, it also needs to be consistently applied for the year and has the same substantiation requirements.

Expense Subtraction for Non-Business Guests

People often use conventions and other business travel to supplant family vacations. But you can't deduct the expenses for your family or friends to come with you, only for yourself.

For the airfare, you'd need to examine how much just your share of airfare, taxes, baggage fees, and travel insurance cost out of all the tickets you purchased. This is easier when done in separate transactions but they normally must be booked together to get the desired seating. Then for the hotel, you have to see what they were charging for single-occupancy rooms instead of the one your family is staying in. If the rate at your hotel was $170/night after fees and taxes for one guest but you paid $250/night for your spouse and child to stay in the room as well, you could only deduct at the single-occupancy rate of $170.

The same goes for meals: you can only deduct meals for yourself on travel and business days. The meals for your family members are never deductible. Per convention commonalities, if your family decides to dine with another dev's family, the Dutch rule applies again in that you can only deduct the amounts paid for you and your associate. Not your family, or theirs.

However, indie developers often have spouses or travel buddies who are also in the field to save on hotel costs and split up driving. (I have a great one I've gone on various adventures all over America with!) If we switched everything in the example above to a business associate, then all those expenses would become deductible. That person must be your employee, business partner, or an industry associate who would've been able to deduct the expenses on their own if they took a separate trip from you.

If you're splitting a room, typically only one person's card will be charged, and so your buddy will give you a check or cash to pay for their share. Remember to reduce your deduction by the reimbursement.

Expenses for Dev Team Members Who Are Independent Contractors

If you work on your own as an artist, programmer, and so forth for various studios, you might get an offer for incidentals reimbursement, depending on the studio's budget. You're considered part of the dev team as a person, but in the eyes of the law you're independent of the studio in question.

Most of the time, this is pretty simple in that they'll ask you to make an expense report and you'll get paid for whatever your actual costs were. You still have to report the reimbursement as income, then just deduct your expenses as usual, including ones that were not reimbursed. However, other studios will just send you a per diem amount without regard to how much you actually paid for things like meals and train tickets. Any overages become taxable income. Whether you're paid on a flat allowance or after submitting an expense report, meals and entertainment still have the 50% limit.

On the other side of the fence as the payer, it's a little different in that you might be able to deduct 100% of these costs. If your studio pays someone as a contractor and they have incidentals expenses on your behalf, such as holding your booth for you at a convention you can't make it to or entertaining a publisher while you're busy with other matters, you are subject to the 50% limit on meals and entertainment that you reimburse them for if you request an expense report or if that person has documented their expenses without you asking them to. But if they *don't* keep records or account for them separately, you get a 100% deduction.

Let's say your animator comes with you to E3 to help promote the game and field press for you, and he's treated as an independent contractor. You offer to pay for his fare card, lunch every day, and to take a reviewer out to a concert. After E3, he gives you a report detailing $20 for a fare card, $50 in lunch expenses, and $40 for concert tickets, so you write him a $110 check. Since the meals and entertainment were accounted for separately, you can deduct the $20 fare card in full but you only get a $45 deduction for the $90 in meals and entertainment expenses.

Alternatively, you wait until E3 is over then ask him how much he spent the whole trip. He informs you that he used the receipts as rolling papers at the farewell party at the Fig. "Dunno, dude. $300?" Grudgingly, you write a check for $300. And you can deduct all of it because it's just considered part of his total pay: no differentiating 100% deductible transportation from 50% deductible lunches and bar tabs. It's then on him, not you, to try substantiating those expenses on his own return as well as reporting that extra $300.

Laundry, Dry-Cleaning, and Costumery

I wait until GDC to have my coat dry-cleaned. After a brutal New York winter and far too many hours of sleeping on a plane and sitting around a dingy airport terminal smelling of overpriced burnt coffee and desperation, it really, really needs a cleaning by then. Dry-cleaning a winter coat costs about the same at home as it does to have my hotel do it while I'm at Moscone all day and in delightful weather that doesn't require a coat. And if I had it cleaned at home, I wouldn't

be able to write it off: but under the business travel rules, I can while I'm at GDC. *So…anything you ever wanted dry-cleaned, take it with you on business trips if you can!*

For this deduction, it doesn't even have to be dry-cleaning. It can be wash-and-fold laundry service for your street clothes and business clothes, or buying detergent and getting quarters to do it yourself.

I wanted to address clothing in this chapter specifically because it's frequently a thorn in peoples' sides and the overnight travel element is virtually the only time you can get some relief for what can be a very annoying but necessary personal expense. One of the many, many reasons you could not give me a million bucks to go back to the financial industry is that game development is a profession where it's considered an achievement if you left the house wearing pants. I hated, *hated*, HATED putting on a suit and flushing at least 10% of my salary down the toilet in business clothes and dry-cleaning, and I hated it even more that I couldn't deduct it in any way.

Especially since there is no deduction for *purchasing* those clothes. Several Tax Court cases have proven time and again that there is no deduction for "clothing suitable for personal and private wear." The 1980 case Hynes v. Commissioner asserted that just because you don't plan to wear these clothes in your time off the clock, it doesn't mean they're unsuitable for wear out of the workplace. But while you can't deduct the actual costs of your street clothes or business suits, you can deduct your laundry and dry-cleaning bills when you have at least one night away from home on business.

While buying suits isn't a concern for most game developers, it was worth mentioning. But I think most of us are more willing to put on a Tron costume than a business suit. And funnily enough, THAT we can deduct!

You still need a business purpose for the costume, but providing that you have one, you should have no problem deducting it. For instance, did you put that costume together to try angling for favor with a publisher if it's from one of their IPs? Or is it part of your branding strategy to dress up as a character from one of your own games at conventions and while LARPing? If you said yes to any of these, then you can deduct the costume. Cleaning and care (like mending, tailoring, and storage) of these costumes is also deductible regardless of whether you're traveling overnight or not. But the costume still has to be something pretty out there for a write-off and not easily mistaken for street clothes: Lara Croft shorts and tank tops wouldn't fly, but if you dressed up like Super Meat Boy you'd have no problems.

Tips

Tips add up fast even if you're not staying in the fanciest accommodations. Since tips for hotel and airport staff are virtually always in cash, make sure you are diligently recording how much you pay them.

When you tip drivers, you don't need to account for the cost separately unless it was a situation where you bought a shuttle service in a separate transaction, like buying your seat as part of an

Orbitz package when you book the flight then you tip in cash much later. It's otherwise part of the travel expense if you pay the tip at the time of the fare.

The same goes for tips on meals out: they're not accounted for separately. The food and drink costs plus sales tax and tip are totaled up and equally subject to the 50% limit.

Other Business Incidentals

You're a busy indie developer. At some point when you're on the road, you'll likely need to fax or mail documents, use a phone if your cell's dead or out of minutes, or pay outrageous fees for wifi because you really need to get your work done. If you're in a foreign country, you may need to pay a translator to help you with a conversation or to translate documents.

All of these are deductible regardless of whether it's a business or personal day.

Non-Deductible Conventions

I've only touched upon the super-obvious ones, like GDC and E3, plus local game dev events so far. But there are many, many more kinds of conventions out there: social, religious, political, other industries. And pretty much you can't deduct your attendance unless they're related to your trade.

The only exception to this would be if you did have some kind of direct profit motive or business advancement reason, such as coming up with, say, a way to gamify the home-buying process, and so you make a prototype you want to show at a National Association of Realtors event to get their feedback and a way to market it. Otherwise, if you have personal reasons for attending but only get some incidental networking out of it, then there's no deduction.

Giving Your Friend Tax-Free Income While You Crash on Their Couch

So, like many indie developers, you're a budget traveler. You wind up making friends in other parts of the country so you can futon-surf your way around.

Most of the lodging I've discussed here pertains to staying at hotels. But you'll want to document anything you pay to your friend (or family member or random stranger you met at the bus stop) for crashing with them. They can get some tax-free income, and you still get a deduction. If you've stayed with a friend or business contact, you've likely chipped in for gas or bought them dinner. Nice, but when you've got business elements, like staying for a convention or publisher meeting, you should give them some money and document it, saying that it's rent—not for gas or food.

Remember when I discussed exclusions way at the beginning of this book and how a lot of them are really sneaky? Here's a devious Easter egg for you: if you rent out your *primary residence* for less than 15 calendar days in the year, the income is completely tax-free. So if you live in a prime neighborhood and want to give being an Airbnb host a shot for a few nights to help pay for your upcoming conference expenses, this is a good way to get some tax-free money. Then, when you go to another city and give your friend some money for staying over, have a receipt written up so you can still get a deduction and your friend enjoys some tax-free income. In principle, it's up to them how they want or need to use the money you're giving them, but for tax purposes, say

it's for lodging. You won't have to worry about standard mileage vs. actual cost for gas or the 50% limit for meals, and get a full deduction, and your friend pays no tax assuming they don't rent out a room or two for more than two weeks per year. Talk about finding that hidden 1-Up…

International Travel

Everything we just went over mostly pertains to domestic travel. There are tighter restrictions on international travel because a lot of people try to use business reasons that might be shaky to attempt subsidizing a dream vacation. You need to tread carefully with international business trips and the special, separate rules for international conventions. The whole concept of business, personal, and travel days comes up again when it comes to international trips.

Conjure up a strategy or arcade game that has bonuses that are very hard to get, or at least just hard to get on the nose. I'm thinking of old school classics like *Crystal Quest* because it was so easy to accidentally shoot something that was beneficial, which is seriously the best allegory possible when it comes to both domestic and international travel defenses. But the example I gave way back of *Donkey Kong Country* also fits, because it's easy to waste a perfectly good barrel – your barrels being days and money spent outside America.

In both the time allotted and with the number of obstacles on the screen, can you grab one of these goodies? These conditions lead to one hell of a bonus that you don't get with domestic travel. If you meet one of the four following exceptions for your cross-border business trip, you can deduct ALL of your travel expenses without having to separate out personal days!

- *No substantial control over the trip.* Really only applies to you if you're someone else's employee.
- *You were outside America for less than a week (seven consecutive days)*. The days you are still in the US or departing it don't count, but the day you return does.
- *If you were out of the country for* more *than a week, less than 25% of those days were spent on personal matters.*
- This one is a <u>lot</u> harder to prove, but if you can establish that *getting a vacation was not a major consideration in making the trip*, you'll get an exception.

So let's boil it down to the trip length, because self-employed people immediately don't fit that first exception and that last one is too nebulous to waste keystrokes on.

If you're away from home for less than seven days, not counting the days you're still in America on account of layovers and departures, it's the easiest. You can deduct all of your travel, meal, and lodging expenses. Then, if you're gone for over a week, you have to look at how many personal and travel days there are. Both the days coming and going will count as business days.

We're going to fly out to Japan for a few weeks. Two weeks are purely for business with a publisher and expediting things in person with one of your dev team members, but you stay an extra five days to try giving yourself a vacation. Travel takes one full day in each direction, so that makes for a total of 21 days. With two travel days and 14 workdays, that makes for just five personal days and 16 business days. Just 23.8% of the trip is personal. If your trip was domestic, you actually wouldn't have been able to take food and lodging deductions for the extra days, but under this international exception, you totally can for your basic life-sustaining costs plus incidentals.

If you're going away for more than a week and you don't meet that less-than-25% exception, you still get deductions but you're going to have to account for personal days and leave them out. But even then, there are still some bonus days you'll get with international travel.

International Travel, Personal, and Standby Days

If we turned the sorting out of business days into a card game, international travel has a lot more trump cards than domestic travel does. You'll want to be mindful of when things like public holidays take place as well as when your meetings and other events requiring your presence are scheduled. For instance, if you get to your destination on Friday but your meeting isn't until Monday and this trip doesn't meet one of those four exceptions, then you can't deduct the meals and lodging costs for the weekend. However, if you have a meeting that Friday and your presence is required on Monday, then you can treat the weekend as standby days. Standby days count as business days! Standby days, like weekends and public holidays, are deductible so long as there are business events going on between them. So if you don't meet that 25% personal time exception for a trip lasting more than week? Try to save your vacation time for the end of the trip!

Travel days are still business days, but now you can also count days when you were supposed to work but couldn't due to circumstances beyond your control, like getting sick or when your client winds up double-booking so you can't come in on the date initially planned. Days you devote to your trade are also business days even if they don't totally line up with the initial purpose of the trip. This includes such things as going to workshops and taking care of business, although it does have to take up a significant part of the day – at least six to eight hours.

I made the ensuing example very tricky and very plausible. If you're a fan of twisty logic puzzles like those grids from *Dr. Brain*, you might want to give figuring out the business days a whirl on your own before reading the answer after it!

You're meeting with a French publisher, and you planned enough vacation days out of your two-week stay that you don't meet the 25% exception. Flying to Paris takes a full day in both directions, and you spend your arrival date and the day after it getting acquainted with the city and exploring. Between meetings with the publisher spread over three days, you find out about a local game jam. After a day exploring, one of the Parisian indies at the event is very impressed with your work and invites you to speak at their studio later that week. Good thing it wasn't until later, because you lose the whole next day to a nasty bout of food poisoning that leaves you unable to work on the game or chat with the publisher. After fending off the stomach bug the following day, you manage to get two hours in your hotel room catching up on business email and working on the game. The day after that, you spend a whole day going around to coffee shops working on your game. With your publisher business concluded, the rest of the trip is spent having fun.

So, the two travel days count as business days. The day after the arrival is personal. The three days with the publisher are business days, and so is the day you were unable to work due to unavoidable food poisoning. The day you spent exploring then just going to a game jam would be a personal day because you didn't spend enough working hours doing things to advance the interests of your business; the day that you did only two hours of work would also count as a personal day for the same reason. But since your presence was required for the speaking event you got invited to, that day is a business day even if it was the same length or shorter than the game jam you just attended, where your presence wasn't required. The day you spent working on the game for at least a full workday is also a business day. Since the rest of the days were vacation days, eight out of 14 days were for business (about 57%). The trip has enough business elements to be deductible in the first place, and more than half of it was made for a solid

business reason. Still, the travel, meals, and lodging expenses for those six personal days can't be deducted.

International Convention Rules

International business trips for things like publisher and dev team meetups have more loopholes to exploit than domestic business travel. But for conventions, you don't get a reskin. It's like a totally different engine!

International conventions have a lot of strings attached because it's so easy to make a tax-deductible vacation out of a domestic convention…and then you see the generous deductions and standard allowances there are for international business travel. So, of course an international convention isn't a fast path to a goldmine of deductions. That would be making the difficulty level just *too* easy.

Whenever a convention takes place outside of North America, it has to meet certain requirements in order for you to get a deduction. IRS Publication 463 defines "North America," which isn't limited to the contiguous 48.

First, you have to establish that the meeting is directly related to your trade as a game developer. Easy enough most of the time. But the next part makes for yet another tough building puzzle: you have to establish that there was a good reason for this event to be held outside of North America and thus, for you to attend. Here's what the IRS looks at in international conventions to see if you were justified in writing off your attendance:

- The purpose of the meeting
- The activities that take place
- Purpose and activities of sponsoring organizations
- Homes of the sponsors
- Other cities/countries this conference has been or will be held in, and that of other conventions that the sponsors put their names on
- Other relevant factors that support your argument

Compared to other industries, game developers have a real upper hand here. The ability to enter foreign markets, having dev team members anywhere around the globe, the tax incentives for games that exist in other countries that America hasn't caught onto…all of these things make international conventions viable opportunities to get work, get funding, find talent, and grow your audience. Ergo, reap viable tax benefits because these things all establish a profit motive.

Let's examine our old standby GDC once more. There's the occasional GDC Next in Paris, GDC Europe, and GDC China, all in addition to the flagship one in San Francisco. We're not going to worry about the purpose and activities parts too much; we know what it's for.

A cursory look at each event's page shows that there are a few main sponsors and partners in common but each one has unique sponsors that won't be at the other events. Virtually all of the sponsors are part of the industry. You'd have a harder time proving an international conference is related to your field when totally random companies make up a majority of the sponsors and offer things that are unrelated to game development. For the major conventions like GDC, Casual Connect, and Gamescom, you wouldn't have to worry about this too much.

But do these companies also sponsor a lot of American conventions or just ones in their own country or continent? If they frequently sponsor American events, that could put you in jeopardy. It's not likely to be the defining factor in losing the deduction, but it would get factored in if you don't meet the other criteria.

Moreover, what about the partner organizations? They are more likely to kill you than the sponsoring companies. If IGDA is hosting the event, then you're covered because of the international presence, but if you have a local collective that only has American members which decides to convene in Europe or Asia, you'll be dead faster than falling off a stair in *King's Quest IV*.

As for "other relevant factors," you really need to get a leg up on the business side of your niche to justify the deduction. You're likely to have two major factors to mount a good defense, and that's the talent and the market in those countries. Case in point, my own studio would have perfect justification for attending Adventure X in London. We use Adventure Game Studio (AGS) to make most of our games and a significant portion of AGS devs are in the UK or Europe, and for a long time it was hard to meet other AGS-ers in America. It only helps our cause that point-and-click adventures also sell more in the UK and Western Europe than in America, so reaching a convention center full of foreign adventure game lovers would be crucial for us to make a profit. We hit the talent and market nails on the head without having to solve any nail-hammering puzzles.

Whereas you'd have a harder time proving that your deduction has merit if you went to Casual Connect in Kiev and you aren't speaking at it nor showing your games there, don't make casual games, and have no intent to reach the Eastern European market. If you do have the intent to move into the casual gaming sphere, Casual Connect has American conventions as well; unless you're trying to get Eastern European customers and/or talent, you'd have a much harder time defending the deduction. Even if you swap out the genre and country, the point stands.

* * *

With diligent planning, you can basically get a tax-deductible vacation providing you mix it up with enough business travel, and local travel can also give you some relief along with the actual costs of attending these events. Some of these expenses are obvious and others are hidden more deviously than that one pixel you need to click to go to the next room already.

And the more fellow indies you surround yourself with, the more fun games you will make and the more you can prove these expenses had an actual business purpose!

But now it's time to leave the bonus-heavy games like *Donkey Kong Country* behind and move onto turn-based games like *Heroes of Might and Magic*.

Level 12: Turn-Based Strategy, or Depreciation of Big-Ticket Items

It's important that you know what to do with big-ticket items, as depreciation methods are insanely complex, not to mention so boring that it would make an afternoon of those dollar bin PGA tour 3DO titles look fun. Ergo, I'm not going to go into as much detail on big-ticket items as I did for travel expenses, given that indie developers don't tend to heavily invest in equipment a whole lot. But you should have an idea of how depreciation works.

There are multiple methods of depreciation, but this book concentrates solely on **MACRS (Modified Accelerated Cost Recovery System)** because it's the system you are going to be using 99.9% of the time given the types of equipment indie developers are most likely to purchase and how long you will have these items.

Your tax professional should have a good handle on depreciation. Most tax software intended for the general public is honestly a crapshoot when it comes to inputting depreciation, and the more equipment you have, the bigger mechanical pain it's going to be changing software packages or tax pros. All in all, though, depreciation has some trickiness to it, but it's a bit like that virtual dragon from *Sam and Max Hit the Road* – looks scary and intimidating at first, but is nothing more than knowing where to find the key around the scaly parts.

There's some key concepts you need to get familiar with in order to figure out which depreciation strategy makes the most sense for you in terms of both your tax bills and mental energy. And I'd strongly recommend doing a playthrough or watching some Let's Plays of the older *Heroes of Might and Magic* games (I and II) because I'm going to be referring to them the rest of the chapter.

Depreciation = Turn-Based

Depreciation refers to wear and tear of vehicles, furniture, real estate, and equipment meant to last you more than one year. These things are called **fixed assets**. (Or depreciable assets.) Because game developers tend to tie up their capital into labor and other development costs rather than equipment, depreciating equipment isn't a huge concern if you keep your games simple hardware-wise and your only tool of trade is a laptop. But if you're going into console development, you're definitely investing in more equipment. Sound designers need good microphones, mixers, and keyboards, while many game artists swear by their Wacom tablets and may have special furnishings like drafting desks. Whether or not you exclusively develop for mobile and need native devices for testing, you're going to need a cell phone and/or tablet simply to take care of business at home and on the go. All of these items are depreciable.

When you play *Heroes of Might and Magic*, you can only build one structure in a town per day (turn) until you can build no more. Depreciation works similarly in that you deduct part of that fixed asset every year (one turn) until you can't anymore. Compare this to when you buy things like art supplies that have to constantly be replenished, meals and drinks with your dev team that are enjoyed in the moment, and one-time expenses like convention passes. You just deduct them in the current year and you're done. Depreciable assets are like building those towns: you need

multiple turns to get them to the point where there's nothing left to build. Depending on what your income and other expenses each year/turn are like, this can be helpful or hurtful.

Basis, Repairs, and Capital Improvements

Basis is an extremely complicated subject, as you saw in the breakdown of business entities. When it comes to depreciable property, basis is usually just your purchase price, but other things can get tacked onto it. Because depreciation wears down on the basis, the number after you subtract depreciation is **book value**.

Things like repairs and maintenance for your equipment are deductible expenses that have no impact on basis. But if you send your computer in for repairs and you get substantially more memory and other upgrades that made it better than just restoring it to a serviceable state, you'd have to treat it as a **capital improvement.** Capital improvements then make for an **adjusted basis.**

For example, you spent $500 on a tablet. You buy a $10 case and pay $50 to fix a cracked screen. It initially had a 16GB capacity, but the repairman offers to upgrade your unit to 32GB for $100. The case and screen repair are expensed, but your basis in the tablet is now $600.

Now, let's say you bought a high-end computer secondhand on the cheap because it was under a payment plan with the store, and you assumed that plan as part of the deal. Assumed liabilities are also part of basis: if you paid $500 cash for a computer and took over a $1,500 loan, your basis is $2,000.

It's important to know basis not just for figuring out your depreciation deductions but in the event you sell the item and deal with recaptures after the sale.

How Many Turns?

Computers, tablets, and so forth are what's called "five-year property" in the tax profession, in that you depreciate them over five years/turns. A vast majority of equipment you'll use gets five turns. Furniture and fixtures get seven turns. Since I doubt most game developers are going to use fruit-bearing trees (10 turns) or racehorses (three turns) in making a game, we're going to stick with five turns when discussing equipment. Things that get far more than five turns, such as real estate, are beyond the scope of this book, although we will be touching real estate depreciation just a little in the home office chapter.

Listed Property

The term **"listed property"** is one you're going to have to get familiar with. Items that have a personal and/or recreational element to them constitute listed property. In other words, virtually everything that we work with:

- Desktop and laptop computers
- Related peripherals, like printers, hard drives, and scanners
- Tablets
- Game consoles
- Cameras (video and photographic)

- TV screens
- Microphones
- Instruments
- Cars

And the list goes on. If you can use it to take pictures, record, play, or even communicate, then it's listed property.

So what's in store for you? You need to carefully note where and how much this item is used. Listed property requires more sensitive recordkeeping than other depreciable assets, especially cars. Then, the depreciation deduction can be limited and more complicated if you don't have at least a 50% business usage on these items. Even if you use something 100% for business? *You still have to substantiate it*, such as keeping a logbook and/or photographic evidence. (A blog helps, too!) Listed property can be a real killjoy in that way.

The only exception to this is cell phones. Thanks to the Small Business Jobs Act of 2010, cell phones are no longer listed property. While they're still subject to a business percent if you don't get a separate phone, you don't need to go through the hassle of declaring it as listed property. You also don't need to use it for at least 50% on business, but I'd honestly be hard pressed to find an indie developer where they weren't already using their phones at least halfway for business, what with both correspondence and development needs.

Then there's also an exception for computers and peripherals that are exclusively used in a dedicated office you own or lease or home office. **You must be taking the home office deduction in order to meet that exception if you don't have dedicated external office space.** This is a big deal if you don't use your computer, printer, and so forth at least halfway for business reasons. Laptops don't meet the exception if you take them around with you, so this exception would really only apply to desktop machines and other peripherals that aren't easily portable, like printers.

The listed property restrictions shouldn't be a problem for most indies because it's easy enough to use one of these devices primarily for business. It's substantiating it that can be the hard part if you don't use it all for business. If you use your TV at home all the time and only drag it out with you four or five times a year for conventions and playtests, you're not likely to get a deduction for it, whereas dev logs might be a better choice for proving that you do use an Xbox 50-80% for business.

Key Dates for Big-Ticket Items

The most important thing to note is the date the computer or other piece of equipment is placed into service. More often than not, it's the same day as the purchase or the day after. But things will happen sometimes, such as trying to squeeze that last bit of life out of a hard drive before retiring it and using the new one. Or you're faced with a sudden move and it takes a month or two to locate and unbox a mike. Ergo, it's important to make that distinction, because the *service date* is when you start depreciating that item. So the turn doesn't necessarily start on the purchase date.

The other date you need to note is when you dispose of it (retirement date). Disposal can be through selling it, charitable donation, getting it destroyed in an accident, or just plain throwing it away if it doesn't work anymore. Other forms of retirement are scrapping it for parts or using it personally and not for business anymore.

Depreciation starts the day you start using that item, and ends when there's no more left to deduct (fully covered the cost) or on the date you dispose of that item, whichever comes first.

Also, don't confuse idleness with the service and retirement dates. You start depreciating on the service date. Then, even if you stop using that item, so long as you still have it, you take the depreciation deduction as usual. Things only change when you dispose of it in some way.

Using Conventions: Splitting Turns into Smaller Turns

Going back to *Heroes of Might and Magic* yet again, combat in that game is also turn-based. Each army of creatures attacks once, and if your Hero can cast spells, then he can do so once every turn after all of the troops have had a chance to attack. Each main turn has a bunch of micro turns depending on how many troops you have.

Think about how some enemy troops will fall like stones and others need several hits from all your troops plus a spell from the Hero to go down. Using the five-year property guideline, let's say that your Hero casts a spell, and so in the first turn, all of your troops do a lot of damage plus magical damage from the Hero. The enemy wears on them a little. Now, they fight back consistently for three more turns, then in the fifth and final turn, you only need to do a miniscule amount of damage to get the enemy to go down.

And that's basically how depreciation works in terms of what time of year you placed the item into service. Depending on the convention and method used, you could do a lot of damage in the first year, a middling amount in the next few years, then getting what little bit is left in the last year.

You might be wondering what the significance of the date is if virtually everything else you spend money on just gets deducted in full regardless of what time of year it was purchased. Depreciation goes by the number of months it's being used in both the year you start using that piece of equipment and the year you have to sell it. Then, you have to apply the mid-quarter convention. (MACRS has a few different conventions, and you'll almost always be using mid-quarter for things like computers, tablets, and other development equipment.)

Let's reexamine *Heroes of Might and Magic* combat once more in the *submethods* you can employ under MACRS, **150% or 200% double-declining balance (DDB)** and **straight-line (S/L)**. DDB is more beneficial in the earlier years because that balance is a lot bigger. Taking 150% or 200% depends on how much you think you should deduct now as opposed to future years, and also how much the item cost.

To compare this to the turn-based combat, let's lay out your battlefield: a temporary but powerful troop like summoned elementals, and some Level 2 troops that won't do a great deal of damage but could finish the enemy off, such as gargoyles. The elementals would inflict a lot of damage

(DDB) in the first three turns before evaporating. The gargoyles finish the enemy troop off by consistently doing enough damage in just two turns.

Doing S/L for the whole thing would be more like you cast a consistent and duration-based spell such as Poison. You'd take the five years and split 20% equally over those five years, except that the first and last years will be smaller because of having only partial years for both.

You pay $2,000 for a new computer station on April 1 and put it into service the same day. For simplicity's sake, you use it solely for work at a dedicated office space and use the computer for many, many years, well past recovery point. Under S/L, you'd get a consistent $400 depreciation deduction. But since you placed the computer into service in April, the mid-quarter convention for the second quarter lets you deduct just 12.5% of the $2,000 basis ($250) in the year of purchase. You'd be able to deduct $400 in the ensuing four years consistently, then the leftover $150 in the sixth year.

If we switch to 200% DDB, the way it works is that you use 40% of the computer's basis/book value every year, since DDB is basically twice the straight line rate (20% for five years). There is a MACRS chart to consult for the correct mid-quarter convention, and it says to use 25% for stuff placed into service April-June. Twenty-five percent of $2,000 is $500, so that's your depreciation deduction for the first year, making the new book value $1,500. For the second year, 40% of $1,500 is $600, so you'd deduct $600 that year. You'd do the same for the third year, deducting 40% of the $900 book value ($360). However, with a $540 book value and two years of life remaining, it's no longer worth it to do DDB because 40% of that is $216. Why take $216 when you can deduct $227 by switching to S/L? The reason you can take $227 is that the MACRS table says S/L deductions for the fourth and fifth years can be 11.368% of the original basis, which is $227. You'd deduct $227 for those two years, then have $85 left over that would get deducted in the sixth year.

Check the citations section in the back of the book to locate the right convention tables. There are also many good free depreciation calculators out there, published by schools and small accounting firms. Just remember to get one that has tax depreciation, not books depreciation, because there are stark differences between the two – which is why it's a very good idea to work with a professional.

Expensing Equipment (§179 Deduction)
§179 deduction is named after the section of the tax code and the ubiquitous name thrown around in tax offices nationwide for expensing equipment and real estate.

There are going to be many times when depreciating items just doesn't make sense. If you spend $50 on a new keyboard, it seems frivolous to do all this paperwork only to deduct about $10 every year. You'll want to just expense it in full. You can do this for up to $500,000 worth of depreciable equipment per tax year, so even that $2,000 computer from the detailed example above could be expensed. Going back to *Heroes of Might and Magic* combat, taking a §179 deduction would be like having an insanely high spell power level and using a spell like Lightning Bolt, which winds up taking out the only enemy troop on the map without needing to

deploy your gargoyles and pikemen. You knocked it all out in just one turn instead of having your troops attack the enemy over several turns.

And, let's face it, the simplicity of just casting Lightning Bolt and doing 2,000 points of damage might be more appealing to you than keeping track of usage, service and disposal dates, and so forth. §179 is particularly appealing for electronics prone to insanely fast obsolescence, like tablets and phones. It's reasonable to expect that you would have a microphone or desktop computer for five or more years, but it's highly likely you'll only keep a phone or tablet for about two years. Sometimes less.

But if you don't have a lot of income right now, the §179 deduction won't be too helpful for your big-ticket purchases because aside from the flat dollar limit of half a million, you also need to be racking up a profit. If you try to claim it while you're running in the red, it will get suspended until you're in the black again, whereas normal depreciation can go in with your other expenses to deepen your business loss.

For C corps, this is pretty straightforward: all your other business expenses exceed your income, you have to suspend it until you do have a profit again. But if your business isn't a C corp, other items on your personal tax return will affect your §179 deduction if your studio isn't bringing much money in yet. If you're still receiving wages from a job or doing other freelance and contract work, these types of income will help you in being able to expense your studio's equipment. If your single-member LLC studio brought in $5,000 of income but you had $10,000 in dev costs that you're expensing and you haven't quit your day job yet so you have $35,000 in wages, the wages will help offset the loss so you don't have to suspend your §179 deduction.

A common myth about §179 is that it's all or nothing. For virtually all of the asset classes I've described here that a game dev is most likely to use, you can take normal depreciation, a full §179 deduction to expense it all, or split the two some way. Let's say that this year was very fruitful and you just started a new game that you think will take all of next year to finish, but you don't want to fully expense your new computer because you want deductions two years from now in anticipation of your next title being a hit. You could take a §179 deduction for $1,000 and depreciate the remaining $1,000. Or, expense $500 and depreciate $1,500. The possibilities are endless.

Personal and Business Percentages
Using a business percent on a turn-based deduction like depreciation isn't that dissimilar to when you'd put a business percent on a normal expense, such as your internet.

Going back to the $2,000 computer station once more, if you instead use it 70% for business, you could take a §179 deduction for $1,400 to expense it completely, or you could depreciate the $1,400 using S/L or DDB then S/L. (Comes out to $280/year under S/L.)

Special Rules for Vehicles
Passenger cars have extra limits imposed on them, even more than the ones already in place on other listed property. (Passenger cars are the most common vehicles. There are special rules and limits for vans, trucks, and SUVs that are beyond the scope of this book.) There is a maximum

depreciation for cars that changes every year based on when you placed the car in service. Cars also use a half-year convention, unlike all the other equipment, which uses mid-quarter.

Passenger car depreciation deductions are based on the year you put it in service; there's a chart to consult that's updated every year. Let's say you bought your car and placed it into service in 2014. The maximum deduction for the year is $3,160. If you use your car 30% for business reasons, your depreciation deduction is limited to $948. Per the car expense options already discussed, if you take the standard mileage rate consistently then you don't have to worry about this. But if you use actual expenses, then you do. (You also have to use S/L, not MACRS, if you use the car for less than 50% business during the year.)

Legions of Enemies: Recapture

Well, this round is about to get really challenging. We're going to fight those big, purple, magic-resistant dragons, the most powerful monsters in *Heroes of Might and Magic*. Just when you thought you beat the baddies with your spells, legions of gargoyles, and hordes of hydras, these zounds of dragons had to appear and batter your hard-won deductions with their blue flame breath. Just like those dial-up tournaments of yore when you watched your trolls hit the ground, you're now swearing at your computer.

Recapture generally refers to disposing of a depreciable asset before the recovery period is over and having to claim the depreciation you previously deducted as income. But recaptures aren't limited just to disposals before our five years are up. As game devs whose tools of trade literally all have listed property restrictions on them, you need to be especially careful with how much you use these items and documenting that use in some way.

For most normal equipment, you only need to worry about recapture if you sell or otherwise dispose of it before its predetermined recovery period is up. Listed property is really sensitive to recapture since it can happen *at any time* that your business use falls below 50%! The same holds true of anything you took a §179 deduction for, but this less-than-50% annoyance will be applied under an umbrella since virtually everything we use is listed property and the law states that the listed property rules trump the §179 ones.

We need to first examine a normal disposal before getting into the nebula of business usage causing a premature recapture. Here's a very likely scenario: obsolescence making you scrap electronics.

You paid $500 for a tablet that you used entirely for development and testing purposes (100% business). It was purchased and placed into service February 15, 2012. The tablet became obsolete, so you decided to hock it on eBay for parts. On May 2, 2014, you got a buyer and netted $50 after fees and postage. Using DDB, you deducted $175 in 2012 and $130 in 2013. Your 2014 deduction would've been $78, but you could only take $39 since it was sold in the second quarter (half the year). Thus, the total allowable depreciation is $344.

Deducting this from the original purchase price of $500, the new adjusted basis is $156. Subtracting this from the sale price of $50 results in a $106 loss that you can deduct. If it had sold for closer to what you paid for it, it'd result in a recapture gain. In this simplified example,

there was no question of the item being used solely for business, so we didn't have to worry about this next part. It was pretty cut and dry in that the tablet was solely used for work. But it's going to be harder if you don't use that item for *more* than 50% business reasons, for even if you don't sell that item, the year that you dip below 50% business usage, you'll be subject to recapture of the depreciation you'd already taken!

Don't get toasted to a crisp by dragon breath. If you're in serious doubt that you're going to use listed property (read: virtually everything we use in our line of work) for less than 50% of the year, very carefully note how you'll use it. If it looks like you'll only occasionally use it for business, you might want to play it safe and keep it on your personal finances or buy a separate device solely for business.

Converting Personal Items to Business Property

You already had your computer for a few years before you decided to seriously go indie. It might shock you to learn that you can actually take a deduction! While you can't claim §179 deduction for converted property, you can claim depreciation for the year that you started to use it for business. If you bought your computer in 2012 and used it solely for personal use up until 2014, 2014 is when you'd be considered to have placed it into service. Assuming you don't have a home or external office, you're subject to the listed property restrictions and would have to use a business percentage. No depreciation is allowable for the years it was in personal use, but from 2014 onward you'd still be able to deduct something. This is one of the few instances of being able to take what's essentially a retroactive deduction. This is totally like one of those mutant zombies from *Heroes of Might and Magic II* slopping around the map.

* * *

Depreciation is definitely like a very tricky turn-based game. Unlike the totally fixed combat map in *Heroes of Might and Magic*, you don't know how well you'll do in future years just yet. You just have to make a reasonable forecast and work with your tax pro on what you both think makes sense. I didn't want to bore you with the super-fine details of depreciation because there's a very strong chance you'll either be trusting tax software to handle it or your tax pro, but there's tomes on depreciation that could outweigh all the code from every single *Civilization* game ever made if you printed it all out on a dot matrix machine. We'd be here until we both could've gotten at least six more games out.

Onward and upward…to your home office!

Level 13: Home Offices Are the Turtles That Can't Swim

If depreciation was like a frustrating *Heroes of Might and Magic* tournament, and travel expenses were a *Donkey Kong Country* free-for-all…well, I really, really hate to tell you this, but home office expenses are like a ridiculously unforgiving NES game. Like how you can't land the plane in *Top Gun* or not get killed by every single thing possible in *Silver Surfer*. Home office deductions are truly like those games where you're drawn in by the cool box art or liking the IP it was based on, but you open it up and sit there aghast at the execution fail: how could the Teenage Mutant Ninja Turtles not swim when they landed in water falling off the platform?!

It isn't the concept of the home office itself, like how proving business usage of your gear and/or car can be insanely nebulous. Or that travel deductions are just a common audit target because a lot of people try to deduct personal trips. But rather, it's the sheer fact that well…most people *live* in their abodes, even if they also work in them. That very fact will just leave you dead in the water before you've even begun.

Strap yourself in. It's a rough ride ahead. Rougher than getting hit with those bowling balls we don't remember from *Back to the Future*.

The Soliman Case and Helix Nebula: Is Your Home Your Principal Place of Business?
To defend a home office deduction, the Court looks at three factors.

- Whether a home office is essential to your business
- The amount of time you spend there (regular use)
- Having no other place to do office kind of stuff (exclusive use)

To extrapolate from these factors, let's look at the different ways indies get things done and where we fall on the spectrum. Many of us work from home, but home isn't the only place where we work.

Many devs are digitally nomadic. I fall into this category, as the random observations in my jaunts frequently inspire my work: coffee shops, the bus, the library, the park, you name it. I'd rather buy an occasional day pass to a co-working space than a long-term contract, as I prefer to spend crunch days at home, while other devs have long-term arrangements with co-working spaces and game developer collectives. If you are one of the latter and trying to claim a home office deduction, then I'd worry more than the perpetual coffee shop wanderers.

Before we delve into case law, here are the questions you should be asking yourself:

1. How many days out of a given week are you working from home? How many hours in those days?
2. Does anyone make workspace available to you, like a business partner, other dev team member, game dev collective, friend, or family member? If you are still working an outside job, are you sneaking in significant amounts of game development on company time and thus making use of their resources?

3. If you said no to all the above, do you voluntarily rent co-working space? How often are you there working on the game? Do you also handle management and administrative tasks from there, or do you do those at home out of security reasons?
4. For office errands like preparing mailings, sending faxes, writing checks, scheduling, making and taking calls, and having a place to sort and store business records, how are you taking care of these things most of the time? Do you do them yourself at home? Do you have a virtual assistant who takes care of those tasks in the stratosphere? Do you make frequent use of a Staples or FedEx Office kind of place, or perhaps your lawyer's or accountant's office? If you buy office supplies, where do you store and use them?
5. Where are you having business mail sent? Registered agent, PO box, collective, or your home?
6. In what capacity do you work in the industry? If you have a dev team of at least two people, what is your primary role? Secondary roles?
7. How many people are on your dev team? Where do all of you live and/or work? How do you convene and communicate?

In answering these questions, how does your work situation look?

If you really don't spend a lot of time at home for game development and/or business management purposes, you could have a hard time proving you really need a home office. It all really depends on the circumstances. But if someone is making workspace available to you, or you choose to go elsewhere *regularly*, like buying a subscription to co-working space, it could jettison your whole deduction. If you spend more time at a co-working space than your home, especially if you are receiving mail there and using their office services, it's highly likely you'll lose the home office deduction.

Then, after looking at the time spent at home, the nature of the game development business is key, especially depending on what your role is. *<u>What</u> are you doing there, and how important is it to keeping your studio going?* As you're about to see, game devs are actually pretty fortunate in this aspect.

Soliman v. Commissioner was a precedent-setting case that is one of the most cited in writings on home office deductions and subsequent audit defenses. Soliman was an anesthesiologist who provided pre-op and post-op care at three different area hospitals for about 30-35 hours a week. He didn't have an office at any of the hospitals, nor did he share or have his own external medical office. So he converted a bedroom in his home into an office and spent about two or three hours a day doing administrative and research tasks in this home office. The Court initially struck down his home office deduction because while the work he did there was relevant to his practice, they proclaimed that his home wasn't his *principal* place of doing business. The hospitals were.

Going back to those three basic tests, the only one Soliman had passed was that he didn't have anywhere else to do these things. The time he spent in his home office was miniscule relative to the time he spent at the hospitals, and because the nature of his practice involved going to the hospitals to take care of his patients, the home office was deemed nonessential for the medical care he provided. The Court stated that given Soliman's profession, the home office didn't

provide the kind of *specialized* setting for his work that the hospitals did. He didn't have gurneys and heart monitors set up in there to dole out anesthesia, and moreover, he wasn't seeing patients there.

Landing the Plane in *Top Gun*: The Focal Point Test

However, something outrageous happened: Soliman fought the law, and he won! Thanks to him, Congress rewrote the Internal Revenue Code section regarding home offices being your principal place of business. If a home office is the ONLY place you can get management and administrative tasks done, you can make a stronger case for your deduction. But, with the rise of co-working spaces, virtual assistants, and the like? It's a cause for concern, because these things were not readily available when the case was adjourned in 1992, yet Soliman is still cited to this day. For crying out loud, it took until 2010 to have cell phones – something direly necessary to making a living for most people, regardless of their line of work – freed from the listed property restrictions. In a world where more people are relying on co-working spaces but still maintaining home offices, this could spell disaster for your taxes, and our continually outdated legislation really isn't helping any.

When Soliman appealed, the judges did a focal point test. The dissenting judges admonished the upholding judges for not really looking at the fact that Soliman just didn't have anywhere else to take care of the business end of his practice. No one made space available to him. Yes, he took care of his patients at the hospitals. But in his home office, he was taking care of the *business*: calling surgeons and patients, preparing treatments, billing, researching procedures, doing his continuing education to keep his license, and so on. The dissent cited the law for traveling salesmen, which permits them to take a home office deduction because despite doing most of their business on the road, the time they spend at home is spent on paperwork and calls relating to their business. With his case calling for a rewrite of the law, the Supreme Court declared Soliman's focal point was his home office and therefore he was entitled to a home office deduction.

Let's leave behind *Surgeon Simulator* for a minute and switch to one of those food-stand games with Baie v. Commissioner. Baie owned a hot dog stand, but like Soliman, she converted a bedroom into an office to use for bookkeeping and administrative stuff, and she also used her own kitchen to do prep work and cooking the night before for all of the food she sold. There was no room in her food stand for all of the cooking equipment and ingredients, so she kept them all at home. But the Court zapped her deduction, saying that while preparing and pre-cooking food at home was definitely helpful to her business, this activity wasn't substantial enough. Her focal point was deemed to be the hot dog stand because that's where the food was put together, packaged up, and purchased by the customers.

Well, we have a situation far more confusing than either Soliman's or Baie's. Both of them had to be physically present somewhere to make money: Soliman at the hospitals, Baie at the hot dog stand. Soliman billed from his home office and had checks sent there. Baie had to get cash in person to sell hot dogs. Where does that leave indie developers? We're literally in the ether! Well, speaking in terms of when we get paid for our work, that is.

Once the hard work making the game is done, we can make money in our sleep. People from around the world buy our games on Steam, the App Store, through bundles, on our websites, and many more digital portals at all hours of the day. If I'm making the game here in New York and tell someone at a convention in Montreal to buy a copy and they head to Steam to do so, my studio doesn't get the money instantaneously. It's sent out to cyberspace and not received until a royalty report is generated along with payment based on how many copies were sold that month. Publishers and distributors rarely send checks anymore, either; almost everything is done through PayPal or bank transfer these days unless they're very small companies. But moreover, 98% of the time we can make the game and do management duties from virtually anywhere in the first place.

These attributes strengthen your case. But what about the actual work you do at home? If you spend a lot of time working on the game there, it also helps your case just as much as doing the admin and management work. After all, there's things you'll want to do at home rather than a place with public wifi such as going over your online banking and transmitting confidential documents. But if you still do those things in co-working spaces or a teammate's home anyway, it will throw off your focal point and hurt you.

"But wait!" you shout. "I strictly do art/audio/writing for games and don't deal with the business of publishing. I get checks for each job. What about me?"

Artists and audio designers can rejoice. You're more likely to work solely from home and not have your dedicated space get challenged if you aren't regularly renting studio space. Devs and writers depending on tablets and laptops at co-working spaces and coffee shops have more gray areas to contend with, but it's awfully hard to lug two-foot drawing pads and mixers around, and things need to be done to chemical-proof or sound-proof that area of your home.

So, this section referred to landing the plane in *Top Gun* because while it's stupendously difficult and easy to screw up, it's not impossible.

The Turtles That Can't Swim: Exclusive and Regular Use

Exclusive use means that you use the space allotted for literally nothing but work. Yes, literally nothing but work. Not even getting ten seconds of enjoyment out of *Warcraft* when you really claimed your subscription as a business expense to examine MMO mechanics. Looking back at Baie, she didn't have exclusive use of her kitchen. It was still used to make meals for her family. So even if the Court had recognized her home as the focal point, they only would've allowed her to deduct the bedroom converted to an office.

I'll be upfront: it's this insidious notion of exclusive use that has made appealing a home office denial virtually unwinnable by design. Especially if you have a small abode. It isn't *impossible* to win: one guy used about 75% of his bedroom and was able to defend his deduction. I even listed a few more court cases in the citation section for you, showing what kinds of spaces have been defended. Putting up a partition like a hollow wall also helps, or something like a curtain, dressing screen, or the old indie standby of just putting duct tape on the floor to help measure your square footage. (Conversely, you don't have to limit your workspace to just one room. If

your home is big enough to use multiple rooms, so long as it meets the exclusive and regular use requirements, you can claim expenses for more than one room.)

But make no bones about it – it WILL be harder to prove if you don't have at least one more room sectioned off solely for work. Personal stuff can't be thrown in your exclusive area. If you've got kids, they can't be using your desk to do their homework. For a majority of urbanite indies, exclusivity is really hard to prove when you're making games in the same exact place where you take most of your meals and watch your favorite shows. Sadly, all of these things disallow the deduction.

Devs in areas that don't clamor as much for space frequently have a steadier leg to stand on because having a separate room or even separate structure is less likely to get challenged. Who wouldn't want a game development hut in a backyard? But it could still fail the exclusive use test for some reason or another. It's all too easy for your personal and business spaces to overlap and thus wind up not meeting the exclusive use test even though it has been challenged.

The regularity portion of this is easier. You have to use the place *regularly* to do business. Given how hard it is to drag one of us away from the computer during crunch, the regularity part isn't hard to prove. Just because you might take care of business from the road or a coffee shop doesn't mean you'll lose the deduction. So long as you are in there frequently, you're good. But if someone else does make space readily available to you or your voluntarily rent other space regularly and you're using it just as much or more than your home, it could be a problem.

It's really that exclusivity part that can make your life miserable if you wind up getting audited. Depending on both your life and work set-ups, this is something you can just easily make unwinnable without even being aware of it. Given that homes are well, lived in, it's definitely like wondering why the turtles can't swim in the NES adaptation of *TNMT*. Obviously, if a friend traipsed in there at some point, the IRS has no way of knowing. But if an agent sees something that belongs in a bedroom or living room in there, you'll be met with some side-eye. Don't be *too* scared of these rules; so long as the personal intrusions on your home office are no worse than something that might go on in a real office building, you should be fine.

Mapping Your Business Percentage

Okay, we're done with the masochistically difficult old NES games. Now that you've been given the strategy guide for beating their metaphorical tax counterparts, let's say that from this point forward you've determined you meet the exclusive and regular requirements and your home is undeniably your focal point. Before we get to what you can deduct, we have to look at how you can deduct it.

There's two ways to map out your business percentage of your home: the number of rooms, or the square footage. Let's say that you rent a 1,200-square-foot, two-bedroom apartment and use one of the 13 × 10 bedrooms for an office. There are a total of five rooms in the apartment. The number-of-rooms method is usually used only when the rooms are all somewhat the same size and you're using up an entire room. If your business area doesn't take up a whole room and/or uses up an amount of space where it's hard to figure out how equal all the rooms are, the square-footage method is better. In this example, taking a deduction for a room is more beneficial

because it's 20% of the whole place while 130 square feet is barely 11%. For simplicity's sake, we'll say the rooms in the apartment are all similarly sized and you're going to use 20% to prorate your home expenses.

Indirect expenses will use that 20% rate. This would be rent or mortgage interest, real estate taxes, insurance, security systems, and utilities that cover your entire home. Any unrelated expenses for things that only affect the personal portion of your home don't count, such as lawn care or having the kitchen painted. It has to affect the entire home to be partially deductible. **Direct** expenses are 100% deductible because they only affect your business area, like having the room painted or cleaned, or repairs that were done in there only.

Hierarchy of Home Expenses
We're not in *Donkey Kong Country* anymore, where the deductible expenses were plentiful and could easily be used against your other income to give you a loss if you went over. The following are some scoring mechanics straight out of *Phantasmagoria 2*.

The home office deduction is limited to the income after your other business expenses, your **tentative profit**. If you're running in the red, the only items that can add to your loss are mortgage interest and real estate taxes. You're not entirely screwed if you're a renter, because whatever you can't deduct in the current year can be carried forward indefinitely to future tax years but will still be subject to the tentative profit limit.

So let's say that your studio made $30,000 and you have $10,000 in other business expenses, so your tentative profit is $20,000. You paid $12,000 for a year's rent, $1,000 for a year's utilities, $200 for tenant's insurance, and $500 to have the office painted. $13,200 are indirect expenses, and taking 20% of them results in $2,640. The $500 paint job is a direct expense, so all of it is deductible. Your total home office deduction is $3,140, and since you have more than enough tentative profit, you can deduct all of it and not have to worry about carryovers. Deducting that $3,140 from the $20,000 gives you a total net income of $16,860, and this is what you'd use to figure your self-employment tax as well as other items like the Earned Income Tax Credit.

To illustrate the tentative profit limit, let's say you didn't do as well. We'll reduce your income to $12,000 but keep the $10,000 in business expenses and that same $3,140 in home office deductions. Home expenses are taken in two tiers:

- Real estate taxes*
- Mortgage insurance premiums
- Mortgage interest*
- Casualty losses
    - Depreciation (for homeowners)
    - Rent
    - Insurance
    - Repairs
    - Utilities

Those first four items relevant to homeowners are deductible on some level regardless of whether you use your home for business or not, while the rest of those items are only deductible if you do. Casualty losses and mortgage insurance premiums can't add to your business losses like real estate taxes and mortgage interest can. Since this example is for a renter, we don't have to worry just yet.

If you had $12,000 in income and $10,000 in expenses, that leaves a $2,000 tentative profit. Since the home office expenses exceed $2,000, only $2,000 can be deducted this year. The remaining $1,140 has to be carried into next year, where the same tentative profit limit will come into play. Because your self-employment income is also down to zero, you won't have to pay self-employment tax.

Now if you owned this condo instead of renting it, we'd have a different story. Your mortgage payments were $8,000 for the year, of which $5,000 was interest. Real estate taxes were $2,000 and homeowner's insurance is $400. Utilities were still $1,000 and painting the office also cost $500. After consulting the charts, depreciation is $590.

The paint job would still be deducted in full because it's only for the office. Depreciation is calculated separately, explained below. All the other expenses are subject to the 20% business rate but deducted in a certain order:

Tentative Profit: $2,000
Mortgage Interest (20%): $1,000
Real Estate Taxes (20%): $400
Subtotal: $600

Direct Expenses: $500
Subtotal: $100

Indirect Expenses:
Utilities (20%): $200
Subtotal: $0, you can only use $100 of utilities. Everything else gets carried forward.

Remaining Indirect Expenses:
Remaining Utilities: $100
Insurance (20%): $80
Depreciation: $590
Expenses to be Carried Into Next Year: $770

But what if your mortgage interest and taxes were higher? Leaving the other expenses alone, here's how it would look:

Tentative Profit: $2,000
Mortgage Interest (20%): $2,000
Real Estate Taxes (20%): $800
Subtotal: -$800

Direct Expenses: $500
Subtotal: -$800, need to carry over

Indirect Expenses:
Utilities (20%): $200
Insurance (20%): $80
Depreciation: $590
Expenses to be Carried Into Next Year: $1,370

You'd have a business loss of $800 that you could use to offset other income. If you were already racking up a loss from your other business expenses, that $800 would get compounded into it. The IRS sure loves homeowners, don't they?

Depreciating Your Home

If you own your home, you can deduct depreciation based on the purchase price with some adjustments. Business real estate is depreciated over a 39-year period, and your home is considered to be business real estate once you start taking the home office deduction. Last chapter, I didn't get into real estate depreciation because it's pretty rare that an indie developer will own commercial real estate just for making games, but it's not out of the ordinary for indies to become homeowners.

Depreciation for your home is a mite different than depreciation for equipment. You have to consult a table beyond the first year you start taking this deduction, and for that first year you need to know what the value of the land is, which property tax records will show you if you have a house. If you own an apartment, you can get this from the building's financials, and it'll be calculated for you or you can split up the tax assessment by the number of apartments. Land can't be depreciated, so it has to get removed from this calculation. So for our condo from the last example, here's how depreciation was determined assuming that this wasn't the first year having a home office.

You paid $120,000 for the condo a few years ago and started using the second bedroom as an office last year, so it's your second year of depreciation. Comparable apartments in your building are now selling for $140,000, so you're going to use your purchase price, since you have to take the lower of actual cost or market value to figure out this deduction. The building's financials say your portion of the land is worth $5,000, so your depreciable base for the whole condo is $115,000. The home office is worth 20%, or $23,000. Checking the depreciation chart, since you've been using the home office for a full year, from here on out you can use January's percentage, which is 2.564%, for every year until the 40th one. Depreciation comes out to $590.

Had this been the first year of using the room as a home office, you'd have to go by the month you started using it as a home office.

Simplified but Smaller Home Office Deduction

Starting in 2013, the IRS instituted a simplified way of deducting your home office that's similar to those standard meal and mileage allowances: for the 2015 tax year, you can take $5 per square foot with a maximum of 300 square feet.

You still have to meet all those same tests and take a square footage calculation. You can't use the room number method or claim the full 300 if you only have 130 square feet, per the example. Like the standard meal and mileage allowances, you'd still have to account for properly using your home office, but you're relieved from having to substantiate those expenses. But since 130 square feet only equals a $650 deduction for 2015, the simplified method is really only worth it if you have absurdly low housing expenses resulting from several generations of rent control or get to live somewhere for free. For most people, the actual costs will virtually always yield a bigger deduction.

Karting with Bowser: Homeowners Beware

As you can see, homeowners have several extra benefits that renters do not, aside from being able to take a loss with their real estate taxes and mortgage interest. But renters get off easy if they move. Homeowners don't, if they want to sell the property.

The excluded rules are a bit beyond the scope of this book, but I will provide the *5 Second Movie* version. If you sell your home for more money than what you paid for it, you have a gain. You can shimmy out of paying capital gains tax on up to $250,000 of the gain ($500,000 if married filing jointly) provided that you used it as your primary residence for two out of the last five years preceding the sale and did not use it for business. Home offices count as using it for business! So yes, this feels like you just went Karting with Bowser. You thought you were getting all these incredible write-offs, but you sat next to the enemy boss all along!

But even if you do meet the time guidelines for the excluded gain, those generous depreciation deductions could have a steep price. Whatever your depreciation deductions were over the years, you need to recapture them when you go to sell. Let's say you sell your condo you bought for $120,000 for $200,000. In the years that you owned it, you deducted $5,000 of depreciation. While the $80,000 profit on the sale leaves you well below the $250,000 threshold for not having to pay capital gains tax, you still have to pay taxes on that $5,000 recapture. And not at the soft capital gains rate.

Still, the taxes you pay on the recapture might be worth the price, considering how much home office deductions save you on self-employment tax alone, plus state and local taxes if your jurisdiction is liberal with business deductions.

Compare this to renters, who break or ride out their leases and don't need to go through all this. You just deduct the rent, and then you don't have to recapture anything when you leave. But if you value ownership and want to go that path, this is just what you need to be aware of to minimize the damage Bowser is going to inflict on you.

* * *

It’s not the home office deduction in and of itself that’s insanely difficult, but rather the conditions that let you claim it that make you feel like you’re playing some really sadistic NES title that the developer had only three weeks to make before the Christmas rush.

Speaking of sadism, it’s time to step away from deduction talk and get into RTS mode. Next level’s all about timing!

Level 14: Why Your Fiscal Year is Like Dinosaurs Living With Humans

Ready to delve into *Chrono Trigger*? Where you have to do some time travel in order to progress in the game, and the past is just blown up into the present, like dinosaurs living in the Middle Ages? Figuring out what accounting method to use and whether you should rely on a calendar or fiscal year isn't all that different!

Let's put on our programmer hats for a minute. Think about defining parameters that are used in game design, particularly a room or certain areas of a room. When you're trying to figure out the timing aspects of your cash flows using both a method and a year as global variables, you have a few different parameters that come into play here.

1. How often are you paid?
2. Do you have some degree of control over the amounts (i.e., hours worked) or no control (your game sales are at the mercy of the distributor)?
3. How much are these amounts typically?
4. When do you (reasonably) expect to release your game?
5. How often do you pay people and companies?
6. How much?
7. Does your studio have other sources of income aside from game royalties?
8. Do you value mental energy over potentially saving tax dollars?

If you haven't released a game yet and are totally pre-revenue, the timing of your first dollar is important per the whole discussion on start-up costs. But when you reasonably expect to release your next game is also important, because if it's going to be in the next year or so, you'll want to weigh the benefits and disadvantages of a calendar year or a fiscal year, as well as what accounting method to use.

Your taxes can wildly vary depending on how much you're bringing in and how many people owe you (, and vice versa). Deciding how to time your income might not be that crucial in the early years when you're probably not making much money yet. But depending on how you structure your business, nailing which time flux to use can wind up costing or saving you thousands. And now, let's switch gears and think about designing a board game!

Calendar vs. Fiscal Years

Imagine a board game that has a looping structure, like *Monopoly*. You start at Go and move around the board, and it's just a square loop. Passing Go means that you completed the loop and you collect $200 to signify that. That's basically how a calendar year is: the year begins in January, and once December 31 passes, rather than collect $200, we change the year on the calendars.

Most individuals are calendar-year taxpayers. So are a lot of small businesses. Many freelancers and small companies opt for the calendar year just for the sheer fact that it's easier to keep track

of. There’s no additional paperwork required to use a calendar year; it’s the default setting for small businesses.

Fiscal years can be 52 or 53 weeks and are good for businesses with cycles or seasonal aspects, like resorts. A business that relies heavily on the summer and winter vacation months but is vacant the rest of the year might not be accurately represented by a calendar year. Thus, a fiscal year is a more popular choice. An ice cream shop in a temperate zone like the East Coast would be likely to open in the spring and shut down by Halloween. A fiscal year starting April 1, 2015, and ending April 2, 2016, would be more helpful than a calendar year in terms of income accuracy and being able to get the most deductions. (Fun fact: a fiscal year that is exactly 12 months is considered an improper tax year, hence the 53rd week in a lot of fiscal years. The example above is exactly one year and two days, or 52 weeks and four days. So even though 2016 is a leap year, it wouldn’t hit 12 months on the nose in the future.)

Alas, game developers are neither ice cream shops nor ski resorts. Because every game developer has different timelines, it’s hard to say which year type is better. It depends on how many games you currently have out (if any), the kind of games you make, and the timing of events that could cause surges or drops in income. The latter is the hardest to predict, because you honestly have no clue when a Twitter firestorm is going to bless you with thousands of sales, or if you’ll have protracted timeframes of very little or no income because some bugs just won’t die.

Your decision to do a fiscal or calendar year will also depend on what structure your business is and will tie in with the way your personal income matches up with that of the business. Having served clients of all income levels, here’s how I see it: how do you want your tax return data to look if personal taxes are a factor for your business structure? Namely, are you more concerned about paying less taxes or having your income appear a certain way? It almost always boils down to housing. If a fiscal year posts bigger profits, it means paying more taxes, but it also helps you get approved for a mortgage, since your tax returns are how you prove you have the income to buy, or prove that you make more than a landlord’s annual minimum to rent. Conversely, if a fiscal year posts smaller profits and you’re in income-restricted housing, it’ll help you stay there without getting penalized because tax returns are needed to recertify every year.

It can be hard to tell in the beginning. You’re on calendar year by default, and you can always change to a fiscal year down the road after you’ve had at least two or three historical years to compare. But in the name of not wanting to expend too much mental energy on it, a lot of people just stick to the calendar year. Recordkeeping can get confusing for sure under a fiscal year. Virtually every example I gave in this book relied on the calendar year to avoid further confusion. If you plan to use a fiscal year, I’d definitely run it by a professional first, especially since if you want to change it, you have to file for a change of year, and the IRS only grants this once every 10 years unless you have an extremely bizarre case.

Cumulative Rewards and Baddies in Accounting Methods

Accounting methods are a different animal than tax years. If we switch to a game that has a stage-specific scoring mechanism plus goodies you can store for future use like *Angry Birds*,

accounting methods will make a little more sense. **I'm also going to assume we're using a calendar year for all of these examples.**

So, you release your game this year and a publisher picks it up. They issue quarterly royalty reports and pay you a month after you receive those reports. You don't get your fourth-quarter report until January of the following year, and you aren't paid until February. How do you handle this under both methods?

Cash Method and Constructive Receipt

Cash accounting means that you recognize income and expenses as they happen. Thinking of *Angry Birds*, you have your score for each stage. How well you play in stages that precede or come after it will have no effect on that stage's score. Basically, that's how cash method business taxes work. Barring carryovers from the prior year, like §179 deductions or excess home office expenses, the concept is essentially the same. If you didn't pay for something in that year, you don't deduct it. If you didn't receive the income in that year, you don't recognize it until you actually get paid.

The money the publisher owes you for your game sales between October and December is going to go on the following year's tax return even though the sales took place in those months. By the notion of **constructive receipt**, you didn't get the report until January, and the money wasn't in your hands until February. It's off the hook for the prior year's tax return because it wasn't made available to you in that year.

Confusion with royalty reports is a common situation for a lot of game developers. But it's about to get murkier than an *Angry Birds* level because constructive receipt is all about *when the money becomes available to you without restriction*.

This is a concept that definitely feels like channeling that annoying green boomerang bird. When I handled business taxes for more traditional businesses that accepted checks, some people would have a check dated for the end of the year but hold onto it and not deposit it until January because they thought they could defer income that way. That strategy is made of fail.

If you receive a check for royalties or work-for-hire toward the end of the year and aren't sure what year to report it in, look at the date on the check. If it's 2016 but the check has a 2015 date, you have to report the income with your 2015 taxes even if you didn't receive and deposit the check until early 2016. The money was made available to you in 2015. And if you ask a client or publisher to just postpone the date on a payment, it's also not going to work. Constructive receipt took place simply because they made the money available to you beforehand and said it was yours for the taking.

But since we have to contend with primarily digital payments, things can get confusing. Many publishers and distributors often don't issue royalty reports until well over a month after royalties have been accrued, and sometimes there are minimum thresholds that you have to meet in order to get paid. But even if you don't actually get paid until January, you still have to include those royalties in the prior year's income if it was made available to you and not processed yet due to

holiday closure. Contrast that to a publisher that has a minimum royalty policy where the money isn't available to you until you hit a certain amount.

Publishers A and B both prepared monthly royalty reports for you. Publisher A sends your report in December, showing that you earned $300 in November, and the payment arrives in the middle of January. Publisher B has a minimum payout of $500 and your report shows that you only sold $250 worth of games. Under the constructive receipt rules, you only have to recognize Publisher A's $300 because they made it available to you before the year was over. Publisher B isn't making it available to you until you hit that $500 limit.

Despite the confusion that constructive receipt can cause, a lot of small businesses like using the cash method because they just find it easier. When you're small, you also have more choice as to whether or not to use the cash method. Once you start pulling in $5 million a year or more, you'll be mandated to use the accrual method. If you have inventory, you also have to go accrual unless you pull in less than a million per year. If you're a C corp, you can't use the cash method regardless of how much you make.

Prepaid Expenses

If you use the cash method, there's one exception to the whole shebang of "deduct it if you paid for it now" methodology, and that would be prepaid expenses. This wouldn't be stuff like retainers for lawyers or accountants because a retainer can be cashed out at any time. But if you're prepaying for hosting, insurance, and so forth, you're subject to one of two rules: the 12-month rule and the general rule.

The 12-month rule is the easiest. If the benefit doesn't stretch beyond 12 months of when it starts, you can deduct it in full. If you spend $100 on a one-year policy for your electronics where the coverage kicks in on October 1 of this year and expires September 30 of the next year, you can deduct it in full under the 12-month rule.

Whereas the general rule comes into play when you prepay for more than a year. Like, if you spend $240 on a hosting package to save money over two years, you have to prorate the costs to the years that they cover and by the month. Your hosting starts April 1 and ends March 31 of two years from now. The 24 months are $10 each, and your first year is nine months of coverage for $90. The second year's deduction is for the full year of $120 and the third year gets the remaining three months at $30.

Accrual Accounting

Think about the various bonuses you spin for when you open up *Angry Birds*, those goodies like the power slingshot and accuracy guides. While your score will change every level, those goodies stay with you until you use them. They're recognized in your inventory as you obtain them and its use isn't recognized until you use it. And accrual accounting is sort of like that: expenses are deducted when they're incurred, not necessarily paid, while income is recognized when it's earned and not necessarily received.

Going back to the two publishers from the cash method example, if you used the accrual method you'd have to recognize *both* royalty payments in the same year. The $300 for the royalties

earned in November and payable by December are taxed even though they're not received till the next year, and the same goes for the royalties that depend on making at least $500 before you get paid. That $250 would get added to your income even though you have no idea when you'll hit that minimum. Thus, even though you didn't actually use that superpowered slingshot until several stages after you received it, you still picked it up much earlier.

When it comes to income under the accrual method, you recognize it either when "required performance" occurs, when payment is due, or when you actually get paid – whichever comes earliest. For things like royalties earned through distributors and publishers, it's pretty clear. Since these publishers have automated systems, there are no due dates you are enforcing, and "performance" would be people paying for your games, which definitely takes place before the royalty report gets generated. (And that certainly comes before you get paid.) If you offer services that require invoicing, such as doing web design work, then you'd have to recognize the income upon billing that client after doing the work. Even though they haven't paid you yet, you did your required performance first, so that's when you'd recognize the income.

But it's not so simple with a crowdfunding campaign.

What Accrual Method Really Means for Crowdfunded Games

Timing is definitely important if you plan to crowdfund your game, as is choosing the right tax year and method to help time your income and expenses. A lot of indie developers will get utterly burnt by running a Kickstarter in the middle or end of the year but then wind up incurring the related expenses a year or two after receiving the funds. Ergo, many financial professionals have recommended switching to the accrual method for those not using it already because in the eyes of the law, it'd be seen as prepayment. And prepayment means that while you'd have to recognize the income right away under the cash method, you could defer the income under accrual to the date that you deliver the product.

In the big picture, your required performance would be releasing the game, and you indeed got paid before your required performance. So does crowdfunding constitute prepayment under the accrual method?

If anyone from Congress is reading this, **crowdfunding is not prepayment.** Creators and backers alike take a risk that the game won't get released. Even if they are backing a project with a very well known development team with a history of always delivering, there is still the risk that it won't get delivered. Then what? It is really, truly not on the same page as taking prepayment for orders that have a much shorter and more definite timeline to be delivered, like when a publisher offers a game up for preorder that will most definitely be released.

So where does this leave you if you want to go the rewards-based crowdfunding route? Take a look at the timing of your deliverables and what seems like a realistic date for them. Not just when you think you'll release the game, but how many other promises you'll fulfill in your campaign. Then, think about expenses and when you'll be most likely to pay them. Other deliverables are frequently part and parcel of the campaign, aside from the game itself. Some project creators will start sending out rewards before the game is complete to keep their backers happy in anticipation of a very, very long time until release. In-game rewards, such as having a

character modeled after you or having your own voice or dialog in the game, also count as deliverables. So, this definitely muddies the concept of required performance.

When planning a crowdfunding campaign, it's best to look at what you plan to offer as well as when you plan to deliver those things, aside from the game itself. Speaking from personal experience having had a successfully Kickstarted game, your release date can wind up being insanely far off from when you were hoping to release the game. Life itself happens, as indie developers commonly need to keep working an outside job or find other sources of income. Work on the game itself winds up getting delayed based just on the scope, or on feature creep if you blew past your goal. If you think that some of your deliverables are going to be done in a tax year prior to release, then the accrual method doesn't necessarily mean that you'll be recognizing the income in the year of release.

But in spite of when your deliverables will come out, under the ruling that determines when accrual taxpayers recognize income, there are still situations when someone using the accrual method can be treated as a cash taxpayer if they get the money before economic performance occurred. Which…applies to a vast majority of crowdfunding campaigns. Depending on how long it takes and what kind of deliverables are done before the game officially gets released, even if you are an accrual taxpayer you can still wind up having to recognize your crowdfunding proceeds in the year they happen and not the year you release.

It's like a very painful RTS with shoddy mechanics, for sure. Accrual doesn't mean a total complete deferral. Try to best guess when your most major expenses will happen relative to when you will collect the funds if your attempt is successful.

Expensing Under Accrual Method

Then, as for expenses, it's a fairly similar concept to recognizing income but a little inverted. All the events that confirm racking up that liability must have occurred, the liability must be easily quantified, and economic performance took place. For an example in English, you hire a social media manager to help you reach people and grow your presence. She provides a detailed consultation as well as reference materials, then actively manages your social media accounts for a month. At the end of the month, she sends you a bill.

Under the cash method, you wouldn't deduct this expense until you pay that bill. But under the accrual method, you'd be able to take a deduction once you get billed. Accrual taxpayers take a deduction once the expense has been *incurred*, not necessarily paid. In this example, it's easily quantified with a bill, and the economic performance – the consultation and active managing of your accounts – overlaps with the events that confirm incurring the liability.

To make this like yet another round of *Heroes of Might and Magic*, if you can't see what the other side is doing on the unexplored side of the map, that hurts your deduction. If someone has been doing work for you but hasn't sent you time logs or invoices, or anything that could provide you with a reasonable estimate for what they're charging, you can't take a deduction until they provide you with at least one of those things.

Baddest Baddies: Bad Debts

Accrual taxpayers get a benefit that cash taxpayers don't: the ability to write off bad debts. If a client or publisher doesn't pay you and it becomes hopeless that they ever will pay you, such as the company declaring bankruptcy or going MIA longer than an MMO server after announcing new content, you can deduct what they owe you. But the catch is that you had to recognize the unreceived payments as income at some point before. You can't just take a deduction for what didn't happen.

Digging up our publisher example once more, if you never hit that $500 threshold with that one publisher and they just completely skip town without paying you, then you can deduct that $250 you never received since you recognized the income as it accrued. You'd still need to sufficiently document efforts you made to collect on the amount, like email chains or phone records or, if it was for a pretty big amount, any hiring of lawyers or collection agencies. Then, if you invoice a publisher for royalties and they go bankrupt, it's a lot easier to prove you had no hope of ever collecting that money.

Some smaller companies that are barely breathing but not quite dead yet may want to honor their agreement with you by offering a settlement or partial payment if they can't pay the full amount owed. If this happens, you just get a bad debt deduction for the part you don't collect.

Stuff You Paid For With a Credit Card

If you pay for your expenses with a credit card and don't pay it until the next month or carry a balance, whether you are cash or accrual, you just treat it like you paid in cash, i.e., like every other expense that you pay. What really matters is *what* the credit card paid for and the nature of each expense, not the fact that you used one. That, and keeping it separate from your personal credit and debit cards.

*   *   *

You'll indeed feel like you're playing with the forces of time trying to figure out which year type and accounting method to use. For crowdfunded projects in particular, it spells a lot of gray areas based on the current regulation as well as deliverable timelines. That, and the risk that a crowdfunded project might not live…all while the laws are stuck in the past.

Level 15: Endless Runners, or Ways to Treat Your Development Costs

We've now gone over how to deduct your expenses, from simple and recurring ones like your hosting to more complex ones requiring additional records, like travel. But I left dev costs out of previous chapters because we've now hit a fork in the road, and you have a couple of options. I liken this to an endless runner because that's exactly what game development frequently feels like: you think you're finally making traction, and then things backslide because a team member isn't able to commit to the project anymore, an engine goes through upgrades and it completely upends your work, or you lose some health points and simply have to focus on getting better. Ergo, when things stop feeling like an endless runner, which could be years down the road depending on the size of the game, you'll need to assess how much the game cost you and what you can reasonably expect to earn from it.

You are standing in an open field west of a white house, with a boarded front door. You open the mailbox and a postcard says the most direct route is to simply expense all of your dev costs as they happen. To your left, there is a sign pointing to a craggy valley where you can capitalize your dev costs over a 10-year period. A sign pointing south indicates that the steep mountain ahead is the R&D credit. Wasn't the road to the south impassable? (And wouldn't it be great to just whack a tree to get zorkmids instead of all this paperwork?)

Are You Just Starting Out?
Remember going over the load screen, your start-up costs? You might have some research and experimentation expenses that can be expensed in full, or amortized like your start-up costs but with a much shorter period under the creative safe harbor.

Unlike the start-up costs, which have an option for you to expense up to $5,000 then amortize the rest over 15 years, for dev costs, you can choose to expense them in their entirety, or recover them over five years if they are not experimental. If they *are* considered experimental, then you can amortize over 10 years separate of your start-up costs with no expensing. This option is there for you for projects further down the road, but has a unique aspect in that it has to get treated this way whether your business is brand new or long established. **You cannot lump your development costs in with your start-up costs, even if you have a brand new company.** You have to expense them in full when they occur, or amortize them over five years, 10 years if experimental.

For most businesses, this 10-year election wouldn't apply because methods and processes in product development either don't apply to them or they are doing something that is already proven. As game developers, you fall into a unique category: both technological and artistic loopholes will apply to you, such as the high-tech maneuver to treat development costs differently. These costs are actually referred to as **research and experimentation costs** because you take some uncertainty in developing a new product or process even if it's using an engine countless developers have already used, such as Unity. Most of you are game *designers*, amirite? You're trying to perfect your design even if it's a proven engine and a genre that's already established. You could be trying to improve upon mechanics you saw elsewhere or trying to

come up with entirely new mechanics. There's a saying that only seven stories exist in the world and that anything you could possibly create has already been done before. The same pretty much holds true for games. EVERY game was inspired by something else. There's tens of thousands of Match-3 games out there, and the same goes for hidden object games. But each is still unique in *some* way, whether it's in the storyline, the art assets, or how the narrative is implemented. Maybe it employs mechanics from a different kind of game, or does an unprecedented genre merge.

Game development IS often rife with experimentation, so you get to treat your development costs completely separate of your start-up costs, and also decide whether you want to expense them or do this 10-year election.

As for what constitutes eligible dev costs for this election and what, once again, cannot be treated as a start-up cost, most of your obvious dev costs would fall in this category: licensing an engine, paying people to work on the game, and licensing costs for anything else to go in the game, such as sound effects or usage of images or logos. Interestingly, your beta testing and QA expenses do NOT count for this election; you have to expense them. The same goes for your marketing expenses as well as any costs incurred to survey potential players.

Based on conversations with other indies, the general consensus is to expense your development costs whether you've just started up or have been in the business a while. But if costs wind up becoming significantly high and you aren't sure what your income will be during those stretches of time where you have no new games to release and no other income to use a business loss against, you might want to take advantage of stretching out your dev cost recovery over 10 years. (Five, if not experimental.) If you're doing pretty well now and expect to have a high income consistently, expensing may be more favorable for you.

What is the R&D Credit?

You've read the Gamasutra pieces and gotten starry-eyed. You heard about the hundreds of thousands, if not millions, of dollars that Activision and EA save every year thanks to the R&D credit. "Where is MY cut of this?!" you query.

Don't shoot the messenger. After all, your state might have something for you to take advantage of in conjunction with the federal R&D credit or in lieu of it. But this messenger is telling you not to get your hopes up on the federal level; if you're a non-employer and not making a whole lot of money just yet, you're likely to get little or no benefit from the R&D credit.

The Research and Experimentation Tax Credit, simply known as the R&D credit, encourages businesses to invest in new products, processes, and take risks by giving them a tax credit for certain expenses in taking these risks. Because these attempts fuel economic growth and innovation, even if it's only on a small level, lobbyists in tech, pharma, and gaming fought for years to make this credit a permanent part of the tax code. At the time of writing, this credit isn't always available for you to claim because Congress needs to vote on renewing it every year.

Chances are you've read about the R&D credit in Gamasutra and the other industry rags. If you're not paying yourself yet and paying only freelancers, you might not really benefit. But if you've got employees or plan to soon, read on.

Overview of How the Credit Works

Most indie developers, who are small non-employers, will benefit more from the R&D deduction than the credit. The main reason for this is that this is a wage-based credit, and the vast majority of us rely on a mix of contract freelancers, game outsourcing companies, The Asset Store, and ourselves. You could still qualify using freelancer payments and your own compensation (if a corporation), but the benefits are slashed compared to what the credit is worth when you're claiming employees. That's how AAA developers get millions off their tax bills. Take Activision, where they have both external and internal development and more employees than entire towns in rural America. Even if you only looked at the relevant internal departments, it's enough bodies to form the Republic of Warcraft. Compare that to the average indie who subsists off free food from collective meetings and will have a long time before they can pay themselves consistently, let alone other people.

Then there's the fact that the R&D credit is non-refundable, which if you recall from earlier means that you can only use the credit to the extent that you have an income tax bill. Unlike most refundable credits, though, the R&D credit doesn't have a "use it or lose it" policy. You can carry your credit forward up to 20 years! If you deduct all of your R&D expenses and it creates a loss, you can also carry that loss forward, but it's pretty unusual for a business credit to do this. But it still isn't refundable like the Earned Income Tax Credit, which is money in your pocket regardless of how much tax you get assessed.

But let's say you are at a stage where you are doing well enough that you're taking on employees and paying yourself a regular salary on an actual W-2. It could very well be time to weigh the benefits of taking the R&D credit. There's a four-part test to determine if you're eligible for it:

1. Does your studio intend to develop a new product or development process – that is, make new games and not just improve old ones?
2. Technical in nature? (Game development is part of computer science, so yes.)
3. Is your studio's activity out to eliminate technological uncertainty, whether it's in terms of feasibility or the uncertainty of the design?
4. In doing all this, are you following some process of experimentation to overcome the uncertainty?

Projects That Do and Don't Qualify

The project must be an original product where you will own the results and IP. This means publisher projects and other work-for-hire won't qualify, nor will updates and revamps to games that are already for sale. Want to do a reskin, though? Don't worry; so long as it's a totally new game, you'll qualify for the credit. Same goes for sequels and spinoffs. The IP itself need not be brand new, only the game.

Because of the murky rulings on this, mods and DLC available for purchase that are intended for a game you already have out are likely to not be eligible for the credit. It would only count if it were part of the original release.

Projects that won't qualify for the credit:

- Research that you conduct after development has kicked off
- Adaptation or duplication of existing business components, such as revamping a game you already have for sale
- Reverse engineering
- Surveys, studies, market research, data testing, and quality control
- Software developed for internal use
- Funded research/development if it's been given to you by an individual, a grant program, or any other third party (like a publisher)
- Research related to arts, humanities, and social sciences (but games still manage to fall under computer science!)
- Foreign research conducted outside of the US

Actual Expenses Eligible For the Credit
Wages to employees directly engaging in, supporting, or supervising the R&D activity (read: making the game or helping get it shipped) make up the bulk of the credit. This would include producers and other managers, along with coders, artists, sound designers, level designers, and writers. Now, provided that you've got an instrumental part in making the game (which is the case for a vast majority of indies), you can use your own wages for this if you've declared yourself an employee of your own S or C corp.

One hundred percent of the wages paid can be used to figure out the credit. It must be people who you definitely pay as employees, and it's just wages, not payroll taxes. Only 65% of contingent labor/independent contractor pay can be used towards the credit.

Supplies (not equipment) that were used to make the game can also be figured into the credit at 100% of their cost. For most game developers, this would be stuff like art supplies and office supplies used in paper prototyping, brainstorming sessions, and hard copies of game design documents. So long as you can prove it was linked to the game's development, you're good!

Stuff like computers, tablets, consoles, and so on won't count for the credit. Interestingly, if you're renting or leasing computers outside of where you normally work, that DOES count. But I'm going to assume that like most indies, you're attached to your laptop and that's that.

How the Credit is Calculated
All of the costs outlined above are the qualified base costs. There are a couple complex ways that the R&D credit is calculated once you've figured out all your base costs (which are virtually always labor).

Since it's typically the more established studios that take advantage of the R&D credit, let's say you started your studio in 2010 and you're at the point where you paid yourself a $60,000 salary

for the first time in 2014. You also contracted a sound designer for $5,000 and an animator for $10,000 while you did all your programming and writing, and spent $100 on art supplies to do your own concept art and experimentation. One hundred percent of your salary and supplies will count, but only $9,750 (65% of $15,000) will count for the people you had on contract. This would bring your total qualified research expenses to $69,850.

Here's where it's about to get more obnoxious than not knowing you needed to pick up that moldy cheese with the fish hook to shut down Mordack's machine. You'll now have to figure out what your fixed base percentage is, and this depends on how many years you've been at this and what your qualified dev costs were in those past years. (This is why recordkeeping is very, very important.)

Using the alternative simplified credit formula, you have to take those qualified costs for the past three years. If you had none at all, your credit would just be 14% of the current year's costs, $69,850, which comes to $9,779.

If you did have dev costs that qualified for the credit in prior years even if you didn't take the credit, it's more complicated. Let's say that your qualified dev costs after percents were applied to contractors were $35,000 in 2013, $20,000 in 2012, and $8,000 in 2011, which makes your total qualified dev costs for the past three years $63,000. You have to take 1/6 of that ($10,500) and deduct it from this year's qualified dev costs ($69,850), which makes your fixed base $59,350. Then, you take 14% of your fixed base for your final credit: $8,309. Remember, this is $8,309 that gets directly shaved off your tax bill and can be suspended if you don't want to use it now!

There's two other methods that are more complicated, particularly if your company has been around more than three years. But a majority of tax pros will direct you to the simplified method based on both your dev costs as well as how long you've been in the business.

Do I Need To Be a Corporation to Take the Credit?

No, you can take the R&D credit against your personal taxes if you're a partner in a partnership or as a sole proprietor (or LLC taxed as one of those). However, single-member LLCs and sole proprietors are a lot less likely to benefit because you're not paying yourself wages. Your income is considered to be distributions of the company's profits, not wages. For most indie developers out there, keeping it small and agile, the R&D deduction will be on par with or exceed the benefits of the R&D credit. You'd have to run both scenarios through your tax software and see which one benefits you more.

Can I Take Both the R&D Credit and Deduction?

Nope. No double-dipping. Whether you're doing that 10-year research and experimentation amortization when you're starting out, or you've got a new game in the works long after starting up, if you're using these costs to figure out your tax credit, then you can't also deduct them. That's true even if they've been subject to a percentage, like the payments to independent contractors, and even if you're going to suspend the credit for a future year, such as the case where you're hitting the glut of your dev costs now but won't release the game until next year.

(That strategy could save you thousands of dollars if you have little or no income at the moment!)

What if the Game Bombs Financially?

You can still take the credit even if the game you claimed the credit for fails. After all, the credit promotes risk-taking! And you still created some economic growth by supporting other people in the industry.

* * *

So, that wraps up the infamous R&D credit. You can't use it for games that aren't new or are funded by a publisher, investor, or grant program, and whether you'll benefit depends on how your pay structure is set up and how much income you're bringing in now and reasonably expect to in the future.

Now it's time to switch gears to inventory, because while our space is predominantly digital, there's still a physical element with boxed editions and swag.

Level 16: Rubber Chickens with Pulleys in the Middle (Inventory)

If you're a die-hard adventure gamer like myself, you'll likely think of that ubiquitous red satchel from *King's Quest V* when it comes to the word "inventory," or the random gathering of nonsensical objects like moldy bits of cheese, ladders that can be jammed down your pants, and real actual red herrings. Those descriptions, ranging from poetic to whimsical!

Unfortunately, inventories in this context are something of a snore. You're likely to have thousands of items that look exactly alike. If you're keeping goods on hand or in storage to sell, your recordkeeping burden significantly increases. You need to keep tabs on what's coming in and out, and depending on what you sell, this can be very daunting and frequently requires extra pairs of hands. Most accounting software also usually needs a third party add-on to tackle complex inventory systems. Luckily, most game developers aren't faced with this, but the more items you have on hand, the harder it will be.

But to give a heads-up, these rules only apply if you're buying actual swag and keeping it on hand in some manner, whether it's in your own home, a storage unit or warehouse, or fulfillment center. Items you get printed through services like Zazzle and CafePress don't count as inventory because you're simply giving the company permission to use your logo and images. They're the ones who own all the t-shirts, mugs, and so on unless you're ordering a massive amount to keep on hand *for sale*, as opposed to keeping on hand for promotional use. Money earned from them is just sales commissions.

The same goes for if you do printing on demand or something similar with getting physical copies of your game made and not taking a DIY approach where you place the order yourself and get hundreds or thousands of boxes. If some other company is handling the manufacturing and never sends you any units, you need not worry about keeping an inventory account. But if you're placing orders with replication services and are able to keep them on hand to some degree, like selling them at conventions, then you do need to be concerned, even if those are your only inventory items.

If you have no plans to sell boxed games or swag at all, you can skip this level since none of this applies to you.

Kinds of Inventories

There are three kinds of inventories: raw materials, work-in-process, and finished goods. You need not take "raw materials" too literally; if you're making a special edition box set and ordering various components such as cases, outer boxes, old school manuals, and whatnot, those all count as raw materials even if they're finished goods in the concrete sense. A half-finished set would be work-in-process, while completed sets ready for sale would be finished goods.

To make your life easier, we're going to just be working with finished goods inventory here. But if you do crafting or hand-make any items for sale, you'll want to look into those other inventories a bit more closely.

Inventoriable Costs
It’s not just the actual per-unit price that you have to pay. The following costs get factored into your inventory:

- Setup charges
- Shipping
- Sales taxes
- Customs duty
- Any other fees set by the manufacturer for extras or things like going below the minimum order
- Inventoriable overhead like storage and insurance

If you order a set of 500 figurines, and each costs $4/unit plus $800 in setup charges, $1,000 in freight, and $50 in duty, it’s not just the $2,000 unit cost that gets allocated to inventory. Adding the other charges results in $3,850 of inventory, coming down to $7.70/unit.

Non-Sale Transactions to Keep Track Of
Inventories have quirks to them that can lead to a migraine faster than Sonic mainlining nine shots of espresso. Obviously, you’ll want to keep track of whenever items sell and how much you have left because if you have insurance on your inventory, manual counts are usually required to keep your coverage. But you still need to record the following:

- Items taken out for personal use
- Units that break from everyday handling
- Damaged units from unplanned disasters like fire or zombie apocalypse
- Any units you set aside for promotions, giveaways, or marketing samples
- Inventory donated to charity

They’re treated a little differently than simply selling stuff.

Cost of Goods Sold
Inventory is an asset, like your cash and receivables. What you pay for inventory doesn’t get deducted right away. Not until it’s sold or something else happens to it. On your books, the cost of goods sold is normally equal to your beginning inventory after deducting your ending inventory. For tax reporting, it’s a little more complicated. If you take out items for personal use, like giving gifts to friends and other non-business relationships, you have to report it but can’t take a deduction. Stuff that you set aside for promotional giveaways gets deducted as a marketing expense, not cost of goods sold.

Charity giveaways are treated differently still, as they depend on what you’re giving away, how the organization will use it, and how you set up the company. C corps tend to get a bigger benefit for all charity deductions than the other entities do, primarily because they just get a flat 10% of income limit on donations with an option to carry forward, whereas you personally might not itemize on your personal tax return and thus lose out on any benefit from donating. Your donation will be worth the smaller of its market value (sale price) or the actual cost. For our

figurines, we'd have to deduct $7.70 per unit donated instead of the $20 sale price. It has to be kept out of cost of goods sold.

So we have these figurines you purchased for $3,850 total and that cost $7.70/unit. Let's say that you bought them in May of this year and sold 100 figurines for $20 each by year's end, making $2,000 in sales and $770 as cost of goods sold. Assuming there's no other inventoriable overhead, your profit from swag sales is $1,230. The remaining $3,080 in inventory sits there as an asset. You don't deduct it yet.

Then some other things happen, like you accidentally break five figurines when moving boxes, use 50 of them for promotional samples and giveaways, and donate 10 to a local fundraiser. The five that broke cost $38.50, which you can write off as damage, while the $385 for 50 figurines is deducted as a marketing expense. Assuming that your studio doesn't operate as a C corp, you then have to remove the $77 in donated figurines from your inventory count to be transferred to your personal taxes. In other words, you can still get deductions when you have inventory; it's just not as straightforward and you have to report them in different places.

It's important to bear this in mind because it will affect things like your ability to take the §179 and home office deductions, since cost of goods sold "comes first" compared to your other expenses. So, if you have the $1,230 in swag profits plus another $5,000 in royalty income, $6,230 would be considered your total revenue before your other expenses, not the full $7,000 of royalties plus sales before accounting for cost of goods sold. Because cost of goods sold would create a loss if too many non-sale deductions got up there, that's why it's structured the way it is.

Also, going back to home offices for a sec: if you store a significant amount of inventory at home and want to take the home office deduction, that pesky exclusive use test doesn't come into play if it's *just for inventory*. If you use your linen closet to store game boxes, figures, t-shirts, and the like, the IRS won't care that there's also clean fluffy towels for you and your housemates in there. But tread carefully if you have both a regular home office plus storage space; the exclusive use test comes back to bite.

* * *

I didn't want to spend a whole lot of time on inventories because many people gravitate to game development to deal with as little physical clutter as possible. But I figured you should be aware of how inventories work because some devs like to build up their brand with swag while others just want control over their physical copies. If you make board and card games, you NEED to know what's in this chapter! It's also good to know if you want to do a crowdfunding campaign and you bought inventory but haven't delivered it yet.

To stay on topic with inventory, it's now time to discuss the most annoying baddies since getting blindsided by ghosts in *Pac-Man*: sales taxes!

Level 17: Sales Tax: Torment

Even if you don't plan on selling swag like t-shirts, game pieces, and the like, sales tax could still be of concern to you because some states have started charging sales tax for digital downloads. At the time of writing, the Marketplace Fairness Act is still up for debate and could result in having to collect sales tax from ALL sales tax territories even if you don't have a physical presence there.

There are over 9,600 sales tax jurisdictions in the US. 9,600! Individual towns, cities, and counties can charge sales tax on whatever items they want in addition to what the state collects. Only Alaska, New Hampshire, Montana, Delaware, and Oregon don't charge sales tax at all. If you don't live in those states, you'll have to find out which jurisdiction(s) you're liable for and get a schedule of what items are taxable in your state.

But unless this act or other sales tax legislation passes, it's been generally accepted by the Supreme Court that you'll only have to worry about sales tax in the jurisdictions where you have a physical presence or establish nexus.

What is Establishment of Nexus?

Let's pull up *Quest For Glory V* for a minute. The Hero had these devices called Mystic Magnets, where you placed one in the trunk in your room at the inn and could use its mate from anywhere to be teleported back to your room if you got into a dangerous situation. So you could be almost anywhere on the game map, but the inn would be your nexus because you regularly came back there to sleep, eat, and exchange items.

Let's say we have a couple of Mystic Magnets. We have to place one in the jurisdiction where you regularly work. So, if you work from home, set the magnet where you live. Then, if you're selling swag and you use a fulfillment house on an ongoing basis (as opposed to a one-time job like your first box release or crowdfunding rewards) and it's not in the same state, we have to place a magnet in the jurisdiction the fulfillment house is located in. If you have business partners who don't live in the same jurisdiction as you and they have significant roles in running the ship, you might also have to place a magnet in their jurisdictions if their home states mandate it based on ownership percentage and/or how active they are in the studio. Server location has also been used as nexus establishment for cloud-based companies.

Once you've figured out where your nexus points are, you'll have to apply for a sales tax license for each jurisdiction and collect at the right rates for the right items. Sounds like many planes to cross. Except that this time, you'll totally want to repress each memory as you come across it!

Digital Download Taxes for Direct Sales

Most of your distributors will automatically handle sales tax for you, but if you're accepting PayPal and other processors for direct sales on your own website, you'll have to set it up manually. (The same goes for if you sell physical items at conventions. Most credit card processors will take care of it at the point of sale, but you need to take care to charge sales tax if you get cash payments. It's perfectly legal to absorb the cost by not collecting it from your customers, but you'll still have to report the sale.)

Check with each of the places that sell your game as to whether or not they take care of sales tax. If they don't, and your jurisdiction(s) charge sales tax, you'll have to absorb it or risk getting smacked with a cash register audit. This means that if you have a game that sells for $5 a copy and your jurisdiction charges a 6% digital download tax, if you don't receive the 6% from the customer at the point of sale then you'll have to pay out that 30 cents per copy yourself.

Before you start hyperventilating, this wouldn't apply to a digital store such as Apple, Steam, Big Fish, and so forth because *you're not being paid directly*. Those stores are the point of sale and it's their job to collect sales tax, then send you royalties after taking their cut. You only have to worry about sales tax for the copies being sold directly on your website.

Resale Certificates

If you're buying goods in bulk for selling on your website or using as rewards in a crowdfunding campaign, you can fill out a resale certificate to bounce the sales tax on those goods. Usually you can't skip out on the sales tax if you're buying them for a different purpose, like promotional material, but your state might allow it.

Remitting Sales Tax

So you've had some direct sales and swag sales and have to file a sales tax return. States make you do this quarterly or annually and in varying levels of detail. This is why good recordkeeping is very important because the sales tax reports usually want to know what your total sales were compared to the taxable sales. Some will also want to know what kinds of items were sold.

Don't do what some unfortunate cash register audit victims did and accidentally spend the money that was supposed to get sent to the sales tax authorities. Keep track of how much you've collected and as a result owe the state/county, and remember to keep this money separate from the rest of your expenses so you don't have to be totally shell-shocked when the sales tax return is due.

Do I Owe Sales Tax on My Crowdfunding Campaign?

You might. Crowdfunding is still the wild yonder as far as legislators are concerned, and the only action that's taken place lately is in the equity crowdfunding field. Authorities have pretty much fallen silent on rewards-based crowdfunding, and this is troubling.

If I were a legislator, I'd point out that crowdfunding campaigns are not an actual purchase of an item ready for sale. Thus, shouldn't pledges not be subject to sales tax? Platforms like Indiegogo and Kickstarter are not stores. They don't collect sales tax on projects the way that Apple and sundry collect sales tax on digital downloads or Amazon does on physical goods. Why would they? With the exception of goods on Indiegogo's InDemand program, these are not products that are ready for sale in stores or online. Pledges are risks that the backer takes that it might not get funded. In the troubling recent legal actions against project creators, including the first Federal Trade Commission suit against a board game developer which went down in 2015, consumer affairs gets involved and applies laws meant for finished goods for sale because there is virtually no specific legislation for (rewards-based) crowdfunded projects at the time of writing.

Alas, I am not a legislator. Merely a fellow indie developer who wants to help you understand your tax and legal issues. Despite crowdfunding projects that haven't delivered and had the law misapplied to them after backers filed suit, this hasn't stopped revenue-starved counties and states from slamming successful project creators with sales tax levies regardless of whether they delivered or not. Most creators are too busy with trying to grow their business and fulfill the promises to their backers to want to put time and money into contesting the levies. If your campaign grossed less than $20,000 and you didn't receive a 1099 form as a result, you're a tad more likely to stay under the radar. But if you got that 1099, then you're at far higher risk for a cash register audit.

Going with the typical single nexus of where you set up your studio, you'll probably only have to worry about collecting sales tax from the people in your home state who pledged, rather than every single one of your backers. But I'd consult a sales tax expert before the campaign if you live in a particularly money-hungry state and/or have multistate issues, just to be on the safe side.

*   *   *

For most indies, you'll want to check with your nexus point's Department of Finance or Consumer Affairs to get a schedule of taxed items. I also included a free guide from NOLO in the citations. If you don't plan on selling any physical items or doing a crowdfunding campaign that has physical rewards, just check for digital downloads and whether they're taxed or not. Remember, you only have to worry about this for stuff sold directly from your website!

Level 18: Classification Quest: Do I Issue a W-2 or 1099?

Most indie developers treat the people outside of themselves and their business partners who work on their games as independent contractors. Sometimes this treatment is correct, but not always. For a lot of small businesses regardless of industry, owners don't want the ongoing cost or administrative burdens of having employees. For a vast majority of indie developers, there's also the concern of not even being able to pay yourself, let alone regularly pay other people. Ergo, the use of contractors. Even for AAA studios and large software companies, the use of contingent workforces is very common. Indies like us tend to completely rely on contingent labor for whatever we can't do ourselves.

When you have employees, it's not just a matter of being able to regularly pay them. Payroll taxes and their administration add at least 15% to their gross pay. You need to file quarterly payroll tax returns as well as buy workers comp insurance. Whereas with a contractor, all you need to do is file 1099s for each person who received $600 or more during the tax year.

Confusion over worker status leading to them getting the wrong forms and not enough/too many taxes taken out of their pay is called **worker misclassification.** This is an area that bleeds into labor law because of a whole host of other worker protection laws concerning things like overtime and the Fair Labor Standards Act, among others. But we're going to concentrate on the tax parts, which are onerous enough.

There are a lot of gray areas in determining who should get a W-2 (employee) or 1099 (contractor.) Just because you don't want to be bothered with workers comp and payroll taxes doesn't mean that you can just declare the people who work for you 1099 and be done with it! Same goes for just saying that you can't afford to make someone your employee.

Having personally suffered with the above situation as well as completed my master's thesis on the societal cost of worker misclassification, misclassification suits were one of my favorite practice areas. If you thought all the other tax law we discussed in this book so far was nebulous, buckle your seatbelt and get ready for a ride! It's a ride nowhere near as thrilling as *Starfox*, but here's what you need to know.

What Sets an Employee Apart From an Independent Contractor?

There are many factors that do. That's why a 20-factor test was devised by both the IRS and the Department of Labor to determine worker status. What the test *really* boils down to, though, is CONTROL. How much control do you have over that coder, artist, sound designer, web developer, and so on? Not just their time, but also how they do the work. Does your arrangement look like an employee-employer relationship, or like you're just hiring them for a single gig or project?

Three main concepts umbrella over the 20-factor test: behavioral control, financial control, and the type of relationship you have with this person.

Behavioral Control

Do your expectations of this person working on the game line up with a client-freelancer relationship or employee-employer relationship? While this also would fall under the relationship concept, behavioral control is really what determines the kind of relationship. An employee-employer relationship means that you have control over not just the results of work accomplished but also *how* that person is doing it. You're telling them when and where to come to work, what programs and tools to use, and other little details.

Do you provide a place for them to work on a regular basis? Are you telling them how to get the job done beyond giving them specs such as dictating what programs to use? Providing tools like computers, software keys, and the like? Beyond giving deadlines, are you telling them what days and hours they have to work? Do you evaluate their work, aside from just looking at the end results?

Timing is also a major focal point in determining whether or not you've got an employee. Do you request a certain amount of hours per week, or do you just want the work done? Are they active in the day-to-day management of your studio, or just there for certain tasks and projects? Is this person with you for the long haul or until the game gets released? While long-term relationships don't necessarily make someone your employee, it's not likely that someone who's truly freelance would stick around after the game's released or their share of development is complete.

Financial Control

Does the artist that you hired for sprite work do this kind of work for other studios, or are you the only one in the picture? Do they have a website, business cards, and other means of advertising their services? If not, are you paying this person like an employee – by the hour, week, or month – or are you paying them per milestone or flat fee? Employees don't send invoices; they just expect a paycheck.

Business expenses are another one. Do you offer reimbursement, or do they take care of expenses themselves? While not a be-all, end-all in figuring out if that person is really an independent contractor, courts still look at it.

Let's say you've got a convention coming and your studio asks that artist who's been contracted to work on your game to come help with the booth and talk about the game at panels and to the press. You throw him some bones to help with gas, give him one of the passes the organizer gave you, and split the costs for the hotel suite you booked. An employee or independent contractor could easily fit in that scenario, though an employee would not expect to cover the hotel.

Compare this to that artist having to buy their own supplies or asking you to reimburse them for supplies specially bought for your game. As an independent contractor, they're less likely to ask for a reimbursement and instead just factor supplies into the quote.

Artists and audio designers also have what the courts refer to as significant investment in their tools, equipment, and skills. Game developers in general fall into a gray area on this aspect because most of us merely invest in a computer and/or tablet plus our skills. Compare this to other skilled trades that have more hard tools and supplies, like construction. Bringing basic tool

sets to work wouldn't be considered a significant investment. Having your own forklift would be.

Part and parcel of that significant investment also includes factoring in whether or not you'll make a profit on the gig. Employees just look at getting paid, while true freelancers factor in things like opportunity cost and the expenses associated with each gig to determine if it's worth their time. While someone seeking a job would probably take one that pays more and look at things like commuting expenses, profit-seeking is still considered an independent contractor realm and usually based on significant investment.

Relationship
Do you plan on having this person around for the long haul and not just one game or task? Are their services *instrumental* to your studio? Just because you hire someone to work on multiple games or help you out with some non-game stuff won't automatically make them your employee, but you need to be mindful of these other behavioral and financial aspects. Contracts, for example: employees don't typically sign contracts before employment begins, but just because you gave someone a contract stating that they're independent contractors doesn't automatically make it so.

Then, what kinds of services are being provided to you? Game developers who need programmers, artists, and so on would be hurt in this area because those services are pretty integral to making a game. While it won't entirely kill being able to claim that person is an independent contractor, it still gets looked at.

Of Code and Coal, or How the Law Was Fought
One of the most infamous and relevant misclassification cases was Microsoft's brobdingnagian settlement that had to be paid at the height of the dot-com era. A class action was filed by several independent contractors who worked for Microsoft but were actually treated just like they were employees in all but name and benefits. They were repeatedly called back for several projects between 1989-1990 and often paid more than the employees but received none of their benefits like 401(k) contributions and employee stock options. They had to sign independent contractor agreements stating they weren't entitled to these benefits.

Microsoft utterly failed to treat these "freelancers" like freelancers. How? They required these workers to work onsite, side by side with the employees, doing the same exact job duties, working the same hours, and were given equipment and supplies. Upon the appeal, Microsoft had to pay a $97M settlement for back pay and benefits since these workers were obviously misclassified. And that's not even counting those non-deductible fines!

In contrast, one of the first precedent-setting misclassification suits took place in the 1940s and wasn't as obvious to the naked eye. A coal retailer named Silk paid workers to unload coal in his rail yard. The workers showed up whenever they pleased, bringing their own tools for the work. Silk didn't own any trucks, so he paid drivers with their own trucks for coal deliveries at a set price per ton. These truckers also did the hauling at their own discretion and did similar work for other coal companies, plus had significant investment in buying and maintaining their trucks. The Supreme Court decided that the truckers were independent contractors but the unloaders

were employees. The reasoning behind this was that the unloaders only supplied picks and shovels, the basic tools to do the job, so this was seen as no significant investment put in or profit to gain or lose by working with their hands and basic tools. The fact that they didn't work regularly at Silk's facilities was insignificant since their services were very much needed for Silk's business to run. The precedent that this case set was that even though Silk didn't really control the unloaders in terms of how often they showed up for work and how many hours they put in, he still *retained the right* to exercise supervision over these workers because he really couldn't have a business without them unless he'd be hauling coal out of rail cars all day himself.

Microsoft is too easy. If we liken Silk to a game developer as best as we can, the unloaders would be like programmers and artists while the truckers would be like marketing managers. Silk needed both services for sure to make a living, but if we set this in modern times, he could always call a trucking company instead of individuals with their own trucks, whereas he just doesn't have a business without people to unload coal even if they choose their own hours. The same could essentially be said of game developers who aren't doing every single thing by themselves or in-house, though it would depend on the scope of the projects. But once the game's released (the coal's ready for transport) and you hire some extra pairs of hands to help you get word out, just like how Silk didn't tell the truckers what routes to take or how to unload the coal at the destination, you're also probably not going to tell your social media manager or publicist how they should apply ethics in gaming journalism. Just so long as they get the word out!

How You Can Get Smacked for 1099 Abuse

It's not just the payroll taxes, labor regulations, and fines, but both imminent and potential liability reasons that cause intentional 1099 abuse. You're held responsible for any damage your employees inflict on other peoples' property and well-being. Behold the following awful but probable scenario: your community manager gets rip-roaring drunk at a convention and hurls a TV out of a hotel room window. It lands in the pool where your game designer was hanging out and they wind up in the hospital. The hotel bills your studio for the damage, so you pay it and then file a claim with your insurance provider, who has to jack your rate now. Your workers' comp policy takes a beating as well. Shortly after that, your artist blatantly sexually harasses and threatens your programmer, who files a suit. Then, when you fire your community manager and artist for reckless behavior and they file for unemployment, your unemployment insurance rate goes up for each employee, too.

Terrible situations like those examples unfortunately happen in every industry. And that's precisely what makes 1099 abuse so tempting to lots of cash-strapped new businesses. They need bodies but risk cutting paychecks more rubbery than an eraser factory, let alone paying the other expenses. And who wants to be held liable for collateral damage once you seemingly no longer have to worry about cash coming in?

Well, the price to pay for trying to skirt the law is even higher. Starting with the IRS, in addition to the payroll taxes you were supposed to pay, there are really steep fines if you misclassify workers. They will either catch onto you when they examine how many 1099s you issue and the amounts and consistency over the years, or if a worker files a request with the IRS to investigate your studio and determine if they're really an independent contractor or employee.

You're also getting the Department of Labor involved because you can be fined for failure to buy a workers' comp policy, or buying one and adding employees to it only after they get injured on the job. You'll be fined for every year that you didn't have a workers' comp policy but were supposed to. These fines can be well into six figures.

Then, you're getting your state involved as well. Your state may come down really hard on you if there are additional restrictions on who's allowed to get a 1099, such as a requirement that the payee has a website and can prove that they're trying to get work with multiple clients.

Play it safe. If you want to remain a non-employer, carefully look at how you pay and treat the people you're non-employing. Don't do what Microsoft did and treat them like employees you're just giving the wrong tax form to.

Safe Space: 1099 Misuse Safe Harbor
If you were a 1990s kid, remember all those PSAs and lectures about the difference between drug abuse and misuse?

It's the same idea here. 1099 abuse means that you are willfully misclassifying workers just because you want to skirt liability and payroll tax expenses. Let's face it, they ARE bigger than zounds of Ancient Behemoths, but failing to play by the rules and paying the damages is like facing off against nothing but archangels. (If we're all still playing *Heroes of Might and Magic III*, that is.) 1099 misuse is where you have some penalty relief because you're not intentionally trying to skirt the law.

Providing that you had a reasonable basis for giving someone a 1099, the IRS will work with you to make your penalties not be that bad. You don't get any protection if you just blatantly give people 1099s when you shouldn't and say, "Hey, I can't afford to have you as an employee but I'm going to treat you like one anyway." The "I can't afford it" defense won't hold up. Nor does the remote work defense. Plenty of companies are offering telecommuting options nowadays but can still put things like time reporting, hour caps, and other restrictions on their workers, which makes them employees.

A reasonable basis for fighting a misclassification notice would be something like your worker having no freelance experience and treating the gig like a regular job, but you don't ask for time logs, tell them they're free to work on other projects, and the like. Another reasonable basis would be one of those games that get trapped in Development Hell where you are billed so much throughout the years that it looks like this person could be your employee, but they work on other projects and showcase your game on their website alongside others. If you just couldn't afford to keep that person as an employee but treated them like one, it's not a reasonable basis.

I Need Employees But Can't Afford Them For the Long Run. Now What?
That's why employee leasing and temp agencies exist. You'd have to pay a significantly higher wage by the hour, but the agency takes care of all the payroll taxes and jazz so you don't have to. It's better than risking some ungodly amount of fines and trying to figure out compliance measures.

Does All This Mean That Game Developers Are At Risk?
Game developers aren't a super high risk field for misclassification suits the way that construction, healthcare, and cosmetology are, where serious gray areas happen all the time with degrees of control, furnishing of equipment, and whatnot. It's largely because a lot of the physical elements are missing…but control things can still slip through the cracks.

Proper 1099 use is very common in the gaming industry and always has been. While the remote work defense won't hold up in court if you did classify someone incorrectly, having no workplace does make the control and timing bits harder for the authorities to test. Unless you actually asked for timesheets or logs, how would you know when and how someone is getting work done on the game hundreds of miles away? Or how they were doing it?

Furnishing tools and space is also usually a non-issue. This is a computer- and device-based business for the most part. For the more physical parts of game development like art and audio, the people offering those services tend to have their own equipment and supplies. Unless you're renting an office or private room at a co-working space, you're also more than likely not providing a workspace for the rest of your team to get the job done.

We tend to not have to worry about the financial aspects too much, given our propensity to just use the milestone, piecework, and backend royalty methods to pay people rather than fixed monthly payments. Most people in the indie space also usually have their own websites and work for multiple studios but there's always the devs who'd rather have a job than their own business.

Basically, don't order someone around as if they're your employee if you don't actually want the cost and liability that comes with the territory. Don't do that and you should be fine.

* * *

If you want to stay a non-employer, it's important to know these distinctions and think about how they've applied to people who've done work for you. If they're not owners and you need them regularly, it might be time to take down your non-employer banner and open up a payroll account if you don't want to take on temps.

You're also going to need to know what an employer-employee relationship really is for the R&D credit, but also even for people outside the US. Since many indies have team members around the globe, that level's next.

Level 19: Where in the World Are Your International Dev Team Members?

Game studios don’t have to be limited to local talent. So many dev teams are formed by people who found each other on indie game forums, at conventions, and the like that having business partners, team members, and investors in other countries isn’t just common. At some point in your interactive entertainment career, it’s probably inevitable!

My business partner is not a US resident. A handful of people who worked on our games also were not, and having a lot of tax treaty and non-resident experience, I was always the person called upon for international matters at past tax jobs. Ergo, I felt this book would not be complete without having a section on what happens on both the domestic and foreign sides when you find cross-border talent. Although we have so many fantastic ways to communicate and work together nowadays, once again the laws have not caught up with the present, let alone the future.

Some of these regulations are complicated for both sides on purpose to discourage hiring outside the country. Companies paying foreigners are frequently met with a lot of confusion and tend to deal with it by not bothering to file the requisite forms at all. It’s such a hassle that it makes you want to stick to using domestic talent only. But life happens. and the most brilliant narrative designer you ever met is from Japan, then you meet your new business partner in your travels who happens to be from Australia, and all of you stumble upon an investor from France who gets you a publishing deal in Sweden.

Hey, not every dev team is necessarily composed of people on your block. So parts of this chapter are written as if I’m speaking to the non-resident developer dealing with the impacts. It’ll be just like those adventure games where you switch playable characters! (Okay, not quite.)

I’ve also avoided giving document numbers and names in most of this book outside of the citation section because, well, it’s boring. And more often than not, they mean something to tax professionals but not to you. But this chapter will name them more because foreigners are subject to some pretty draconian documentation and you should get an idea of what needs to be sent out even if you wind up not getting any foreign talent.

If you’re starting a company with a foreigner, the complexity can range from brain-crushing to not that painful depending on how you set up the business and how much money it’s making. Ironically, it’s harder to figure out on both sides when you have someone on contract. Foreigners with self-employment or wage income in the states can really be in for one hell of a boss battle.

Your Responsibilities as a Studio When You Have Foreign Team Members

When you take on someone who lives in the US as an independent contractor, you need to get a W-9 (information request) from them so you know what tax ID to use on their 1099 at the end of the year if they received more than $600. (And you’ll want to collect this *before* the work starts, along with any contracts.) You don’t need to pay or withhold any payroll taxes on their behalf or do any income tax withholding. If that artist or programmer bills you $1,000, you just pay them $1,000 and file a 1099 when the year’s up. But if they are going to be your employee, you need

an I-9 form with valid ID (passport or driver's license plus Social Security card) that proves they're eligible to work in the US. You do have to pay payroll taxes plus withhold them from their pay, along with federal and state/local income taxes.

It's a mite different with foreigners. When you have a foreign contractor, they fill out a form called W-8BEN unless they don't have a valid tax ID, like an employer identification number (EIN), Social Security Number (SSN), or International Tax Identification Number (ITIN). If they have an EIN or ITIN, being a pure contractor, you'd send them a 1042-S, not a 1099. Foreign employees need authorization to work in the US, which you'll determine by the kind of visa they hold if they're not residents or dual citizens with green cards and SSNs. You also have to check the totalization agreement set by the Social Security Administration to see if you need to take out payroll taxes or if they live in a country that gives them an exemption. Then, regardless of whether those taxes are paid or not, they get a W-2, just like a citizen would.

We'll focus more on independent contractors from foreign countries, as well as owners, because it's what the average indie developer is most likely to deal with. Aside from the obvious reasons you need to understand the legal differences between an independent contractor and an employee, I went through them in depth because you're also going to have to comply with that 20-factor test with foreigners – *even if they don't live or work stateside*. Foreign governments can have different ideas of what constitutes someone as your employee even if you've made the IRS and Department of Labor happy. If you hire someone for more than a specific amount of weeks, it can quickly hurl you into a misclassification suit across the pond even if that person totally satisfied the independent contractor rules over here. Same goes for you being their only client. Things like foreign payroll taxes, overtime, and paid leave can come into play even though you and the person in question never leave your respective home countries. Yes, this is live-action *Papers, Please*, complete with Jorji handing over a passport made with a crayon.

But if we go with indie norms (the assumption that someone overseas meets both countries' standards for being an independent contractor), you might have to do some withholding from their pay, depending on a few factors:

1. What country they live in
2. If a tax treaty exemption for reduced or eliminated withholding applies
3. If you're paying them for services or game royalties (this affects the withholding rates, as they're usually different)
4. If they have an ITIN

We've got another building puzzle, one that's a bit backwards: if someone has an ITIN, then they can claim a tax treaty benefit based on what their home country's treaty offers. If they *don't* have an ITIN, no benefits can be claimed. You have to withhold taxes at 30% of whatever you pay them. So if you pay a composer $2,000 to score your game and they don't have an ITIN, you'd send them $1,400, but $600 to the IRS, along with a 1042-S form showing that the $600 was taken out. It's then out of your hands whether or not they file a US tax return to try getting that money back. This is all starting to sound more fun than foregoing the Mad Monkey and attempting to get the 6,000 pieces of eight you need to charter Kate's ship in *Monkey Island 2* by polishing the pegleg that many times before you saw it off, isn't it?

Foreign Business Partners
If you're starting a business with someone who isn't a citizen, you can't do an S corp. You'll have to do a partnership, an LLC taxed as one, or a C corp. It's also a good idea to get the ITIN business sorted out as soon as possible, though I'll get into what's involved with applying for one, because unfortunately it's not a process that makes sense.

Partnerships and LLCs taxed as partnerships have a rule involving the maximum personal tax rate – 35% at the time of writing. If you've got a foreign partner, your studio will have to send 35% of their share of the profits to the IRS. Even if they took home no money! Going back to the chapter on business entities, partners are taxed as the money's earned, but the studio doesn't have to take out any taxes if they're citizens. So if your studio has two partners with 50% ownership, one citizen and one foreigner, and you post a $10,000 profit, then the both of you are taxed on $5,000 each regardless of whether you take out any distributions (payments). The studio won't have to withhold any taxes on your earnings, but you will have to send $1,750 to the IRS on your partner's behalf even if they didn't take any money home. Like the foreign contractors, they will need to file a tax return to get this money back. And even if a tax treaty is on file, that 35% still needs to be taken out! The only circumstance you're allowed to skirt this withholding payment is if the studio has a loss for that year.

This makes C corps a little more favorable for indies with foreign business partners because you're only taxed if you take out money, and you have the option to classify that payment as compensation or a dividend, which could result in a far lower withholding rate. If no money was taken out, then assuming that's the foreigner's only US-sourced income, they don't need to file a tax return.

For Foreigners: Are You a Resident or Non-Resident Alien?
Let's press B and switch. From here on out, you're a foreigner who is getting offers from American studios to come work for them. For simplicity's sake, you're a freelancer/contractor and not an employee or owner. Regardless of which one you are anyhow, you need to know the following distinction.

Aliens aren't referring to Sariens or Keronians, or perhaps those Two Guys From Andromeda. Rather, an **alien** is merely someone who isn't a citizen. A **non-resident alien** (the case for most foreign contractors in the game dev world, as well as some co-owners) is someone who doesn't establish residency in the US while a **resident alien** is someone who does. Your US taxes are most definitely affected by which category you fall into based on how many days you spent here in the past few years. By default, you're considered a nonresident unless one of the following situations applies:

1. You got a green card for lawful permanent residence at any time in the year. (Even if you got it on New Year's Eve, you'd be considered a permanent resident for the entire year.)
2. You meet the substantial presence test.

Assuming you don't have a green card, the substantial presence test is based on the days you spend in the country over a three-year period, but we got shades of a math puzzle here. Your

"substantial presence" has to be 183 days or longer over a three-year period. This comprises at least 31 days during the tax year in question, AND looking at the full year for the present one, one-third of the year for last year, and one-sixth for two years ago. If you total up 183 days after those phase-outs, you'll be considered a US resident for the year.

Let's say you were in the states for 120 days every year in 2013, 2014, and 2015. You'd count the full 120 days of presence in 2015, 40 days in 2014 (⅓ of 120), and 20 days in 2013 (⅙ of 120.) Because the total for the three-year period is 180 days, you're not considered a resident under the substantial presence test for 2015 despite being on US soil for longer than 31 days in 2015.

You'll need to keep track of how many days you spend here not only to figure out whether you're a resident or non-resident, but if you are indeed a non-resident, you have to report how many days you spent in the US on your tax return. Resident aliens need to file the same tax return as citizens, a 1040, while non-resident aliens file a 1040NR. We're going to assume that you need the latter in this chapter.

How Do I Know If I Have Tax Treaty Benefits?

Pulling from the citation section of this book, IRS Publication 901 has a full list of the provisions located in each tax treaty currently on file. Look up your home country and see if you have a lower withholding rate or a slashed or eliminated *tax* rate, depending on what kind of income it is, plus the rules you have to meet for each country. Some may have time limits or things like being provided a workplace, which would take away your benefits or even make you an employee and not a contractor.

The Turtles That Can't Swim, Redux: Filing a Non-Resident Tax Return

We've got one of those sidescrollers where you can see that gem or other item you really need to progress stuck inside this impenetrable area, and you have no idea how to get there. That gem represents all that money you had deducted from your pay even though you don't live in the US. The impenetrable area is the regulation surrounding getting an ITIN.

Logic would dictate that you file for an ITIN, then file a tax return. Or that you'd file for an ITIN long before you started working for American companies.

But nope. Here we have another situation where a turtle falls off a platform and dies upon landing in the water when you'd think they'd be able to swim. You actually have to wait until you need to file a tax return in order to get an ITIN. Even if you need one to claim tax treaty benefits, it's virtually always easier to just wait until you actually get a form from one of the companies you're working with, then fill out the ITIN app (Form W-7) and file it with your tax return.

I put that here just in case you were operating on normal human logic and thought you could take care of the ITIN thing right away.

Glory to Arstotzka: Documents Foreigners Need to Get an International Tax ID Number (ITIN)

I’ll be blunt with you: getting an ITIN is an extremely painful process. You need to actually be in a position where you must file a tax return because exceptions are pretty rare. If you need an ITIN, you’re about to go on a really frustrating fetch quest.

After your tax return has been prepared, you also need to fill out the ITIN app and submit proof of identity and non-resident status. The best way to do this is with a certified copy of your passport because processing can take easily 8-12 weeks if not longer, and it could very well take forever to get the original back. It’s best to go to a US embassy or consulate to get a certified copy. Check out the instructions of Form W-7 to see what other docs are acceptable if you don’t have a passport.

Once you have this certified copy of your passport, you have to send it along with your tax return and completed ITIN app by mail. If you happen to be stateside for a bit, you can also go to a tax professional who’s a Certified Acceptance Use Agent, who can file it for you. Tax pros don’t have this certificate by default, so if you go to one to help you out with the app and do your tax return, chances are they can get those documents ready for you, but you’ll have to mail them in yourself.

It makes you understand the lovable Jorji so much more.

Payment For Work = Effectively Connected Income; Royalties = Not Effectively Connected
After going through the endurance test of getting an ITIN, the next thing you have to worry about is whether or not your taxable income is effectively connected (ECTI).

In English, **effectively connected taxable income** means that if you have work or a business in the US, all income connected to it is ECTI, plus the business income itself. So if you own a game studio stateside, profits from it would be considered ECTI whether it’s a partnership or corp. Whereas you have some unrelated book royalties and dividends from an American brokerage account, those would **be non-effectively connected taxable income (NECTI).**

Having met lots of people in the adventure game community who typically reside in Europe or Australia, many of them don’t want to go through the hassle of obtaining an ITIN, so they instead file for an EIN and just do a sole proprietorship or single-member LLC if they have effectively connected income through freelancing for American clients. You’ll still have to file a 1040NR plus a Schedule C showing your income and expenses. You could also technically do all this without having an ITIN. But it’s still considered ECTI.

If you have ECTI, you still have to pay tax on that income after deducting business expenses as well as some allowances similar to ones that citizens get. Then, you also need to check that totalization agreement once more to wiggle out of paying self-employment tax. If your home country is not covered by the agreement, you have to pay it!

NECTI, on the other hand, would be things like your royalty income. Thinking of foreign actors and directors who receive royalties from film and TV, it’s virtually never considered effectively connected income for them even though those royalties are a direct result of their work. This is because they don’t have a fixed base in the US available for them to work. Film sets can be

literally anywhere in the world, and even if the production company shoots on location in the US or has sound stages here, that self-employed actor or director doesn't regularly have an office or set provided to them by any one studio.

The same could easily be said of a game developer, as we really tend to lack physical space. But depending on the conditions under which you're receiving royalties, it could easily be considered business income (ECTI), since in most cases you have to have worked on the game in order to be receiving royalties and have some kind of fixed and determinable timeframe that you're receiving them. If you get bonus royalties for helping sell the game, for instance, that could be construed as ECTI. But if you were going to get that royalty check even if you never made a game again, then you likely don't have to worry as much.

Tax treaty benefits also kick in for copyright royalties, like the ones received for games that you wouldn't get for contributing your services to an American company. It can include low *tax* rates, not just low *withholding* rates. Because with ECTI, you still need to pay tax at the ordinary rate.

But regardless of what kind of income it is, rest assured that non-residents will only have to report their US-sourced income. Whatever you earn in your home country or other countries won't have to be reported on your 1040NR tax return.

Potential State Tax Issues for Foreign Owners

Some states will reach into foreign countries and have nasty repercussions for owners/partners even if they never set foot in that state at all throughout the year. You'll want to be mindful of the state where you set up your studio to make sure that it makes sense for where your business partners reside as well as for you.

Most articles only talk about federal taxes when it comes to foreigners, but having seen lots of businesses get set up in my home state and watching non-residents get zapped, I figured I'd warn you. New York likes hogging the controller, so to speak.

Expats: Rooms That Don't Reset

Press A to go back to tax issues concerning US citizenry. Or rather, someone who still has a Social Security number and is considered a dual citizen but does not live in the US anymore: an expat. Expat taxation is insanely complicated and a bit beyond the scope of this book, but every time I've taught tax courses for indie developers, I wound up getting questions about it. So here's the basics.

There are only two countries on the entire planet – the US and Eritrea – who tax dual citizens, in that even if you leave the country, if you have dual citizenship you are taxed based on *citizenship* and not *residency*. State taxes might not be of concern to expats anymore, since you no longer have residency in any state at all, but you'll still have to file a federal tax return every year. It's a bit like a game with multiple rooms where one room resets after you leave it, but then there's that one that doesn't. In terms of nations, the US and Eritrea are those two nations whose rooms won't reset if you leave them.

If someone on your team is an expat, you generally treat him or her similarly to a US citizen. They need to be issued a W-2, 1099, or K-1 tied to their SSN. Beyond that, it's on them to report the income.

Conversely, if you are an expat receiving income from a company in the US, then you need to report it on your tax return. You have a complete inverse from non-residents who get some preferential treatment for royalty income. Game royalties would be earned income, but there's something called the foreign earned income exclusion, which is adjusted every year for inflation. (Worth up to $100,800 for 2015.) You have to be a bona fide resident of a foreign country for the year or be present for a majority of the year (330 days). But this income has to be *foreign-sourced*, meaning that it has to come from studios and clients who aren't in the US. If American studios are paying you for your services and/or giving you royalties, you can't opt to exclude it from your income because it wouldn't be foreign-sourced.

But, there is a foreign tax credit that you can claim for taxes that you have to pay to the foreign country to prevent double taxation. However, just like with lots of other tax benefits, you can't double dip, and you will also still owe Social Security taxes unless you fall under the protection of that totalization agreement. This includes the self-employment tax, which you also have to pay if you're not protected under the agreement, even if you're taking the foreign earned income exclusion.

* * *

Having foreign talent can have both obvious and hidden costs, but needing it is often inevitable for a lot of digital nomads and indies who can't find fellow developers and fans for their genre locally. Recordkeeping burdens can definitely go up on both sides.

I saved one of the most important bits for last: how you can find the professionals who are best suited to help you.

Level 20: How to Choose and Work With a Tax Professional

CONGLATURATIONS! You've made it to the end of this book alive! You have prooved the justice of our culture! (Okay, some younger readers might not get the reference.)

But, yes. I've given you (or at least hope I did) an understanding of the taxation environment of game developers and all its special quirks. Now it's time to figure out how you find a good tax professional if you've never worked with one before or are dissatisfied with whom you're currently working with.

Why Should I Work with a Tax Professional?
Unless you have someone in your family who taught you well from an early age or come from a taxation background like I did, you are definitely going to have to enlist a pro when you have your own business. You want a competent professional – not just for doing the actual tax returns, but also for structural things that change over time and having someone who is regularly available to consult with. For state and local mandates in particular, they'll be more apt to know when you're close to a filing deadline than you are.

When you spend your whole life working for someone else, you usually only have to worry about the ubiquitous April 15th. Not so when you have your own business. Even if you've done some simple self-employment forms yourself if you had very few expenses, a pro knows exactly what to do with complicated topics like depreciation, if you want to buy and sell IPs, and can even introduce you to other loopholes that are beyond the scope of this book. And even if you don't have employees, tons of stupid forms sneak up on you like enemy clusters in *Magicka*. Late fees can pile up faster than cranking up 12,000 CPU cycles in DOSBox.

A good tax professional can prevent that.

Credentialed tax pros I'll be describing in more detail are also mandated to do continuing education every year to stay updated on tax laws that constantly change. The tax code is about 1.4 billion words long. You're a busy game developer crying out for a TARDIS and lamenting having to eat and sleep. Is staying up to date on how much the standard meal allowance is for this year and deliberating for hours whether or not you should do a §179 deduction *really* something you want to spend time on? Didn't think so!

What's the Difference Between An Accountant, Bookkeeper, and Tax Preparer?
You may have heard these three terms used interchangeably, but they actually pertain to different aspects of financial management.

Bookkeeping refers to maintaining your chart of accounts, then keeping track of your income and expenses as well as capital contributions and drawings. Bigger companies that can have thousands of transactions per day will usually hire internal bookkeepers, while small businesses like us tend to use a service or an individual bookkeeper on contract if you don't do it in-house. I personally handle both of my companies' bookkeeping as a matter of scale and of all the things I could outsource I'd rather save it for other things since I have the skillset. If you have no idea how to journalize, adjust, post, and close accounts correctly, and you have so many transactions

that you've gone beyond just keeping track of things on an Excel sheet, you'll definitely need a professional bookkeeper. If you don't have many transactions and a spreadsheet or two is sufficient, you probably don't need a bookkeeper just yet.

An **accountant** is someone who looks at what the bookkeeper has kept track of and then prepares financial statements and other documents and calculations, like trial balances in accordance with US GAAP (generally accepted accounting principles) or IFRS (international financial reporting standards). Accountants also analyze and interpret the financial data given to them, like providing you key ratios based on those statements and how you can improve your bottom line.

So, the bookkeeper keeps track of the data and enters it in the system. The accountant tells you what it means and puts it into the format that external users know. These external users would be banks, investors, and third parties like business data services. Most indie developers don't care about that last one, but if you want to be an iOS developer and/or get certain publisher contracts, you WILL need properly kept books. Apple requires you to make an account with Dun & Bradstreet as part of your draconian trial to become an official iOS developer. You will have to have financial statements prepared every year and hand them over to D&B.

Don't want to work with publishers or Apple? That's totally fine. But you'll also need books data for your tax returns once you start making serious dough because you'll be required to do books-to-tax reconciliations. It's also simply a good idea to really know how well you're doing financially, and even if you're well aware you've been running in the red, it's important to know how much of these expenses are allocated to stuff you can pare down or to important investments in your game, skills, or professional network that were unavoidable.

The tax professional that you hire may offer bookkeeping. If you go with a full-service tax firm, they usually hire bookkeepers just for this reason or possess those skills themselves. This offers them a more up-close-and-personal view of their clients' finances as opposed to having do a lot of back-and-forth with external bookkeepers. But not every firm does this.

A **tax professional** is just what it says on the tin: someone who is a tax expert. A tax *preparer* may be a full-blown tax professional, or they could be just the tax equivalent of a bookkeeper, someone who knows the basics of filling out forms and simple tax structure but not the intense representation matters and law application.

Now, you know how you hate it when someone on the street says, "Oh, you make games? So you make stuff like *Mario*?" and you're facepalming while trying to keep your composure? That's how a lot of accountants and bookkeepers without tax knowledge feel when asked complex questions about taxes.

Just because someone knows accounting doesn't mean they know tax law. And vice versa. Don't assume that because someone knows one area that they know the other. I'm going to get into this further talking about professional licenses and designations, but just because someone is a really sharp bookkeeper doesn't mean they know how to apply these transactions to your taxes. Or that they know how representation and the actual law works.

So while the terms are frequently used interchangeably, accountants, bookkeepers, and tax pros are not one and the same. It doesn't mean you won't find a firm or independent practitioner who does all three, as there are many, but it's important to know that distinction based on your financial priorities. If you'd like to stay small, working with just one professional should be fine. You'll definitely need to know the difference once you're making a lot of money or you'd like to grow.

Practice Standards That Apply to Accountants and Tax Pros

With the exception of CPAs and public accountants (rarely seen anymore except in a few states), you don't need a license to call yourself an accountant. Unlicensed accountants usually hold degrees in accounting and/or business and are more common in the non-profit and governmental sectors. This is because a lot of business transactions in the private sector usually require a CPA's signature. CPAs are bound by the American Institute of Certified Public Accountants' (AICPA) code of conduct, followed by similar codes instituted by professional associations they voluntarily join. This is also in addition to the standards set by the states they practice in.

Tax pros who aren't CPAs have to adhere to the practice standards outlined by the IRS. The tax code enforces these standards on **enrolled preparers**, which encompasses CPAs, Enrolled Agents (EAs), and attorneys. **Unenrolled preparers** are not licensed and therefore can't represent you before the IRS and state tax authorities and aren't held to these rigorous practice standards or representation privileges that enrolled preparers are.

Why do you need to know this total snorefest that I know you just read in a similar manner to that Anton Fokker book from *Leisure Suit Larry 7*? First, it's better to work with a professional who is licensed and held to a standard of practice than one who is not. If something goes wrong, you want to go to the right licensing body to swiftly investigate that person. Unenrolled preparers may be good people in a tax chain or private tax office who are just working on their degrees and getting their feet in the door. They have to start somewhere. But unfortunately, a lot of unenrolled preparers also just open up shop and wind up ghosting after tax season, and can be hard to trace.

Why You Should Be Terrified of State Tax Departments

Where do you live? Where do you work? Where are the rest of the owners of your studio, if you're not the only one? Your location is definitely going to factor into who your regular tax pro will be. It's cool to work with a bookkeeper across the country who knows the gaming industry, but you'll want someone who knows tax law for where you live and/or set up the studio to do your taxes. Because state tax agencies are scarier than the Great Cartridge Crash of 1983.

When you piss off a state tax agency or something got misreported to them, you have a hot mess on your hands. They are the ones to be really afraid of – more than the IRS, contrary to what the media depicts. Thanks to the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA), the IRS can't just swoop into your home unannounced for a shakedown. But your state totally can.

RRA made the IRS provide you with due process as well as settlement programs for back taxes. You will receive multiple written notices before they start angling for your money, whereas in New York, you can just get smacked with a levy with only one letter that you barely had time to respond to. Even if you manage to get the levy reversed, you still have to pay this no-recourse $125 “legal fee” for them sending a third-party thieves’ guild to raid your bank account in the middle of the night.

States don’t necessarily have due process. They don’t have to provide you with the option to settle back taxes, states’ rights issue and all. Over 50% of states even publicly shame you for unpaid taxes! (Twenty-nine to be exact, according to the *National Journal*.) While unannounced shakedowns are more common with sales tax audits than income tax issues, you could have a state income tax issue or local small business filing that you overlooked and it will be a recipe for a state revenue officer showing up at your door. (The latter is especially common where I live. Not the revenue officers turning up, but forgetting about local small business taxes, particularly if you didn’t make enough to have to pay them before, like the MTA and unincorporated business taxes in New York, but you do now and it gets overlooked.)

Because it can be insanely tough to find a tax pro who knows the gaming industry, it may seem great to stick with one from an industry hotbed like California or Washington, but then you’re screwed for your home state if you don’t live or set up shop in California or Washington. Even if you live in a state with no income tax, you could still have to deal with state and local taxes to some extent, like a horrific sales tax burden or a franchise tax that’s more complex than “we’re charging this just because you exist.”

Why mention that in this chapter? Because you want a tax pro who knows how to fight your local power, not just the IRS. The former has a much stickier and worse yet, closer, hand than you’d think.

What to Look For in a Tax Pro

Obviously, you want someone who you like and have a good rapport with, whose knowledge and experience can help your studio as it grows. But you can meet one who’s very nice and competent and they’re just not the right fit. There are other qualities you should also look for – and avoid – in the person you hire to help with your taxes:

1. Available year-round. Most credentialed professionals will be unless they’re on contract with a firm, in which case availability might be up in the air. Avoid tax chains because you have no guarantee of getting the same preparer every year and most chain offices only operate seasonally.
2. Definitely avoid those fly-by-night places that promise you a bigger refund than the competition. They’re not knowledgeable about actual tax preparation, but know all about selling you refund anticipation loans. The only promise a legit tax pro makes is that they will get your tax bills as low as they legally can.
3. Second to that, never hire a tax preparer who charges their fee as a percentage of your refund or says they’ll take it out of your refund. A real credentialed tax expert will only charge you based on the complexity, or perhaps by form number or amount of pages.

(And as a self-employed person, you'll likely be saying good bye to the days of receiving refunds!)

4. Good tax pros ask lots of (relevant) questions about your life and business to get a thorough assessment of your overall financial situation. If they just take your documents and don't say much, or ask mostly fluff during the interview, you've got a dud.
5. Technologically literate. If they can barely turn a computer on and/or are using machines that were dug out of Sumerian ruins, RUN, DON'T WALK! You're in a digital profession. You need someone who understands the digital world and subsequent digital laws instead of the accountant who can't comprehend that yes, you are business owner who doesn't have a fax machine. (Before people from the tax community start hurling 1960s fax machine parts at me, this need not mean they have a new computer every year and top-of-the-line equipment. But if they're barely able to use the technology around them, you should look elsewhere for someone who gets how the digital world operates. Game development isn't a brick-and-mortar business with filing cabinets.)
6. What are the services you specifically require? Do you need a bookkeeper yet? Help with sales tax? International tax forms and law interpretation? Factor these into choosing your tax pro by asking them about their specialties and services offered.

Etiquette When Working with a Tax Pro

There's two groups of people in life who you should never mess with: the people who handle your food and the people who handle your money. Your tax pro is someone you want to feel warm fuzzies when they hear from you, and not just because they're cashing your checks. Here's how you need to behave with a tax pro.

1. This should go without saying, since a lot of indie developers work for themselves and hate it when this happens to them, but don't balk at a tax pro's fees. If you're shopping around for one, do that based on how you like them, their specialized knowledge, and other important factors instead of just going for who will do it the cheapest. Would you want someone whining about how you're too expensive to hire? I think not! Yeah, we know that Phil's Tax Hut down the block with the guy giving you his used car salesman grin while you gape at the fax machine that's been laying there since Israel declared statehood charges less. If you like his prices better, why aren't you over there? And, is the biggest financial transaction you may have this year really something where you want the lowest bidder who will also have access to your Social Security number?
2. Be a good record-keeper, including taking sums of your expenses from your receipts, bank statements, and so on. You will be loved for this. If you get met with this horror-stricken stare after bringing in a shoebox or a thumb drive full of mangled spreadsheets, don't be surprised if you have to pay extra to get them broken down or summarized. Some small firms who don't have enough bodies on hand might postpone your appointment until you do that yourself or outsource it.
3. If you use a system like QuickBooks, *use it correctly*. You will be loved for this even more. I know that the nice instructor said you wouldn't need an accountant once you got used to the program and devoted a whole week to learning the system. Well, 99% of the time they're lying. If you submit a QuickBooks file that's got income accounts in asset accounts and expenses that seem suspiciously personal, don't be surprised if you are

charged dearly for having a professional fix that mess because the chart of accounts wasn't properly set up in the first place.

4. Whatever you do, and I mean ***whatever you do***, DO NOT tell a licensed tax professional some bull like, "My cousin's barber's psychic told me I could write this off!" Or, even worse, "But so-and-so used to let me deduct it." We hate this more than indie developers hate being asked if we make games like *Mario* and why won't we get some nice job with a big AAA studio. Would you tell your doctor, "A Band-Aid on this grievous head injury is fine because a crackhead on the subway told me WebMD said it worked!" I don't think so. Don't tell the pro how to do their job. Now, if you have a citation from an authoritative source like the actual Internal Revenue Code, IRS publications, the Internal Revenue Manual, or Tax Court cases? Say that's where you found what you want to know more about. Isn't it nifty that I provided those things for you so your new tax pro doesn't give you a bunch of side-eye? But, it's also not a matter of "letting" you deduct things. Firms that tell people what they want to hear in order to get business go down soon enough. Or you'll just get a nice letter in your mailbox one day about those penalties and additional taxes you owe.

Who's Ultimately Responsible?

You. You, you, you.

While you have some protection under the law for having reasonable reliance on a licensed professional, you are still ultimately responsible for what goes on your tax returns, be they business or personal. You have to hold onto at least the last three years' worth of information for your personal taxes, six years for business. All those lovely substantiation rules we went over come into play.

The TurboTax defense also does not hold up in court if you go the self-prepared route. You still have to make sure the returns are done correctly and that everything is accurate. Tax Court says ignorance of the law is no excuse. But if you put yourself in a professional's hands, you'll have a little more protection if something goes south.

It's a tax professional's job to advocate for you rather than play auditors-and-tax-evaders. But if you tell your tax pro that you spent $5,000 on deductible business travel this year but you really only spent $2,000, you're still ultimately held responsible for that flagrant overstatement.

Accidents happen, like misreading or transposing numbers, so if you spot something you or they tabulated incorrectly by accident, you need to tell your tax pro ASAP so they can amend your return. However, if your tax pro pulls an overstatement or intentional transpose, steals your refund, or any other nasty violations of their duty of care, you can file a grievance with the Office of Return Preparers (oversight division of the IRS) to get that bad egg investigated.

Types of Tax Professionals and A Longtime Debate

The kinds of tax professionals out there can be dizzying. There's this whole enrolled-versus-unenrolled preparer dealie and all the different designations. Here are some of the most common ones and how they are significant to you. I wanted to give each one their own section, but something had to be said about the whole CPA vs. Enrolled Agent debate that constantly takes

place in tax pro circles. They must be explained together. I know you're sharing this with a tax pro, and some of my old peers are also reading this, so here we go.

Certified Public Accountants (CPAs) and Enrolled Agents (EAs)
The most well-known designation, CPAs are licensed by their state's accountancy board and must pass a rigorous four-part exam in all aspects of financial accounting, with some tax law in there. Most states also require CPAs to have an advanced degree –at minimum, a bachelor's degree in accounting, or a business or law degree with 30-36 credits in accounting coursework. Some states also institute a supervised work requirement of at least one or two years before they can get licensed. CPAs must get continuing education every year to stay updated in their practice areas and keep their licenses current. Peer review is also required by some states for certain clients or transactions.

But once again, going back to the "do you make games like *Mario*" thing, not all CPAs concentrate in taxation. Yet that's the impression the public is under. It's not necessarily false, but CPAs aren't the only experts out there, either.

Enrolled Agents (EA) expressly concentrate in taxation. EAs must pass a rigorous three-part exam on nothing but tax laws, IRS protocols, and practice standards. An accounting degree isn't required, as any education level and major can apply for the license so long as they pass the exam and background check. Enrolled Agent licensure is federally granted directly by the IRS. There's no supervised work requirement or mandated peer review, but EAs must do at least 24 hours of continuing education every year, including at least two in ethics.

Alternatively, if you work for the IRS for at least five years in certain capacities, you can become an Enrolled Agent without having to take the exam once you leave the Service.

I am an Enrolled Agent and have the distinction of passing all three parts of the exam on the first try as well as writing and review of the exam's questions and determining the minimum competency for EAs. And…it's rare to find someone outside of the financial industry who actually knows what an EA is. I got really, really tired of having to constantly explain it!

I also got really fed up with all the stupid and pointless infighting, like EAs snubbing their noses at CPAs over representation matters and vice versa, and these really snotty Big Four CPAs I knew who felt that becoming an EA wasn't a big deal unless you moved in low circles.

I've known experienced CPAs and lawyers with years of experience and multiple degrees who failed the EA exam miserably. Familiarity with tax law requires a mixture of calculations and legal argument, as you've probably gathered by now if you made it this far in the book. Wanna know what the big difference between CPAs and EAs is when it comes to *competently helping you with your taxes*, aside from the ones I gave above?

Marketing. That's all.

AICPA has more marketing pull than EA advocacy groups and tax pro societies do for the sheer fact that, well…CPAs vastly outnumber EAs. According to *Forbes*, there are only about 50,000

EAs admitted to practice while there are 650,000 CPAs. While there have been more concentrated efforts in recent years to raise awareness of the EA designation, more people gravitate to CPAs based on the marketing as well as wider availability. After all, doesn't "certified" sound more trustworthy than "enrolled"? And wouldn't a dev whose game got 650,000 paid downloads have a lot more cash to market with than one who sold 50,000 copies?

I've sounded off my cases with many extremely smart and competent CPAs over the years. I've also known CPAs who were brilliant at corporate auditing or financial accounting but utterly hopeless with tax law. Then there were the ones who got "creative."

Both EAs and CPAs can represent you in an audit and in discussing your tax matters with the authorities so you don't have to. When it comes to representation matters, sometimes EAs are a safer bet because, historically speaking, IRS employees have played nicer in the sandbox with EAs. Not always, but frequently. Despite this, EAs remain the jobbers of the industry, if we have any wrestling fans here.

So, when you're trying to figure out what kind of tax expert to regularly work with and are pondering if a CPA is a better choice than an EA, it's not about which group of letters after their name is better. It's merely about the differences in standards and licensing requirements both professionals are held to and that the public is more familiar with.

To conclude this long-winded explanation, both EAs and CPAs will be smart and competent for the most part. The best way to tell which is the right one for you is to prioritize the industrial specialty, as gaming industry experts are hard to find in the professional sector, followed by any additional concerns and needs that you have.

Tax Attorneys
Tax attorneys practice tax law from analytical and interpretation-based standpoints and can go to bat for you in Tax Court. Like EAs and CPAs, they can also represent you to the IRS and state tax authorities but might be limited to the states in which they are licensed. So they will be your go-to people for legality gray areas and petitioning Tax Court, as opposed to the rote preparation of tax returns.

Tax attorneys can also provide structuring advice when you want to start a new business and file your incorporation papers for you, and are also frequently the go-to people for worker misclassification suits, as some of them also concentrate in labor law.

United States Tax Court Practitioner (USTCP)
The only non-attorneys allowed to go before the court, USTCPs are like the EAs of the law field in this regard. They are pretty rare and have a razor-sharp focus on tax law applications and how Tax Court works. If you can find a USTCP who knows the games industry, who's capable of both preparing your return and fighting things out in Tax Court, hold onto them and never let go!

Registered Tax Return Preparer (RTRP) and Annual Filing Season Program (AFSP)
RTRPs were a short-lived designation that came up in the early 2010s as a result of public pressure. For a long, long time, you needed more licensure to cut hair or sell hot dogs than to

assist Americans with what's often the biggest financial transaction of the year. An RTRP had to pass a less comprehensive exam on individual tax law, do a smaller amount of continuing education every year, and did not have the same representation privileges as an EA, CPA, or attorney. But there was pushback from the hordes of unlicensed preparers who resented having to get continuing education and pay for a license. They were led by an unlicensed preparer, SabrinaLoving, who took the matter to the Supreme Court, saying that it was unconstitutional for the IRS to overstep their authority in instituting the RTRP designation. Much to the surprise of the tax professional community, Loving won and struck down the RTRP designation. Then, the IRS lost their appeal.

You might still see some people putting RTRP after their name, even though it no longer exists as of 2014 when the decision was upheld that unlicensed preparers shouldn't be required to get continuing education and pay licensing fees. RTRP was replaced with the voluntary AFSP certification, which entails continuing education for unlicensed preparers. It's a yearly certificate best suited to novice preparers and students.

* * *

And so, dear indies, it comes to an end. Thanks for buying this book, and good luck in the tough but rewarding indie developer path! Be sure to keep your eyes trained on sonictoad.com, the new pad for indie developers and creatives to dish about the indie life and contemporary development issues (plus random rants).

Now I don't know about you, but I'm ready to actually play something after all this. Even though I've been playing *Heroes of Might and Magic* for over 15 years and now can't look at it the same…

Index of Citations

Here are citations as well as helpful references for the various tax topics addressed in this book. It would be impossible for *every* single statement to have a citation attached, so it was saved for the more complicated and nebulous explanations particularly in the later chapters. But you have enough to show your tax professional if you have questions or would like to research the matter further yourself.

These statements go in order of chapter then content. No need to jump all over the place!

Publications, forms, notices, Tax Topics, and instructions can be found on irs.gov unless otherwise noted. Federal and some state case law is referenced but sections (§§) refer to the Internal Revenue Code (Title 26 of the US Code) or Income Tax Regulations unless a different piece of legislation is being cited and therefore noted.

Levels 0-1 have no citations.

Level 2: Chaotic Neutral Married (Filing Statuses)

1. Publication 17: Your Federal Income Tax
2. Publication 501: Exemptions, Standard Deduction, and Filing Information
3. Publication 504: Divorced or Separated Individuals
4. Publication 929: Tax Rules for Children and Dependents
5. Public Law 110-28: Rules for qualified joint ventures. See also: https://www.irs.gov/Businesses/Small-Business-&-Self-Employed/Election-for-Husband-and-Wife-Unincorporated-Businesses

Level 3: Deductions, Credits, and Exclusions

1. Form 1040 instructions
2. Schedule A instructions
3. Publication 17: Your Federal Income Tax

Level 4: Keep Records Like Developer Diaries

1. Publication 583: Starting a Business and Keeping Records

Level 5: Tax Impacts of Funding a Game

1. Publication 525: Taxable and Nontaxable Income
2. Publication 559: Survivors, Executors, and Administrators
3. Publication 970: Tax Benefits for Education
4. Corporate grant exceptions: §118
5. §351 tax-free transfers to corporations

Level 6: Is Game Development Your Livelihood or Just a Hobby?

1. Hobby loss rules defined: §183
2. Reg. §1.183-2(b) the nine-factor test
3. FS-2008-23: Is Your Hobby a For-Profit Endeavor?
4. Publication 535: Business Expenses

5. J. Tinnell, 81 TCM 1569, TC Memo 2001-106, Dec. 54,327(M): Court ruled that Tinnell indeed had a business but it was hard to prove since he didn't keep books and records, or any way to evaluate how he did.
6. R.J. McKeever, 80 TCM 358, TC Memo 2000-288, Dec. 54,040(M): Failure to market yourself in some way could constitute failure to operate in a business-like manner.
7. Tony Zidar v. Commissioner: TC Memo 2001-200, 82 TCM 357
8. R.N. Nelson, 81 TCM 1632, TC Memo. 2001-117, Dec. 54,341(M), note 7 for time and effort factor. Nelson needed to keep her job to support her business. Respondent concurred.
9. M.T. Shane v. Commissioner, TC Memo 1995-504: note 2 for financial status
10. Morton v. United States, 107 A.F.T.R. 2d Par. 2011-1 U.S.T.C.: Morton forms S corp to use private jet for his various businesses. Wins based on profit motive.
11. TC Memo 1999-83, C. Lundquist, 77 TCM 1556, Dec. 53,295(M): Lundquist's horse breeding efforts didn't make sense without the fun parts.
12. L.T. Hoyle v. Commissioner, TC Memo 1994-592: unlike Lundquist, Hoyle managed to prove the fun he got out of his horsing around was merely incidental.

Level 7: Business Entities and Formalities

1. Publication 541: Partnerships
2. §705: partner basis computation
3. Publication 542: Corporations
4. Publication 334: Tax Guide For Small Businesses
5. Publication 536: Net Operating Losses (NOLs) for Individuals, Estates, and Trusts
6. Schedule C instructions
7. Form 1120 instructions
8. Form 1065 instructions

Level 8: The Load Screen, Start-Up & Organizational Costs

1. Publication 535: Business Expenses
2. Publication 334: Tax Guide For Small Businesses
3. §248(a): $5,000 expensing election

Level 9: The Main Event, Business Expenses

1. §162(a): deduction of business expenses; but only if you have intent to profit
2. Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930) For the Cohan rule to apply, there must be sufficient evidence in the record to provide a basis for the estimate. See also: Vanicek v. Commissioner, 85 T.C. 731, 743 (1985)
3. Deputy v. du Pont, 308 US at 495 (1940): definition of ordinary expense: "of common or frequent occurrence in the type of business involved."
4. Commissioner v. Heininger, 320 U.S. 467, 471 (1943): Necessary expense: appropriate and helpful in carrying on trade/business. See also: Heineman v. Commissioner, 82 T.C. 538, 543 (1984)
5. Schedule C taxpayers ultimately bear the burden of proof for their deductions: Rule 142(a); Hradesky v. Commissioner, 65 T.C. 87, 90 (1975), aff'd per curiam, 540 F.2d 821 (5th Cir. 1976)

6. §1.162-5 Income Tax Regs. sets forth the guidelines for determining educational expenses incident to a taxpayer's trade or business that are deductible. See also: TC Summary Opinion 2014-55, Peppers v. Commissioner
7. §1.162-5(a), Income Tax Regs.: Educational expenses are not deductible if they are paid by an individual for education which is part of a program of study that will lead to qualifying the individual for a *new* trade or business.
8. Schwartz v. Commissioner, 69 T.C. 877, 889 (1978): Taxpayer must show sufficient nexus between education expenditures and trade or business.
9. Publication 970: Tax Benefits for Education
10. Form 1040 instructions (for self-employment health insurance deduction)
11. Publication 502: Medical Expenses

Level 10: Lost Levels, Non-Deductible Items

1. Welch v. Helvering (290 US 111, 54 S.Ct. 8, 78 L.Ed. 212): 1933 Supreme Court landmark decision that decided on what was the difference between business and personal expenses and differentiating ordinary business expenses from capital expenditures.
2. §162(f), no deduction for violations of the law
3. §162(e), political and lobbying expenses aren't deductible
4. R.L. Vitale Jr. v. Commissioner, TC Memo 1999-131: Vitale was just starting out as a writer and racked up many expenditures, including several visits to prostitutes and brothels as part of doing research for his book. Court disallowed many of his expenses because they were not substantiated. However, under the strict substantiation rules of §274(d) he was able to deduct some of his travel to the brothels. Despite this, the Court ruled that the money actually paid to the brothels was so personal in nature that there was no way it could be deductible.

Level 11: Travel, Meals, and Entertainment Expenses (The Bonus Round)

1. Some expenses cannot be estimated under the Cohan rule per §274(d); subject to very strict substantiation requirements. §274(d)(4) pertains to travel expenses in particular. See also: Sanford v. Commissioner, 50 T.C. 823, 827-828 (1968), aff'd per curiam, 412 F.2d 201 (2d Cir. 1969) for misuse of the Cohan rule.
2. Publication 463: Travel, Entertainment, Gift, and Car Expenses
3. §1.274-5(j)(2), Income Tax Regs., §162(a): deductible business expenses include the cost of transportation related to business, both local transportation and the cost of traveling away from home on overnight trips.
4. §1.274-5(j)(2), Income Tax Regs.: A taxpayer who opts to use the standard mileage rate is relieved of the obligation to substantiate the *dollar amount* of the expense but is <u>NOT</u> relieved of the obligation to substantiate the amount of the *business use* of the car or truck (the amount of business mileage and how often the car is used for business purposes), the time of the use of the car or truck, and the business purpose of the use (driving to a convention, to see a team member, from equipment rental to event site, etc.)
5. Crawford v. Commissioner, TC Memo 2014-156: Crawford tried to corroborate his testimony of what he used his car for (namely driving to meetings where he discussed sales of Vemma products, recruitment of new agents, or both) using his noted-up calendar where it had both business and personal remarks on it, and numbers that may or

may not have been miles. The Court found that his calendar was NOT reliable because it would have a location on a date marker, but then his receipts would show he was in another location that day and/or time. Crawford then admitted some entries were incorrect. The notations were also too vague and ambiguous for the Court to know what to do with them as to determining Crawford's business use of his vehicle.

    i. Crawford also admitted to his employer reimbursing him for a lot of trips and mixing personal items in. So, it's a VERY good example of a case where the business expenses have no merit. He didn't keep strong enough substantiation but also seemed undecided on using actual cost of gas or standard mileage.

6. §274(n): the cost of business-related meals is a deductible business expense, at least in part.
    i. §162(a): payments for meals on business trips away from home are deductible business expenses. §274(d)(4) provides that these business expenses are subject to strict substantiation requirements.
7. Publication 535: Business Expenses
8. §1.274-5T(b)(2) Income Tax Regs.: those four things your overnight travel records must contain
    a. The expenses of travel away from home are subject to the strict substantiation requirements of section §274. §274(d)(1); §1.274-5T(b)(2), Temporary Income Tax Regs., 50 Fed. Reg. 46014 (Nov. 6, 1985).
        i. With respect to travel expenses, the taxpayer must show the amount of the expenditure, the date of departure and return for each trip, the number of days away from home spent on business, the destinations or locality of travel, and the business purpose of the travel. As previously stated, each of these elements must be proven by (1) adequate records or (2) other sufficient evidence corroborating the taxpayer's own statement.
        ii. This also includes who paid: going back to the 2014 Crawford case (TC Memo 2014-156), it's unclear as to whether Crawford paid those invoices or his employer did. Having invoices alone isn't proof you actually paid for these things.
9. Danville Plywood Corp v. United States, 899 F.2d3: invited his customers to the Super Bowl in New Orleans that included a hotel and riverboat cruise. Court declared that the scattered business discussions were only incidental, the trip was purely for entertainment. Doesn't pass the "for only" test.
10. Blackshear v. Commissioner, TC Memo 1977-231: Minister Blackshear escorted a tour group of parishioners to Europe but couldn't demonstrate a profit motive for the trip.
11. §1.162-2(b)(1), Income Tax Regs.: if a trip is undertaken for both business and personal reasons, travel expenses are deductible only if the primary purpose of the trip is business.
    a. §1.162-2(b)(2), Income Tax Regs.: Whether the primary purpose of the trip is business or personal depends on all the facts and circumstances, and particularly on the amount of time during the trip that the taxpayer devoted to business as compared to the time for personal activities.
        i. In English, that second part means that if taking the trip just doesn't make sense without the personal elements, it's not going to be deductible. Just having some personal elements in the trip won't jettison your whole

deduction, but the main reason you’re traveling still needs to be for business.

12. Peppers v. Commissioner, TC Summary Opinion 2014-55: the Court sustains disallowing her travel and meals deductions for the trips she made that were supposedly meant to help her travel agency get reviews. Family members also went with her, which made it harder to prove that trips were for business, especially since reviews weren’t published on the site. EVERY trip was made with at least one family member.
13. §1.274- 5T(c)(2), Temporary Income Tax Regs., 50 Fed. Reg. 46017 (Nov. 6, 1985): “To meet the adequate records requirements of §274, a taxpayer must maintain some form of records and documentary evidence that in combination are sufficient to establish each element of an expenditure or use.”
    a. In English, this means that you need something more than just a receipt or bank/charge statement to give your deduction merit. Like, if you went out to California for GDC, do you have your pass and program? Tweets you sent during that time that prove you were there?
        i. If you don’t have any of those things, at the very least, do you have a confirmation email that you attended? For trips that aren’t conventions, what about proof of what you did in these other places, such as email and text trails, phone records, etc. that confirm meetings and plans?
14. McClellan v. Commissioner, TC Memo 2014-257: The couple’s company, BCMC, had proof of payment for meals from their bank statements along with several theater ticket stubs. For the three years they got audited, they spent $19,200, $35,800, and $36,640 on meals and entertainment. Tax Court declares that the McClellans failed to substantiate whether these meals and entertainment were connected to their travel or to business dinners and entertainment with colleagues: merely having proof of payment and attendance isn’t enough. Thus, the Court slashed their deductible meals and entertainment down to $103, $9,603, and $4,708 respectively for each year. And that’s *before* the 50% allowance.
15. §1.274-5T(c)(1), Temporary Income Tax Regs., 50 Fed. Reg. 46016-46017 (Nov. 6, 1985): “A contemporaneous log is not required, but corroborative evidence to support a taxpayer’s reconstruction of the elements of expenditure or use must have ‘a high degree of probative value to elevate such statement’ to the level of credibility of a contemporaneous record.”
    a. In English, this means that while you need not keep a day-to-day journal with a captain’s log of what you did at certain times of the day, it certainly helps. If you don’t keep a journal of sorts, then you need other proof that what you were doing on this business trip was well…business.
        i. It’s not that hard to prove this for conventions because you’ll have PDFs of programs you can download online plus the justification letters on their websites. But it can be a lot harder to prove this for meeting a dev team member, publisher, or other business relationship.
16. Federal meal allowance for domestic travel: http://www.gsa.gov/portal/content/104877
17. Department of Defense meal allowance for AK, HI, US territories: www.defensetravel.dod.mil/site/perdiemCalc.cfm
18. Department of State foreign travel allowances: https://aoprals.state.gov/web920/per_diem.asp

19. Hynes v. Commissioner, 74 T.C. 1266 (1980): Hynes worked as a television news anchor and deducted wardrobe, laundry and dry cleaning, haircuts and makeup. He purchased a business wardrobe that was restricted in terms of color and pattern that he was able to wear on the air. The Court reasoned that the restriction on his selection of business attire was not significantly different from that applicable to other business professionals who must also limit their selection of clothing to conservative styles and fashions. The Court further reasoned that the fact that just because Hynes didn't want to wear this wardrobe while away from the station did not signal that the clothing was unsuitable for private and personal wear.
20. Tax Topic 415: Renting Residential and Vacation Property
21. §274(h)(1): if a convention is held outside of North America, you must establish that the meeting is directly related to your trade/business and that it is as reasonable for it to be held outside of North America.
22. What constitutes North American convention areas: https://www.irs.gov/publications/p463/ch01.html#en_US_2014_publink100033843
23. United Title Insurance Co. v. Commissioner, TC Memo 1988-38: The sole owner of North Carolina-based United Title Insurance sponsored out-of-state board meetings every year in major cities very far from home. He held meetings in New Orleans, Las Vegas, and Puerto Rico and would invite 11-14 board members, his employees, and several business guests. These guests were North Carolina real estate attorneys, land developers, real estate agents, bankers, lenders, and their spouses and friends. During these meetings, United conducted the annual board meeting then his employees met with the guests to discuss underwriting policies and other topics related to the title business. With the exception of the expenses for the spouses and friends of the business guests, the expenses were deductible. United had to hold the meetings in interesting locales to ensure that the guests would be interested in coming and the company benefited through the business discussions and strengthening of their business relationships.
24. Private Letter Ruling 8228075: an American medical organization that only had American members held its convention in Paris. Members that attended did not get a deduction. But they would've if it their organization had an international membership, where surgeons from around the world shared knowledge and techniques.

Level 12: Turn-Based Strategy, or Depreciation of Big-Ticket Items

1. Publication 946: How to Depreciate Property
2. §168: everything you ever wanted to know about depreciation
3. Publication 551: Basis of Assets
4. Table 4-1 of depreciation methods: https://www.irs.gov/publications/p946/ch04.html#en_US_2013_publink1000107538
5. §179: everything you ever wanted to know about expensing big-ticket items
6. Publication 463: Travel, Entertainment, Gift, and Car Expenses
7. Car depreciation rates for both actual cost and standard mileage: https://www.irs.gov/publications/p463/ch04.html#en_US_2014_publink1000134864
8. §1250: what you recapture upon selling an asset you've already depreciated, referred to as §1250 gain.
9. Publication 544: Disposition of Assets
10. Form 4562 Instructions

Level 13: Home Offices Are the Turtles That Can't Swim

1. §280A(c)(1)(A): your home must be your principal place of business
2. Commissioner v. Soliman, TC Memo 91-998; 506 U.S. 168, 113 S.Ct. 701: landmark case that established management and administrative duties relating to your business can negate the "focal point" test used in determining if a home office is really necessary, providing that none of the places you work at provide you with a desk or other place to do these things.
3. Jackson v. Commissioner, 76 T.C. 696, 700 (1981): in identifying a taxpayer's principal place of business, the Tax Court often seeks to ascertain the "focal point" of their business activities.
4. Proposed Treas. Reg. 1.280A2(b)(3), 45 Fed.Reg. 52399 (1980), as amended, 48 Fed. Reg. 33320 (1983): Salespersons [506 U.S. 168, 172] would be entitled to home office deductions "even though they spend most of their time on the road, as long as they spend 'a substantial amount of time on paperwork at home.'"
5. Baie v. Commissioner, 74 T.C. 105, 109 (1980)
6. Proposed Treas.Reg. 1.280A-2(g)(1), 45 Fed.Reg. 52399, 52404 (1980), as amended, 48 Fed.Reg. 33320, 33324 (1983): a portion of a dwelling unit is used exclusively "only if there is no use of that portion of the unit at any time during the taxable year other than for business purposes."
    i. In English: that room, series of rooms, or cordoned off portion must never, ever be used for anything other than business year-round.
7. Weightman v. Commissioner, TC Memo 1981-301: the IRS disallowed a home office deduction for a taxpayer who used part of his bedroom as a home office. While it was disallowed based on the exclusive use rule, Tax Court found that there was actually nothing in the law supported the idea that a home office must be an entire room or be physically separate from the remainder of the house.
8. Huang v. Commissioner, TC Summary Opinion 2002-93: the Court confirmed that they could allow the taxpayer a deduction for 75% of a room that was used exclusively for business, even though the entire room was not used for business purposes.
9. Hughes v. Commissioner, TC Memo 1981-140: the Court ruled that a home office could be located in what would be considered an unconventional place – such as a large walk-in closet – so long as the regular and exclusive rules were met for the space. If the home office occupies only an area of the home opposed to an entire room, it's even more important to segregate all personal activities from it. All relevant furniture and equipment must be confined to the specific home office area, not interspersed among personal items.
10. Publication 587: Business Use of Your Home
11. Figuring depreciation of your home using Table A-7 in Publication 946: https://www.irs.gov/publications/p946/13081f08.html
12. Revenue Procedure 2013-13: outlines safe harbor rules for home office deduction in lieu of actual expenses
13. Publication 523: Selling Your Home
14. §121: excluded gain on home sale conditions

Level 14: Why Your Fiscal Year is Like Dinosaurs Living With Humans

1. Publication 509: Tax Calendars

2. §441(g): if you don't keep records, you must use a calendar year.
3. Publication 538: Accounting Periods and Methods
4. §451(2)(a): income is constructively received when an amount is credited to your account or made available to you without restriction. You need not have possession of it.
    i. If you authorize someone to be your agent and receive income for you, you are considered to have received it when your agent receives it. Such as if you're out of town and a friend picks up a check from a client for you: the income is constructively received upon your friend holding that check.
    ii. Income is <u>not</u> constructively received if your control of its receipt is subject to substantial restrictions or limitations. Such as meeting a minimum with a publisher or they just don't issue the payment despite your request.
5. Publication 334: Tax Guide For Small Businesses
6. §448: limitations on who can use the cash method
7. Publication 535: Business Expenses
8. Burck v. Commissioner, 63 TC 556 (1975) aff'd, 533 F.2d 768 (2d Cir. 1976): prepayments which are purely tax-motivated may NOT be allowed as a current deduction even if they meet the 12-month test. See also: McMullan v. United States, 686 F.2d 915 (Ct. Cl. 1982)
9. §461: general rule for tax year of a deduction
10. Revenue Ruling 74-607: under the "earlier-of test," an accrual basis taxpayer receives income when (1) the required performance occurs, (2) payment therefore is due, or (3) payment therefore is made, whichever happens earliest.
    i. Under this test, an accrual basis taxpayer may be treated as a cash basis taxpayer when payment is received before the required performance and before the payment is actually due. (You definitely want to remember this if you're doing a Kickstarter.)
11. Form 3115 Instructions
12. §166(a)(1): deduction of bad debts in whole, §166(a)(2) for partial

Level 15: Endless Runners, or Ways to Treat Your Development Costs

1. §174: option to expense all of your development costs
2. Publication 535: Business Expenses
3. §41: R&D credit basics, the four-part test
4. §41(d)(4)(H): you can't claim the R&D credit for research/experimentation that has been funded by a third party like a grant program or publisher.
5. Fairchild Industries, Inc. v. United States, 71 F.3d 868: Fairchild tried to defend their stance that in order for their research to not be considered funded by a third party and thus eligible for the R&D credit, that they indeed took a risk and had substantial rights to the research's results. The Court found that Fairchild only got incidental benefits, not substantial rights.
6. §41(b)(2)(D): types of wages that are allowed for the credit, and wages must be defined by §3401, which simply means there has to be an employee-employer relationship. Contingent labor where you contract someone out and give them a 1099 can't be used at 100% of the cost for the R&D credit.

7. §41(b)(2)(B) and Treasury Regulation §1.41-2(e): only 65% of contractor pay can be used to calculate the credit
8. Form 6765 instructions

Level 16: Rubber Chickens with Pulleys in the Middle (Inventory)

1. Schedule C instructions
2. Publication 535: Business Expenses
3. Publication 587: Business Use of Your Home

Level 17: Sales Tax: Torment

1. SBA.gov, basic information on internet-based businesses that must collect sales tax and define nexus: https://www.sba.gov/content/collecting-sales-tax-over-internet
2. Quill Corp. v. North Dakota, 504 U.S. 298 (1992): landmark case declaring that businesses can't be forced to collect sales tax in states where they don't have presence.
3. Free sales tax guide from NOLO, just click your state: http://www.nolo.com/legal-encyclopedia/50-state-guide-internet-sales-tax-laws.html
4. National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753 (1967): held that if your only contact with the state charging sales tax is by mail (internet these days) then there's not enough substance to have nexus in that state.

Level 18: Classification Quest: Do I Issue a W-2 or a 1099?

1. Circular D, Employer's Tax Guide
2. Publication 15-A, Employer's Supplementary Tax Guide
3. Publication 1779: Independent Contractor or Employee?
4. Revenue Ruling 87-41: 20-factor test
5. Tieberg v. California Unemployment Insurance Appeals Board 2 Cal.3d 943: established that the right to control prevails over written and executed independent contractor agreements. See also: SG Borello & Sons Inc. v. Industrial Relations Board 48 Cal.3d 342
6. Employment Tax Regs §31.3401(c)-1(b) defines employer-employee relationship in extreme detail. Primary factor is the right to control and direct not just the results accomplished by the work done, but also HOW they do the work (details and means of getting it done.)
7. Vizcaino v. Microsoft Corp., 120 F.3d 1006 (9th Cir. 1997): when Microsoft had its payroll initially examined, there wasn't an appeal that got dragged out to Tax Court. The IRS said the "freelancers" were employees and Microsoft didn't challenge it. Backdated payroll taxes were paid but Vizcaino later led a class action upon reading the fine print of the generous benefits Microsoft employees were entitled to. District Court threw the case out but Vizcaino won on the appeal.
8. United States v. Silk, 331 U.S. 704 No. 312 (1947)

Level 19: Where in the World Are Your International Dev Team Members?

1. Publication 519: US Tax Guide for Aliens
2. Revenue Procedures 80-56 and 84-54: Foreign employees of American businesses who want exemption from payroll taxes under the totalization agreement need to get a

certificate of coverage from their home country and give it to the employer. See also: Revenue Ruling 92-9

3. List of countries in the totalization agreement, and some details on how the agreement works: https://www.ssa.gov/international/agreements_overview.html
4. §1441: tax withholding rules for non-resident aliens in general, default rate is 30%
5. §1446: tax withholding rules for foreign partnerships that have effectively-connected income
    i. §1446(b)(2)(A) says to use the highest rate in §1 if the foreign partner is not a corporation. So it's been 35% for some time now.
6. Publication 515: Withholding of Tax on Nonresident Aliens and Foreign Entities
7. Publication 901: Tax Treaties
8. Form 1040NR instructions
9. Form W-7 instructions
10. Income Tax Regs. §1.864-4: rules for US-sourced income effectively connected with US business. If those game royalties arose because you gave your services to that studio, it's business income, not a royalty. See also: §864(c)
11. Retief Goosen v. Internal Revenue Service, 136 TC 21 (2011): Goosen, a pro golfer and nonresident alien, had six endorsement contracts with US companies. Three of them were with clothing companies that required him to do things like play golf tournaments wearing their clothes and appear at events then in commercials in the same outfits, in addition to using his likeness to promote the clothes. The three other contracts (including one with EA) allowed the companies to use Goosen's likeness and name to promote their products, but they didn't interfere with his tournaments or require him to appear in commercials or otherwise use the products when he played. The Court decided that the clothing company endorsements were business income but the EA and other contracts that didn't involve Goosen going to the golf course were royalties and therefore not effectively connected income. See also: Cepeda v. Swift & Co., 415 F.2d 1205 (8th Cir. 1969).
12. https://www.irs.gov/Individuals/International-Taxpayers/Social-Security-Tax-Consequences-of-Working-Abroad
13. https://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion
14. Publication 54: Tax Guide for US Citizens and Resident Aliens Abroad

Level 20: Choosing a Tax Professional

1. Circular 230: the tax professional's practice standards bible.
2. 29 states that publicly shame you for not paying your taxes: http://www.nationaljournal.com/congress/2014/09/09/29-States-That-Shame-Their-Bad-Taxpayers-Internet
3. Ellwest Stereo Theatres, Inc. v. Commissioner, TC Memo 1995-610: Reasonable reliance if the adviser has sufficient expertise to justify that reliance (EA, CPA, tax attorney.)
4. Forbes piece with EA and CPA counts and some excellent breakdowns of what both designations tend to specialize in: http://www.forbes.com/sites/peterjreilly/2013/06/26/enrolled-agents-deserve-more-respect/

5. Loving v. IRS background and 2014 appeal outcome: https://www.irs.gov/uac/Newsroom/IRS-Statement-on-Court-Ruling-Related-to-Return-Preparers
6. Not cited but interesting history of EAs and CPAs from TaxMama, a long-established tax pro. The Horse Act apparently gave birth to EAs. http://irsexams.com/news/careers-where-does-an-enrolled-agent-fit-into-the-accounting-landscape/

Acknowledgements

I'd like to thank the amazing indie developer community in NYC for standing behind me all this time, particularly everyone at Playcrafting and all of the talented and innovative indie developers who came to my classes and said they'd love to see a tax guide written for us by one of us.

Other thank-yous: Danny Flexner, Chris Reid Law, Gamasutra, Zach Strebeck and the *Legal Moves* podcast, Yael for being a soothing and supportive toad, Wolters Kluwer CCH, Cornell Law School and Legal Information Institute, Don Mikrut and Marc Goldman, Christie Giraud and Jason Scheiderman, and my family and close friends for putting up with not seeing me for months on account of feverishly trying to finish this book before tax season.

No pixels were harmed in the writing of this book.

* * *

Rachel Presser is an Enrolled Agent who retired from the tax profession just shy of 30 to use her years of taxation experience to help other creatives go their own way with Sonic Toad Consulting and works as a consultant, writer, blogger, and game developer. She formed Sonic Toad Media to provide a new platform to discuss entrepreneurial and personal growth in an indie developer context. Ms. Presser co-runs Himalaya Studios as CFO and Executive Producer and has taught courses and spoken at various gaming industry events about business development and tax issues for indie developers. She lives in the Bronx with her incredibly spoiled toad, Yael.