Analyzing Compensation and Valuation Issues for Authors in Divorce

~ GUEST COLUMNIST ~

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Valuation analysts are often asked to assist counsel with unique scenarios or industries. One situation requiring nuanced consideration is when an author divorces. This article will explore how the treatment of an author's income requires a clear understanding of the publishing contracts and the various categories of payments received.

Imagine the couple's 2010-2013 tax returns show an average of $1,000,000 in Schedule C profits from the husband's fiction writing. The 2014 return reports $2.5 million. How do you resolve the compensation and valuation issues in this situation?

The key issues involved in analyzing income and business valuation for authors are 1) compensation for writing and 2) amounts attributed to income from marital assets. As shown below, compensation for writing should be related to individual efforts as this contains elements of personal goodwill not transferable. Earnings attributed to marital assets should be based on royalty payments for published books less related expenses.

Earnings from an individual's occupation as a writer are generally reported on Form 1099s from the publishers. The publishing reports often segregate the earnings into the following categories:

- Signing
- Delivery & Acceptance (D&A)
- Publication
- Lecture
- Miscellaneous
- Royalties
- Advance
- Contract Amendment
- Reprint
- Reserves

Collectively, these items will be reported on Schedule C of the author's tax returns. In order to allocate the earnings into compensation and income from marital assets, the analyst must understand the terms of the publishing agreements as well as the industry benchmarks.

The table at the bottom of this page is an example from a four-book publishing agreement. The table illustrates the payments are based on various milestones reached. Note the agreements often contain provisions for potential bonuses, which complicates the classification of earnings.

As shown below, the total advances per the agreement were $2.55 million with the potential for an additional $450,000 if units sold exceeded 100,000. It is only once the milestones have been reached for the advances and the book is published when the potential for repayment is removed. Assuming the agreement above was signed in 2014, this would likely explain the tax return variance from the prior years.

Advances are considered refundable by the author until earn-

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DESCRIPTION	BOOK 1	BOOK 2	BOOK 3	BOOK 4	TOTAL
Signing of Agreement	$ 137,500	$ 137,500	$ 137,500	$ 137,500	$ 550,000
Manuscript Accepted (D & A)	125,000	125,000	125,000	125,000	500,000
First Publication - Hard Copy	125,000	125,000	125,000	125.000	500,000
First Publication - Paperback	125,000	125,000	125,000	125.000	500,000
Six Months After Paperback Publication	125,000	125,000	125,000	125.000	500,000
Total Advances	$ 637,500	$ 637,500	$ 637,500	$ 637,500	$ 2,550,000
Option:					
Bonus for 100,000 Units Sold	112,500	112,500	112,500	112,500	450,000
Total Advances Including Bonus Option	$ 750,000	$750,000	$ 750,000	$ 750,000	$ 3,000,000

ings materialize greater than the consideration advanced. After the book sales recoup the advances, then the author is eligible for royalty payments. The royalty rates vary by the media sold (hardcover, paperback, audio, electronic, international, etc.) and are based on the retail price of the units. The royalties continue until the copyrights expire.

The advance payments are segregated into four different metrics as illustrated at right.

The categorization is relevant to determine the nature of the earnings for purposes of our analysis. To distinguish each category of earnings, the author's receipts were segregated into two different classifications of earnings:

- **Compensation to the Author –** This classification was determined based on the individual efforts of the author in order to produce a complete and final manuscript of a novel acceptable to the publisher. This category also includes book signings for published works based on the author's time and efforts promoting the book. In addition, expenses related to the writing activity (such as the home office expenses) were deducted from the earnings. Unless indicated otherwise, compensation to the author is assumed "earned" or "vested." However, there are two instances where advances may be received for services not yet performed, in other words, "unvested." These are described in the following points.

  ❑ **Unearned Compensation –** This situation may occur for books under contract but unpublished in the year of receipt. These payments represent a liability to the author until the final manuscript has been accepted by the publisher. While the payments should be included as taxable income in the year received, the funds have not been "earned" through performance of the contract. As indicated above, the publishing agreements have the risk of repayment until the terms are fulfilled. Once the completed manuscript is accepted and the book published, the proceeds are considered earned.

  ❑ **Deferred Compensation –** This category relates to agreements where no contract milestones have been reached. Accordingly, any payments relate to advances for signing the contract.

- **Income Attributed to Marital Assets –** This classification is based on royalty payments from the publishers or management companies for copywritten materials. Where there are no ongoing efforts from the author, the royalty payments should be considered marital assets subject to division. Expenses associated with these payments (such as commission fees) should be deducted from the royalties received in order to calculate the income attributed from the asset.

  Some advances could be partially considered compensation and partially considered income from a marital asset depending on whether the specific book had materialized sufficient earnings to cover total advances.

ADVANCE PAYMENT	DESCRIPTION	CATEGORY
$125,000	Execution of agreement	Signing
$125,000	Acceptance by the publisher of the complete and final manuscript	Delivery and acceptance (D&A)
$125,000	Publisher's first publication of its hardcover edition of the work, but no later than 18 months after acceptance	Publication
$125,000	Publisher's first publication of its trade paperback edition of the work but not later than either 12 months after first publication in hardcover or 30 months after acceptance	Publication

Based on the above analysis, the earnings classifications are presented in the chart below.

Note the author will incur self-employment taxes and may contribute to a self-employed retirement account. For simplicity, the table below excludes

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COMPENSATION TO THE AUTHOR	INCOME ATTRIBUTED TO MARITAL ASSETS
Signing	Royalty income
Delivery and acceptance	Less: Publisher expenses
Publication	Other income/(expenses)[1]
Advances as compensation	Advance generated from marital asset
Less: Schedule C self-reported expenses	

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these items.

The contractual terms and various milestones associated with book publishing necessitate treating portions as compensation and others as income from martial assets. Careful review of the agreements and categories are key to navigating the proper classification of the payments. ℘

1 Includes miscellaneous, reprint, contract amendment, and reserves earnings/(expenses).

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