NATIONAL ENDOWMENT FOR FINANCIAL EDUCATION

CONSIDERING SELF-EMPLOYMENT?
BE SURE YOU UNDERSTAND THE TAX CONSIDERATIONS
To Work for Yourself Successfully,
Know What You Must Pay, and What You Can Deduct

ENGLEWOOD, COLORADO—So you're about to take the plunge—or perhaps you've been pushed. Either way, you've cut the corporate apron strings and are seriously thinking of joining the ranks of the self-employed.

Currently, roughly 7 in 100 people work for themselves, according to the Employment Policy Foundation. Some of those individuals become self-employed out of necessity, others by choice. Some plan to work for themselves for a long period of time. Others only see self-employment as a short-term venture. Regardless of the specific situation, individuals who are considering self-employment should understand the associated tax considerations before becoming fully independent.

"From a tax standpoint, self-employment is a case of both good and bad news," says William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®). NEFE is an independent nonprofit foundation whose mission is to educate Americans about personal finance. Anthes says, "On the one hand, you'll face additional taxes and paperwork you don't have as an employee. On the other hand, you can offset much and maybe all of those additional taxes if you understand the deductions available, keep accurate records and generally make effective financial planning decisions."

Additional Taxes Paid By the Self-Employed

Before you become self-employed, you should consider the taxes you'll have to pay, above and beyond what you paid as an employee. First, you'll need to begin paying your federal and any state income taxes in four quarterly installments. Taxes won't be withheld from your earnings automatically.

Generally, these quarterly payments are due April 15, June 15 and September 15 during the tax year, and January 15 following the tax year. If you fail to pay estimated taxes or underpay what you ultimately owe by a certain amount, come April 15 you'll have to pay what you owe, plus penalties and interest.

However, to help you with your estimate, the IRS supplies a worksheet for calculating your payments. You also can use one of three calculation methods. While you'll still owe any taxes due, if the amount you pay throughout the year falls within one of the following three calculations, you won't incur any penalties for underpaying.

1. Simply pay 100 percent of what you paid in taxes the previous year, dividing the amount into four equal payments (or 110 percent of the previous year's tax bill if you anticipate your adjusted gross income to exceed $150,000).
2. Your total estimated payments are at least 90 percent of the final tax bill.
3. Your total estimated payments are within $1,000 of what is ultimately due.

Additionally, most states with income tax filing requirements have similar provisions regarding estimated tax payments.

The self-employed also are responsible for paying all of their Social Security taxes, which includes Medicare, instead of splitting payments with an employer. That means that you pay the full 15.3 percent on up to $87,000 of your net earnings. (This limit will rise to $87,900 in 2004.) Money you make beyond the earnings' limit will not be taxed for Social Security. However, the Medicare portion continues indefinitely. Remember, you must pay your Social Security taxes as part of your quarterly estimated payments. Although you can deduct half of your Social Security taxes on your income tax return, making the effective tax rate lower than 15.3 percent, the additional Social Security taxes still can be a major financial burden for the self-employed.

How to Reduce Your Taxes Through Deductions
While you will face a number of additional tax obligations as a self-employed individual, you can take advantage of numerous deductions to help reduce your estimated taxes and what you ultimately owe on your income tax return. Anthes says, "The key is learning what are and are not legitimate deductions, and keeping meticulous records to prove the ones you take are valid."

Generally, deductible expenses must be "ordinary" and "necessary" for your line of work. Common expenses include advertising, travel costs, insurance bought specifically for your business, bank charges for business-related accounts, office supplies, rent, postage, and legal and professional services. In addition, self-employed individuals now can deduct 100 percent of premiums for medical insurance they buy on their own for themselves or members of their family.

You also can deduct any furniture and equipment bought for your work, such as a computer or file cabinets. You have the option of depreciating the equipment over several years, thereby offsetting some income each year, or writing off some or all of the new purchase during the tax year in which you bought it, under what is called Section 179. The equipment write-off has quadrupled in value from the $24,000 limit in 2002 to $100,000 in 2003. The only hitch is that, in a single year, your equipment write-off can't exceed your taxable self-employment income. But, any excess can be carried into future tax years.

In addition, you may have deductible expenses unique to your specific work. A freelance ski writer, for example, could deduct the expenses of ski equipment that a food writer could not. "Usually these types of deductions are judgment calls, so be sure you can defend them should you be audited," says Anthes.

Another point to keep in mind is that if your deductions (not including those taken for equipment) exceed your income in a particular tax year, you normally can deduct any excess self-employment expenses against other household income. But, remember that you generally must show a net profit to the IRS for at least three out of five consecutive years—otherwise the IRS might treat your self-employment work as a hobby rather than a business, which has entirely different tax consequences.

Other potential tax deductions stem from your office environment. Many self-employed individuals work out of an office in their home. The home office can provide valuable tax deductions, but, Anthes cautions, the claim is a complicated one fraught with potential tax traps.

To claim a home office, the space must be used regularly and exclusively for your work. It can be a traditional office space, or it can be part of a larger room in your home. It must, however, be the *principal* place where you conduct your business, store the inventory for your business or do your administrative chores for work that mainly takes you out of the house (for example, service calls made by a plumber).

If your office passes this test, you can take a variety of deductions based on the percentage of your home's total square footage that is occupied by the office. For example, imagine your office consumes ten percent of the total square footage. You then can deduct ten percent of expenses such as your home's real estate taxes, homeowner's insurance, utilities, mortgage interest or rent payments, and the cost of certain home repairs or improvements, like a new roof or furnace. Repairs completed directly for your office can be deducted in full. Improvements specific to the home office can be depreciated over time.

Other Tax Considerations

Deductions can provide much-needed tax relief for the self-employed. However, in order to claim them properly, you must keep proper records. "While the IRS currently audits less than one percent of all individual taxpayers, self-employed taxpayers are three times as likely to be audited as standard filers," Anthes says. "That suggests the need for good record keeping."

Keep all receipts to prove expenses and track qualified mileage as it occurs. Log expenses in an accounting book or on a computer budget program. Also, keep careful track of income declared on 1099s. An employer issues this form to all independent contractors to whom it pays $600 or more in a single year. Employers send copies of these 1099s to the IRS, which scrutinizes them as closely as it does W-2 forms, so you want to be sure the income declared on a particular 1099 matches your records. Keep all your tax records for at least three years, and preferably six. Hold on to any records related to your home office for at least three years after the sale of the home. Doing your taxes with a computer program or hiring a tax accountant may reduce your chances of an audit. The program or accountant also can alert you to any potential problems before you file your taxes.

Retirement plans are another important tax consideration for the self-employed. They can reduce your taxable income, and they are simply smart financial planning. "The self-employed now have several retirement plan options that allow them to put away far more money for retirement in a year than they can with an individual retirement account, and in some cases even what they could if working for an employer," says Anthes.

The principal retirement plan choices for the self-employed are the SIMPLE IRA, the SEP (Simplified Employee Pension), the Keogh and, most recently, the owner-only or solo 401(k) plans. Each of these plans has their advantages and disadvantages, so you'll need to become acquainted with them to see what works best for your situation.

In general, the SIMPLE works well for those who make relatively little self-employment income—the most you can put away is a little over $8,000 a year. With the SEP, Keogh and 401(k), however, you can invest as much as $40,000 a year, and another $1,000-$2,000 if you are age 50 or older. The Keogh also allows you to set up your own traditional pension plan with a defined benefit at retirement. This version allows you to contribute, pre-tax, up to $160,000 a year.

"From choosing the best retirement plan to reduce your taxable income to estimating your payments properly, the tax duties associated with self-employment can seem overwhelming," Anthes says. "However, in order to make sure that you aren't paying too much or too little, it is critical that you understand and adhere to the tax rules associated with self-employment."