AKD Consultants
Adam Dworkin
CPA
188 Whiting Street
Suite 10
Hingham, MA 02043
781-556-5554
Adam@AKDConsultants.com

Tax Planning for the Self-Employed (Overview)

Tax Planning for the Self-Employed

What is it?

According to the IRS, you are self-employed if you carry on a trade or business as a sole proprietor, as an independent contractor, as a member of a partnership, or if you are otherwise in business for yourself. You can be a full-time employee and still have self-employment income from a side job. To determine whether particular income is self-employment income (rather than employee wages, for example), you should look at the source of your income and the extent of your involvement in the activity.

If you are self-employed, you should understand the self-employment tax. You should also be aware of certain tax planning opportunities.

Tax consequences

You must pay self-employment tax if you have more than a minimal amount of self-employment income. If you file a Schedule C as a sole proprietor, independent contractor, or statutory nonemployee, the income listed on your Schedule C is self-employment income and must be included on Schedule SE, which is filed with your Form 1040. Schedule SE is used both to calculate self-employment tax and to report the amount of tax owed. Self-employment tax is used by the federal government to fund Social Security and Medicare benefits.

The self-employment tax rate on net earnings is 15.3 percent (13.3 percent in 2011 and 2012) (with 12.4 percent (10.4 percent in 2011 and 2012) of this rate going to Social Security and 2.9 percent allotted to Medicare). All net earnings from self-employment in excess of $400 are subject to the Medicare portion of the self-employment tax. However, the Social Security portion of the self-employment tax applies only to net earnings from self-employment in excess of $400, up to and including $113,700 (for 2013, $110,100 for 2012). (The maximum is reduced if you have income from sources other than self-employment that has been subject to Social Security tax.)

> **Caution:** Starting in 2013, an additional 0.9 percent Medicare surtax will apply to wages and self-employment income in excess of $200,000 for single taxpayers and over $250,000 for married couples filing joint federal income tax returns ($125,000 for married individuals who file separate returns).

Employees generally have income tax, Social Security tax, and Medicare tax withheld from their paychecks. If you are self-employed, it is likely that no one is withholding federal and state taxes from your paychecks. Therefore, you should make estimated tax payments on your own to cover your federal income tax and self-employment tax liability. This will help you to avoid liability for penalties, interest, and substantial tax bills at the end of the year.

Planning opportunities

As a self-employed individual, you have a number of income tax planning opportunities, some of which are not available to employees. This discussion provides a brief overview of some of the tax planning opportunities you may wish to consider.

Shifting income/timing income

Shifting income to family members can be an important tax planning technique. If you run your own business, your ability to shift income to a family member who is in a lower marginal tax bracket can be a significant advantage. Your relative may benefit from the increased income, and you may benefit by the decreased tax liability. In addition, it's possible that the overall amount of federal income taxes paid by the two of you would be lower. However, be aware that the IRS could question compensation paid to a family member unless the compensation was reasonable in amount, considering the services actually provided by the family member.

As a self-employed taxpayer, you also have greater control and flexibility regarding timing the receipt of your income.

Retirement plans

Establishing a retirement plan is another tax planning advantage for the self-employed. If you are self-employed and have no employees, a qualified retirement plan (such as a Keogh) may allow you to place pretax dollars into a retirement account to grow tax deferred until withdrawal. If you have employees, your business may have to provide coverage for them as well. The type of retirement plan that your business should establish depends on your specific circumstances.

Other benefit plans

Aside from retirement plans, there are certain other employee benefit plans --such as cafeteria plans and medical benefit plans--that are really intended to benefit your employees. Nevertheless, you may wish to have your business establish one or more such plans. Employee benefit plans play an important role in attracting and retaining employees. In addition, sole proprietors may derive certain limited benefits under these plans.

Business expenses and other deductions

Verify that your business is taking advantage of all of the deductions to which it is entitled, including deductions for certain start-up costs. For instance, did you know that you may be able to deduct a portion of the expenses for a business trip even when the trip is combined with vacation? While our discussions on deductions aren't exhaustive, we've tried to pick out some key items that you should consider, including the use of a home office, automobiles, and business assets.

One major area of concern for many self-employed individuals is the high cost of health insurance. Fortunately, some of your health-care related expenses may be tax deductible. For instance, you may be eligible for the self-employed health insurance deduction, which would enable you to deduct the cost of health insurance that you provide for yourself, your spouse, and your dependents. This deduction is taken on the front of your federal Form 1040 (i.e., "above-the-line") when computing your adjusted gross income, so it's available whether you itemize or not. In 2010, the self-employed health insurance deduction was also available for self-employment tax purposes.

Contributions you make to a health savings account (HSA) are also deductible "above-the-line." An HSA is a tax-exempt trust or custodial account you can establish in conjunction with a high-deductible health plan to set aside tax-free funds for health-care expenses.

Hobby classification

Sometimes it is unclear whether you are engaged in a trade or business or whether you are merely deriving occasional income from a hobby. Although income generated from a trade or business activity is taxable, losses from such an activity are generally fully deductible. For this reason, taxpayers sometimes try to classify a hobby as a trade or business. Consequently, the IRS closely scrutinizes purported trade or business activities that regularly show losses. If your business consistently shows a loss, you should be aware of the IRS's rules for classifying activities as hobbies.

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