

Beginners Guide to Self-Employment Taxes

Being your own boss may mean saying good-bye to office politics and long commutes, but you will not escape paying taxes. Self-employment taxes, which are similar to the FICA (Federal Insurance Contributions Act) taxes that wage earners pay, provide funds for Social Security benefits (old-age, survivors, and disability insurance) and Medicare benefits (hospital insurance).

The Texas Society of Certified Public Accountants offers the following overview of self-employment taxes so you can better understand your tax liability.

Who Pays Self-Employment Taxes?

If you earned at least \$400 in net profit from your work as a sole-proprietor, independent contractor, or partner in a partnership, the income you earn is generally considered self-employment income and is subject to self-employment taxes.

Your business can be full-time or part-time, you may also work for someone else as an employee, and you can even have more than one sole-proprietorship.

But as long as your business is not incorporated, it's likely that your net business income will be subject to self-employment taxes. You are required to pay self-employment taxes on your self-employment income even after you retire and receive Social Security benefits.

What Is The Self-Employment Tax Rate?

The self-employment tax rate is 15.3 percent, with 12.4 percent allocated to the Social Security system and the other 2.9 percent going to Medicare. If you worked as an employee of a company, your employer would pay half, which means only 6.2 percent would be taken out of your wages for Social Security and 1.45 percent for Medicare.

But as a self-employed individual, you are considered both the employer and the employee, which makes the entire self-employment tax burden yours. You do, however, get a tax deduction for one-half of the self-employed taxes paid as an above-the-line deduction to arrive at adjusted gross income.

How Do You Calculate Self-Employment Taxes?

Taxpayers who are self-employed use Schedule C or C-EZ to figure their net earnings from self-employment. Schedule SE is used to compute and report self-employment taxes.

Taxpayers with more than one business producing self-employment income must combine the net profit or loss from each to determine the total earnings subject to self-employment taxes. If your business showed a net loss, you won't owe self-employment taxes, but you will still need to file Schedule C to report your loss.

Does The Social Security Earnings Limit Apply?

For 2006, the Social Security earnings limit for self-employed workers is \$94,200, the same limit that applies to employees. The earnings limit means only the first \$94,200 of your net business earnings, combined with your wages and tips if you have another job, is subject to the Social Security tax.

The earnings limit is adjusted annually to reflect inflation. Regardless of how much you earn, all of your earnings are subject to the 2.9 percent Medicare part of the self-employment taxes.

What Tax Deductions Apply?

There are two tax deductions that reduce your self-employment tax liability and attempt to place self-employed individuals on the same level as employees who are subject to FICA taxes.

First, your net earnings from self-employment are reduced by an amount equal to half of your total self-employment tax rate for the year. For 2006, this is 7.65 percent of the net earnings from self-employment.

Second, when you complete your personal 1040 tax form, you can deduct half of your self-employment tax from your gross income. Because this deduction is made on the 1040 form and not on Schedule C, it does not have any effect on your net earnings or the amount of self-employment taxes you pay.

Consult With A CPA

The rules covering self-employment taxes can be complex. Taxpayers who are new to self-employment should consult with a CPA for advice on fulfilling their tax obligations.

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