Tax aspects of self-employment

There are several important rules that self-employed individuals should be aware of:

(1) For income tax purposes, you'll report your income and expenses on Schedule C of your Form 1040. The net income will be taxable to you regardless of whether you withdraw cash from the business. Your business expenses will be deductible against gross income (i.e., “above the line”) and not as itemized deductions. If you have any losses, the losses will generally be deductible against your other income, subject to special rules relating to hobby losses, passive activity losses, and losses in activities in which you weren't “at risk.”

(2) You may be eligible for the pass-through deduction. To the extent your business generates qualified business income, you will be eligible to take the 20% pass-through deduction, subject to various limitations. The deduction is taken “below the line,” so that it reduces taxable income, rather than being taken “above the line” against your gross income. However, you can take the deduction even if you don't itemize deductions and instead take the standard deduction.

(3) You may be able to deduct office-at-home expenses. If you'll be working from an office in your home, performing management or administrative tasks from an office-at-home, or storing product samples or inventory at home, you may be entitled to deduct an allocable portion of certain costs of maintaining your home. And if your office is in your home, you may be able to deduct expenses of traveling from there to another work location.

(4) You'll have to pay self-employment taxes. For 2023, you'll pay self-employment tax (social security and Medicare) at a 15.3% rate on your net earnings from self employment of up to $160,200 ($147,000 for 2022), and Medicare tax only at a 2.9% rate on the excess. An additional 0.9% Medicare tax (for a total of 3.8%) will be imposed on self-employment income in excess of $250,000 for joint returns; $125,000 for married taxpayers filing separate returns; and $200,000 in all other cases. Self-employment tax is imposed in addition to income tax, but you can deduct half of your self-employment tax as an adjustment to income.

(5) You'll be allowed to deduct 100% of your health insurance costs as a trade or business expense. This means your deduction for medical care insurance won't be subject to the rule that limits your medical expense deduction to amounts in excess of 7.5% of your adjusted gross income.

(6) You'll have to make quarterly estimated tax payments. We can work with you to minimize the amount of your estimated tax payments while avoiding any underpayment penalty.

(7) You'll have to keep complete records of your income and expenses. In particular, you should carefully record your expenses in order to claim the full amount of the deductions to which you are entitled. Certain types of expenses, such as automobile, travel, entertainment, meals, and office-at-home expenses, require special attention because they're subject to special recordkeeping requirements or limitations on deductibility.

(8) If you hire any employees, you'll have to get a taxpayer identification number and will have to withhold and pay over various payroll taxes.

(9) You should consider establishing a qualified retirement plan. The advantage of a qualified retirement plan is that amounts contributed to the plan are deductible at the time of the contribution, and aren't taken into income until the amounts are withdrawn. Because of the complexities of ordinary qualified retirement plans, you might consider a simplified employee pension (SEP) plan, which requires less paperwork. Another type of plan available to sole proprietors that offers tax advantages with fewer restrictions and administrative requirements than a qualified plan is a “savings incentive match plan for employees," i.e., a SIMPLE plan. If you don't establish a retirement plan, you may still be able to contribute to an IRA.

Please consult your tax advisor for how these rules may impact you specifically. Your individual circumstances may require further analysis or consideration of how these rules interact with other elements of your overall tax situation.