
PART 1

Self-Employment Basics

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CHAPTER 1

Being Self-Employed and On Your Own

What Does Self-Employment Mean?	4	Practical Issues in Self-Employment	7
Legal Consequences of Self-Employment	6	Tax Terminology	8
		Being 1099ed	8
		What's Ahead	9

Being self-employed is an awesome thing. You control your destiny and your earning potential is limitless. Of course, you have many obligations that come along with being self-employed. Whether your business makes or loses money, you have to report your income and expenses to the federal government if you are otherwise required to file a tax return. Depending on the state you reside in, you'll also have to report your business activities to your state.

In order to report your income and expenses, you need to understand how being self-employed affects your taxes. If you are just starting out in business and formerly were an employee, things are very different as a self-employed individual. Instead of receiving a W-2 from your employer telling you exactly what you must report as income for the year, it's now up to you to track what flows in and out of your business coffers so you can report this at tax time. You may receive 1099s from businesses for which you perform services, but these forms may not tell the whole story of your revenue for the year.

You also must become familiar with tax terminology and rules that affect your tax responsibilities. And you should think about matters beyond taxes that become your responsibility as a business owner, including your health coverage (Chapter 8), retirement savings (Chapter 8), and insurance protection.

4 **GUIDE TO SELF-EMPLOYMENT**

What Does Self-Employment Mean?

Solopreneur, independent contractor, freelancer, consultant—whatever term you apply to yourself, you are a self-employed person if you have not formed a corporation for your business activities. If you have no co-owners, then you are automatically treated for tax purposes as a sole proprietor and are required to file Schedule C with your personal federal income tax return, Form 1040.

Self-employed farmers file Schedule F; that is not discussed in this book even though many of the deductions and strategies in this book apply to farmers. Suppose you set up a *limited liability company* (LLC) to achieve personal liability protection (explained later). If you are the only owner (technically called a *member*), then you, too, file Schedule C unless you take steps to be taxed in another manner.

Being self-employed means that you are taxed on the net result of your efforts for the year, regardless of what you have left in the bank, what you spend on your personal needs, or what you reinvest in your business.

Example

If the revenue you take in is \$78,000 and your deductible expenses are \$22,000, your net income (essentially your profit) is \$56,000. You pay federal income tax on \$56,000, regardless of whether you've withdrawn \$56,000 from your business bank account, spent it on your family, or used it to purchase realty for your business.

Strategies for Your Living Expenses

If you're like most self-employed individuals, you need money from your business to pay your personal rent, buy food, make car payments, go to the movies once in a while, and pay other personal expenses. You can take out as little or as much money from the business as you wish for this purpose. Your use of business funds for personal expenses has *no* impact on taxation. You can't deduct the business's payments of your personal expenses. The amount of money you take from the business (often referred to as a *draw*) is entirely up to you. It is based on what the business can afford and what you need, rather than on any tax consideration.

You'll probably want to do a budget for your personal needs as well as your business expenses. This will help you figure the amount to take from your business bank account each week or month, depending on how you want to arrange withdrawals.

If you have a significant other with whom you share living expenses, factor in contributions toward household expenses from this person. During the period in which you are just starting your self-employed business, the other person may

TABLE 1.1 Audit Rates for Schedule C Filers

Income Schedule C	Audit Rate
Under \$25,000	1.2%
\$25,000 to under \$100,000	2.4%
\$100,000 to under \$200,000	3.6%
\$200,000 or more	3.4%

Source: 2012 IRS Data Book.

need to bear a greater share of expenses until your business activities start to bear fruit. Or you may need to live with a parent or someone else willing to put you up. Discuss your personal financial situation to make sure the person you live with is supportive, not only in the time you devote to your business, but also for your financial needs.

Greater IRS Scrutiny

Being self-employed and filing Schedule C puts you under the IRS's microscope. Audit rates for Schedule C filers are higher than for other individuals because the IRS believes that self-employed individuals have a greater opportunity to underreport income, overstate deductions, and fail to pay self-employment tax (this tax is covered in Chapter 9).

If you have a loss on a Schedule C but also have significant other income from a job or investments, you risk being questioned about whether your activities are really a business or are merely a hobby (see Chapter 4).

At the other extreme, the better you do in your business, statistics show, the greater the likelihood you will be audited. For example, the overall audit rate on individuals without business income reporting income under \$200,000 was just 0.4% for the government's fiscal year ending September 30, 2012. The rate jumped to 2.8% for those with income of \$200,000 to under \$1 million. In contrast, the audit rate for Schedule C filers was higher, as shown in Table 1.1.

IRS Action

If the IRS believes you have underreported your income, it can reconstruct income using bank deposits and other methods. You can, of course, contest this IRS action by going to court, which is a timely and usually expensive endeavor.

Take this real-life situation: An enterprising couple owned a number of businesses, including a trucking business that the husband ran and a daycare business that the wife ran. His business reported gross receipts on his Schedule C of \$8,000; her Schedule C showed a profit of \$6,000. The IRS found \$151,564 in taxable deposits, including \$72,125 in cash, into the trucking business account and \$11,168 in deposits, including \$6,410 in cash, into the daycare business account. Once the IRS questioned their income, the burden was on them to show they properly reported all their income, something they failed to do. So the IRS, with

the Tax Court's approval, increased the income from their businesses based on their bank deposits.

Legal Consequences of Self-Employment

There are important non-tax results from being self-employed as a sole proprietor. You are personally liable for all of the debts of the business. If, for example, someone is injured on your business premises and your business insurance doesn't cover the claim, your personal assets—the home you own, your car, your savings account, and other personally owned property—can be taken to satisfy the claim.

Personal liability probably isn't an issue for many types of sole proprietors. What's your exposure to liability if, for example, you're a freelance writer? However, for other sole proprietors, such as daycare owners, liability can be an issue. Fortunately, it can be addressed satisfactorily by having adequate insurance. Whatever type of business you're in, be sure to discuss your liability coverage with an insurance expert to cover your bases.

When you start a business, the farthest thing from your mind is failing. You are optimistic, are confident of your business idea and abilities, and expect to achieve success. Of course, the reality is that nearly as many businesses go under each year as start up. Being a sole proprietor means that if business debts mount and you're going under, your only bankruptcy option is to file as an individual. Your business cannot go bankrupt separately from your personal affairs.

Keep in mind that you don't have to stay self-employed forever. If your business takes off and you want to expand, you may change your business organization from a sole proprietorship to something else, such as a corporation or a limited liability company. At that time you'll base your decision for which entity to use on a number of factors beyond obtaining personal liability protection, including whether you take in co-owners and what your ultimate plans for exiting the business will be (see Chapter 12).

Strategies for Liability Protection and Other Risks

Even though you're self-employed and your type of business organization (sole proprietorship) doesn't afford you any personal liability protection from the claims of others, you don't have to feel naked. You can get covered with proper insurance. Most small businesses carry a *business owners' policy* (BOP), which includes coverage for liability, which protects third parties, and property damage, which protects you. Typically, the policy costs only a few hundred dollars a year, depending on the extent of coverage, your deductibles, and other factors.

For greater protection for claims arising from the performance (or nonperformance) of services, consider carrying an errors and omissions policy. For professionals, this type of policy is commonly known as *malpractice insurance*. The

cost of this coverage can be modest or steep, depending on what type of business you're in, your prior experience, and other factors.

Did you know ...

According to the American Red Cross, 40% of small businesses *never* recover following a disaster. You don't have to become a statistic; be prepared! In addition to having property insurance to cover losses from fire, storms, and other disasters, consider business interruption coverage. This will help you pay bills during the period in which you are shut because of a disaster. Business interruption coverage will reimburse you for rent, utilities, insurance premiums, and other fixed costs as well as lost profit. It may also enable you to operate from a temporary location until you can get back to your regular business location. Find more about business insurance by speaking with an insurance expert or from Insure U for Small Business at www.insureuonline.org/smallbusiness.

Practical Issues in Self-Employment

Working alone means you shoulder all of the responsibilities for your business. You're the head of marketing, chief financial officer (CFO), and mailroom worker all at the same time. All of the business activities, from producing income to administrative chores, are up to you.

You can share the workload with others, by hiring employees, engaging independent contractors, or using temporary workers (who are employees of the agencies that send them to you). Whatever works best for you is fine, as long as you remember that, to paraphrase President Truman, the buck stops with you. The results of your workers' efforts are your responsibility. If they make mistakes, you must deal with it. If an outside bookkeeper fails to include all your fees in your accounting software and you don't report the income on your tax return, it's your neck, not the bookkeeper's.

Keep in mind that this book will help you handle the tax results of outsourcing the work you need to get done. It will not cover all of the details of employer responsibilities for putting people on your payroll, which is a book in itself, but will inform you of the basics of becoming an employer (see Chapter 12).

Another consequence of being self-employed means you don't have a government backstop if you lose work or are injured in the course of business. Unlike employees who can collect unemployment benefits when they are laid off or can collect workers' compensation benefits if they're injured on the job, self-employed individuals need to take care of themselves. Only employers contribute to the unemployment fund through state and federal unemployment taxes; as a self-employed individual you don't have any employer, including

8 GUIDE TO SELF-EMPLOYMENT

yourself, to make the payments. In some states, self-employed individuals, who are exempt from workers' compensation, can opt into the workers' compensation system by making certain annual payments.

Did you know ...

Displaced workers may be able to collect unemployment benefits while they start a business. Under the federal Self-Employment Assistance Program (SEAP) at <http://workforcesecurity.doleta.gov/unemploy/self.asp>, unemployed workers who opt to become self-employed rather than seek new employment can collect benefits if their state participates. Currently, only Delaware, Maine, New Jersey, New York, Oregon, Pennsylvania, and Washington have active self-employment assistance programs. Other states, such as Alabama and California, have such programs under consideration.

Tax Terminology

Before you can report your income and expenses on a tax form or use tax-saving strategies, you need to understand the terminology. The terms you use in business are not necessarily the same ones used for tax purposes. For example, your business income may be called *revenue*, *gross receipts* (a term associated with businesses that sell goods rather than services), *fees*, *commissions*, or *earnings*. For tax purposes, they are collectively called *income*.

From a business perspective, you may think "profits." In tax jargon, profits are called *net earnings from self-employment*.

Not all money coming into your business is taxable. If you borrow money, the loan proceeds are not taxed, regardless of amount. By the same token, when you repay the principal, you can't write this off.

Losses for tax purposes may also differ from your business perception of this term. Sure, the term applies when you sell property for less than you paid for it. In this book, the focus is on losses from your business activities. Losses result when your *deductible* expenses are greater than your income (other than income that is not taxed). For example, as you'll find out later in this book, only 50% of the cost of business meals is tax deductible, even though you've paid 100%. The full cost is a reasonable and appropriate business expense, but the tax law still has this limitation. You may, as a result of limits on write-offs, suffer an economic or financial loss, but still show a profit, and owe taxes, for tax purposes.

Being 1099ed

When you perform services for another business and are self-employed, that business is required to issue Form 1099-MISC, *Miscellaneous Income*, if it pays

you \$600 or more in total for the year. Box 7 of this form lists *nonemployee compensation*. The form is given to you and to the IRS. With its computers, the IRS matches the information on the form with what you report on your return to make sure you've fully and properly reported the income.

The business will request that you complete Form W-9, *Request for Taxpayer Identification Number and Certification*, so it can have your proper tax identification number (explained in Chapter 2). This form does not go to the IRS.

If your customers or clients are individuals (consumers), they do not have to issue a 1099. Regardless of this, you must report *all* of the income you receive—from businesses and individuals—whether or not it's reported to the IRS.

If you are paid by credit card or electronic transfer (e.g., PayPal), the business you performed services for does not have to issue Form 1099-MISC; the bank or credit card company will issue Form 1099-K instead (assuming this form is required).

What's Ahead

Before you can complete Schedule C, you have to get set up to deal with taxes for your business. Chapter 2 explains why recordkeeping is important for business and tax purposes, and how to keep your books and records. As you'll see, good recordkeeping and taking other measures ensures that you are in the best position to take advantage of tax breaks to which you are entitled.

Chapter Takeaways

- You are taxed on all your profits annually, regardless of what you do with the money.
- There are tax, legal, and practical consequences to being self-employed.
- Understanding tax terminology is essential for tax reporting and tax planning purposes.
- Only business customers and clients, and not clients and customers who are consumers, provide you with 1099s.

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