

Tax aspects of self-employment

As a sole proprietor, you would report net income or loss from your business on your personal income tax return. However, there are several important rules that you should be aware of:

(1) For income tax purposes, you will 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 subject to the 2%-of-adjusted-gross-income floor or the 3%/80% reduction rules). 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) If you will be working from an office in your home, performing management or administrative tasks from a home office, or storing product samples or inventory at home, you may be entitled to deduct an allocable portion of certain of the costs of maintaining your home. And if you have a home office, you may be able to convert nondeductible commuting expenses (of going from your residence to another work location) into deductible transportation expenses.

(3) You will also be required to pay self-employment taxes at a rate of 15.3% on your net earnings from self employment of up to \$102,000 for 2008 (\$97,500 in 2007), and at a rate of 2.9% on the excess. (The maximum amount will be reduced by any non-self-employment wages you earn.) One-half of your self-employment taxes will be deductible as a trade or business expense (that is, as a deduction against gross income, not subject to the limits that apply to itemized deductions).

(4) You will 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 limited by the normal 7.5%-of-AGI floor on itemized medical expenses.

(5) Your income won't be subject to withholding tax. However, you will be required to pay estimated taxes quarterly. We can work with you to minimize the amount of your estimated tax payments while avoiding any underpayment penalty.

(6) You will have to maintain complete records of your income and expenses. In particular, you should pay attention to recording your expenses in order to be able to take the full amount of the deductions to which you are entitled. Certain types of expenses, such as automobile, travel, entertainment, meals, and home office expenses, are subject to special recordkeeping requirements or limitations on their deductibility and require special attention.

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

(8) 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 make a contribution to an IRA.

If you would like any additional information regarding the tax aspects of your going into business, or if you need assistance in satisfying any of the reporting or recordkeeping requirements, please contact us.