Tax Tips You Can Use Aug 2006

Self-Employment Tax

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Many self-employed individuals are shocked and dismayed when they see their annual income tax bill. This is because they must pay self-employment taxes in addition to income taxes. Many feel that they are being unfairly taxed compared to other people. This article will describe the self-employment tax and show how it compares to the taxes paid by wage earners.

Self-employment tax is another name for Social Security and Medicare taxes. A person who works for a company and is paid wages or a salary has certain taxes taken out of his paycheck before he receives it. Two of these deductions are the FICA or Social Security tax and the Medicare tax. Neither of these taxes is deducted from the check that a self-employed person receives, so he must pay these taxes on his annual income tax return. The total amount paid in to Social Security is about the same for the wage earner and the self-employed person. The self-employed person feels it as more of a burden because he pays both halves of the tax and pays it all at once. An example will show how this works out.

If a wage earner earns a salary of $1000.00 for a pay period, he will not get a check for $1000.00. His paycheck will have, at a minimum, deductions of $62.00 of social security tax and $14.50 of Medicare tax, so the maximum check issued will $923.50. His employer will also be required to pay an equal amount of $76.50 to Social Security on his behalf. This employer tax is a deductible expense for the business. At tax time, the employee will pay income tax on the income of $1000.00. The employee’s Social Security account will have $153.00 added to it. The employer will have paid the extra $76.50 but will get a income tax deduction for $76.50.

If the self-employed person receives a check for $1000.00, he gets the entire amount of $1000.00. At tax time, he must pay the Social Security taxes due on that income. The self-employment (SE) tax due on the $1000.00 is $141.00. The SE tax form uses some fancy math to simulate the business deduction. At first glance, it looks like the self-employed person is paying almost twice as much as the wage earner. Remember that in self-employment, the individual is not only the worker, but also the business owner. Self-employment tax is the total of the employee contribution *and* the employer contribution. To make things equal, the 50% “employer” contribution or $71.00 of the SE tax is a deduction on the front page of the federal income tax return. The self-employed person declares $1000.00 of income, but subtracts $71.00 and so pays tax on $929.00. In addition to income taxes, he must pay $141.00 in SE tax, but remember he got the entire $1000.00 when he was paid.

In the end, each of the individuals gets credit for $1000.00 of taxed income in his Social Security account. The wage earner and his company pay $153.00 total to have this occur, while the self-employed person pays $141.00. The big difference is that the self-employed person has to pay the worker’s half and the boss’ half because he works for himself. The other difference is that the wage earner never sees the tax because it is taken out before he gets paid and is done paycheck by paycheck. The self-employed person accounts for all of the earnings once per year and that can create a large tax bill on April 15. If you are a newly self-employed person- beware of the SE tax.