Beacon
SMALL BUSINESS SOLUTIONS

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The Dreaded Self-Employment Tax

I don't like to write tax articles, but here's one topic that certainly hits the Small Business Owner. The Self-Employment Tax, or SE Tax as it is commonly known, can have a major impact on the financial health of a small business.

The idea is simple. When you had a day job (employed for someone else), you had 7.35% deducted from your wages for Social Security and Medicare. And you had other amounts deducted for Federal Income Tax and Social Security Tax.

That's why your paycheck only had $721 in it, when you thought you were being paid $1,000!

Back to the Social Security and Medicare. Your employer also contributed a matching 7.35% on your behalf into the Trust Fund.

That's a cool 15.3% contributed to Social Security and Medicare.

But think about what just happened. The 2005 tax for Married Filing Jointly is 10% on the first $14,600 of income, and rises to 15% for the amount between $14,600 and $59,400.

For most of us, Social Security and Medicare taxes are greater than Federal Income Tax!

When we're working for someone else, though, we just don't feel the full impact.

For a self-employed business owner, however, there is a different story. And you can feel it coming.

The Self-Employed person must make both the employee's contribution as well as the matching employer's contribution.

You might think of this tax as coming out of different pockets, but the self-employed owner owns all the pockets!

The system allows a deduction (technically an exclusion from income) for half of the SE Tax, but the full amount must be contributed. To do otherwise would result in the self-employed individual receiving only half the contribution of people employed by others.

I have seen it happen many times. A new tax client comes in, and has pretty much prepared themselves for a Balance Due tax payment of, say, $1,900.

They are shocked and shaken when I tell them they owe $3,500. It's not a pleasant sight: someone works hard all year to keep things more or less in balance, only to find out that their Federal tax bill will require every bit of cash on hand.

What must be done? That is where the Quarterly Estimated Tax Payments come in.

These payments are due on the 15th of the following months: April, June (which isn't even a quarter, when you think about it), September, and oddly enough, January of the following year.

When the 15th falls on a weekend, as it does in April of this year, the payment is due on the following Monday, or April 17 in this case.

How much should be paid in? Your Tax Preparer or Accountant will help you calculate these amounts. And don't forget that you really have 8 payments—4 large ones to the Federal Government, and 4 smaller ones to your State Government.

The Federal ones are large, because they are a composite of what are really 3 taxes—Income Tax, Employee portion of Social Security and Medicare, and the Employer's matching portion of Social Security and Medicare.

The Federal tax bill alone will usually hit at least 25%, and often will be more. That's 15.3% for SE Tax plus 10 or 15% for Income Tax.

Let's point out that SE Tax applies only to Self-Employment Earnings. It will not be calculated on other forms of income, such as wages (W-2), interest or dividend income, capital gains from sale of stock, and so on.

SE Tax is computed only on Self-Employment Income. And then only if you make a profit.

Here's a classic example. Your business has revenues of $100,000, but total expenses of $110,000.

Bottom line: No SE Tax. You lost money. No Income Tax either: you had no income from the operation of your self-employed business.

And here's a final word about those Quarterly Estimated Tax Payments. The amounts are not written in stone. If you have had a really good year, you should consider increasing your contributions for the September and January payments.

And if your business gets clobbered because you are unable to work for four months, you probably can safely reduce your payments or skip one altogether.

Your goal in all this is to get enough money paid in so you don't have a big "Owie" at a time when you can't afford it. There are also some underpayment penalties and interest that can be avoided.

But it can work the other way, too. I recently delivered a tax return with a $27,000 refund! The owner had been making his Quarterly Estimated Payments all along, and had actually increased them because he was doing so well.

And then the Fourth Quarter came along, and the bottom fell out of his business, as it does for us all from time to time.

Result? He now has a major cash infusion—from the Tax System!—and he's going full steam again.

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