**Self-employment/Small Business Income Tax Guide**

Self-employment income vs. business income

What is the difference between Self-employment income and business income? Self-employment income is business income when the business is taxed as a sole-proprietor or a partnership. A business taxed as a corporation does not have self-employment income. A business operated as a Limited Liability Company (LLC) chooses to be taxed as a sole-proprietor, partnership or a corporation. Throughout this tax guide, I will use the term Self-employment income rather than business income. However other than Self-employment tax, the information in this tax guide is relevant for a business operated as a corporation as well.

Self-Employment Income

What is Self-employment Income? Income you receive from services you provide or goods you sell. Three types of income related to your business is not taxed as Self-employment income:

* Interest earned on your business bank account is taxed as interest income.
* Proceeds from the sale of an asset you used in your business is taxed as capital gain income.
* Rent for the use of a business asset you own is usually taxed as rent income unless your business is renting equipment or other personal property, then it is taxed as self-employment income.

Self-Employment Tax

Why should we care what is Self-employment income? Because, Self-employment income is taxed twice, once as part of your income for State and Federal income taxes and again for Social Security and Medicare taxes. Self-employment income is similar to wage income from a job as an employee. Employees pay Social Security and Medicare tax at 7.65% of their taxable wage, while self-employment income is taxed at 15.3% (double the rate). This may seem unfair, but consider as an employee, your employer actually matches the Social Security and Medicare taxes withheld from your wage when paying employment taxes to the government. As a self-employed individual you are your own employer hence the combined 15.3% rate. Self-employment tax = Social Security and Medicare tax.

Net Self-employment income

An additional and important distinction to add to the discussion of Self-employment income is “Net.” Net Self-employment income is Gross income less allowed deductions. Thankfully, we pay income and self-employment taxes on our “Net Self-employment income.”

Forms 1099-NEC, 1099-MISC and 1099-K

Many of you will receive forms 1099-NEC, 1099-MISC and 1099-K. While the amounts on these forms are an indication of your Self-employment income, they are not fully determinant of the amount we report. We suggest providing these forms to us so that we can properly report your income and not trigger an IRS inquiry.

Deductions against Self-employment income

What deductions are allowed against self-employment income? Broadly, expenditures you make in an effort to derive income are a potential deduction against self-employment income. We categorize these expenditures into three sub-sets. Cost of Goods Sold, Operating and Other Expenses and Assets capitalized and depreciated.

What is included in Cost of Goods Sold? Inventory and raw materials used in products you sell. Cost of Goods sold also include supplies, materials, and sub-contractor fees used in construction, building, manufacturing, and repair and maintenance businesses.

Operating or other expenses include:

* Accounting
* Advertising
* Bank charges
* Car and truck expenses (See page3)
* Commissions
* Consulting and advisory fees
* Delivery and freight
* Dues and subscriptions
* Education, seminars etc.
* Employee benefit programs
* Insurance
* Legal and professional fees
* Miscellaneous expenses
* Mortgage Interest reported on form 1098
* Other interest on loans related to this activity
* Office Supplies
* Rent – vehicles, machinery, and equipment
* Rent – business property (real estate)
* Postage
* Repairs and maintenance
* Retirement contributions for your employees
* Security
* Supplies
* Real estate taxes
* Payroll taxes
* Other taxes (sales and equipment)
* Telephone/cell phone/ internet access
* Small tools
* Travel (including lodging, airfare)
* Business related meals
* Uniforms
* Utilities
* Wages paid to your employees
* Home office deduction (See page 4)

**Rivers and Rivers Payroll Clients:** If we prepare your payroll, quarterly reports, and W-2’s, you do not need to account for those expenses again when compiling your business data. However, most of you pay your worker’s compensation insurance directly – we may not have this information so, please record your payments to the State Fund of Montana or other worker’s compensation insurance provider

Deductions against Self-employment income (continued)

**Assets that are capitalized and depreciated:** What expenditures need to be capitalized as Assets? Factors to consider are the purchase price, use and life of the item. We suggest establishing a capitalization policy considering these factors:

* Price: Expenditures on an item over $1,000. Categorize expenditures below $1,000 as supplies, small tools or repair and maintenance.
* Use: Items sold to customers or become part of a product or service sold to customers are inventory or materials and supplies. An item being capitalized is used multiple times in your business activity and you retain ownership.
* Life: The Item should have a useful life beyond two years. Items that are consumed or used up sooner are a supplies, maintenance or small tool expense.

Depreciation: Depreciation is the deduction of Capitalized Asset over multiple tax years. Tax laws define the amount of the deduction each year as a percentage of the asset’s purchase price. Current tax law allows us to claim 100% of the purchase price in the year purchased. We can elect to claim the deduction over multiple tax years to save some of the deduction for future years.

**Car and truck expenses:** There are two ways to claim Car and Truck expenses:

1. The Standard Mileage Method: This is the simplest way to claim a deduction, and for most of you, it yields the highest deduction. Report the number of miles traveled for business to us. *(Do not be bashful about claiming business travel. For example, you drive to Missoula to pick up some business supplies at Costco; you also happen to visit your daughter who lives there – the trip to Missoula and home can be deductible business miles).* ***The standard mileage rate for 2022 is 58.5-cents/mile from January 1 through June 30, 2022 and 62.5-cents/mile from July 1 through December 31, 2022.***
2. Actual Costs Method: To claim this deduction you need be able to document business use miles compared to total miles for a vehicle. All the costs of running the “business vehicle” are potentially deductible. Gas, Oil, Tires, Maintenance and Repairs, Insurance, and License Plates. You also get to depreciate the cost of the vehicle and the interest paid on a vehicle loan. This method sounds great but unless you are a contractor or someone that continually uses their vehicle for business (deliveries etc.); the Standard Mileage Method usually yields a higher result because your deduction is limited to the business use percentage when using the Actual Costs Method.

**Reimbursed expenses:** Some of us have expenses we pay on behalf of our customers and are reimbursed as part of our fees. It is common for consultants to be reimbursed for travel costs or perhaps you provide a subscription to your client from a platform you control. We suggest simply reporting the payment from your client as income and the expenditure on your client’s behalf as an expense.

Deductions against Self-employment income (continued)

**Retirement Savings:**

As a self-employed individual, you have several different retirement savings options available for you to consider:

**SEP-IRA:** The SEP-IRA is a great retirement plan for individuals that have self-employment income but have no employees or only family employees. A SEP-IRA allows contributions up to $61,000 per year. Contributions are effectively limited to 20% of Net Self-employment income. A SEP-IRA can be established up to the original due date (i.e. April 15th) of the current year’s tax return.

**SIMPLE-IRA:** The SIMPLE-IRA is a great alternative to the SEP-IRA for small business with non-family employees (such as a retail, construction or restaurant businesses). The SIMPLE-IRA plan allows you to contribute up to $14,000 per year (for individuals age 50 or older and additional “Catch-up” Contribution of $3,000 can be added). A SIMPLE-IRA allows a business to provide a retirement plan to their employees while keeping administrative costs very low. The SIMPLE-IRA must be established prior to October 1 of the current tax year.

**Self-employed health insurance:** If you pay your own health insurance premiums, you may be entitled to deduct 100% of the cost of the premium on your tax return. There are a few requirements that you need to satisfy in order to claim this deduction; we will review these with you prior to claiming this on your tax return.

**Home Office deduction:** Generally, to qualify for the home office deduction you need to fit into one of these profiles:

* Your home office is the only office you have where you complete administrative functions for your business. For example, you are a contractor; you estimate and bid on jobs, pay bills, bill customers and perform your record keeping duties from an office in your home.
* Customers come to your home to receive your services. For example, you are a Beautician with your shop in your home or you run a licensed day care out of your home.

The home office deduction allows you to deduct as a business expense, a portion of the costs of maintaining your home. Generally, the deduction is based on the square footage of your home office compared to your entire home. Once we establish your business use percentage, we compute your home office deduction by applying the business use percentage to the costs of operating your home. The costs allowed are:

* Mortgage Interest paid on your home
* Real Estate Taxes paid on your home
* Hazard Insurance paid on your home
* Rent paid (if you do not own your home)
* Utilities (gas, electric, water and garbage)
* Repairs and maintenance on your home (report repairs and maintenance exclusively for your home office as regular business expenses. Report general repairs and maintenance on the whole home here)

Deductions against Self-employment income (continued)

**Simplified Home Office Deduction:**

This year taxpayers that qualify for the Home Office Deduction can elect to use the new Simplified Method, which is a deduction of $5.00 per square foot of the space used for business, with a maximum deduction of $1,500.00

Suggestions to keep in mind related to your business records

**Compiling your business tax data:** You can compile your business data with pencil and paper, excel spreadsheet or use accounting software.

**Quick Books Online (QBO) Certified Pro Advisor:** As a pro-advisor, we may be able to provide you with a 30% discount off the monthly retail subscription price. If you are already using Quick Books online (QBO) invite us as your accounting firm under the Manage Users tab in your QBO account. When completing the invitation through your QBO account send the invitation to, Rich Rivers rich@riversandriverscpas.com.

**Business Checking Account:** Generally, you should have a business checking account. Use this account for paying your business expenses and receiving your business deposits. By operating this way, you capture the majority of your business transactions in one bank account. When you need money for personal use, (your Draw or Salary) write a check to yourself from your business account and deposit this in your personal account.

**Dedicate one credit card to business use only:** A credit card is just another form of checking account. The payment to your credit card company is not what is deductible. It is the purchases you make that are paid for “with your credit card” that gives rise to a deduction. Please do not list “credit card” as one of your expense categories – your credit card transactions will fit into one of the deduction categories discussed earlier in this tax guide.

**Personal bills:** Try to avoid paying personal expenses from your business account. This can make record keeping a headache for you. More importantly if you are audited, an IRS agent is going to have a much higher comfort level (i.e. will probe less) if there is very minimal “personal” activity in your business checking account. Get in the habit of “taking a draw” or paying yourself a set monthly amount with a transfer from your business to your personal account. Then pay your personal expenses from your personal bank account.

**Business Records:** Keep your business records for at least four years. At a minimum you should keep:

* Paid invoices and receipts for business expenses
* Bank Statements and canceled checks
* Check stubs/or carbon check blanks
* Records that report or show your revenue
* Day-timers/calendars/travel logs etc.
* Business credit card statements
* Receipt books and deposit slips
* Any other documents related to your business that can substantiate your income and deductions