Self-Employed Taxpayers: How to Avoid a Large IRS Bill

Are you self-employed? Do you dread tax season each year? Afraid you will owe IRS? Tired of the interest, the penalties, and the stress?

Tax law for self-employed workers can be a little complicated. The Low Income Taxpayer Clinic at Indiana Legal Services, Inc. has prepared this step-by-step guide to help you stay compliant throughout the year. For more detailed information, take a look at IRS Publication 334

STEP 1: IDENTIFY YOUR BUSINESS

You are considered self-employed if you (1) work as an independent contractor, (2) own and operate an unincorporated business, or (3) conduct business as a member of a partnership. You might be self-employed full-time or part-time. You might have a regular source of income and a small business on the side.

If you are self-employed, and if you have no employees, you have two common tax obligations: you must pay income taxes on your net profits (business income minus expenses), and you may be required to pay employment taxes (Social Security and Medicare).

What if you hire people to help you with your business? It is important to determine whether these workers should be classified as independent contractors or employees. Typically speaking, independent contractors work for multiple clients. They keep their own records, advertise their own services, control their own hours, and maintain their own equipment.

By contrast, employees generally work for one primary employer. The employer provides close supervision and on-the-job training. Employees usually have fixed schedules and less flexibility with work assignments.IRS considers additional factors; contact a tax professional if you are unsure how to properly classify your workers.

Why does it matter? If you hire an independent contractor, you may be required to issue a Form 1099-MISC at the end of the year. Yet if you hire an employee, you have substantially more obligations: you must obtain an Employer Identification Number (EIN), you must withhold your employee’s taxes and pay FICA/FUTA taxes, and you must follow federal minimum wage and other regulations. IRS publishes a detailed tax guide for employers (Circular E6), but given the complexities of employment law, you may wish to consult a tax professional.

Remember: If you maintain a part-time job to supplement your business income, you will owe income tax for your employment wages as well. Make sure you have enough tax withdrawn from your regular paychecks to avoid a year-end liability. To adjust your current withholdings, speak with your company's human resource representative about submitting an updated Form W-4.

STEP 2: MAKE ESTIMATED PAYMENTS

So you work for yourself, but it's summertime, and tax season is months away. Nothing to worry about, right?

Wrong! The **number one tax-related mistake** contractors and small business owners make is failing to pay estimated taxes throughout the year. Why is this such a serious problem? Two reasons. First, if you fail to make estimated payments, your liability at the end of the year may be substantial, possibly thousands of dollars if your business is a successful one. It's easy to overlook this expense, and if you're caught off guard, you may have difficulty making that April 15 payment. Second, IRS expects payments throughout the year, and if you owe more than $1000 when you file your return, IRS may assess an underpayment penalty!

Why does IRS expect these periodic payments? It makes sense, if you think about it. Regular employees have taxes withheld from their paychecks. As a self-employed worker, you aren't subject to automatic withholdings. Instead, you pay estimated tax on April 15, June 15, September 15, and January 15 of the following year—although you can skip the January payment if you file your 1040 and pay in full by January 31.

How should you calculate your estimated tax payments? If your earnings are roughly equivalent throughout the year, figure the income and employment taxes on your estimated annual income (don't forget to consider exemptions, deductions, and credits), and divide that number by four. If your earnings rise unexpectedly mid-year, simply increase your next estimated payment. If your earnings decline, decrease your next payment.

IRS publishes a helpful packet of estimated tax worksheets, instructions, and payment vouchers.

Tip: You may be required to make estimated payments to your state department of revenue. If you are an Indiana taxpayer, review Information Bulletin #3 to learn more.

STEP 3: FILE YOUR ANNUAL TAX RETURN

You've put in a good year's work, and you've paid your estimated taxes—but April 15 is drawing near, and it's time to file your annual tax return. If you are like most self-employed workers, you are in luck: you can file your return using the same Form 1040 that regular employees use. You will, however, require special schedules:

Schedule C: Sole proprietors (and independent contractors) use this form to calculate business income and expenses. Use Schedule C-EZ if you operated just one profitable business with no employees and had business expenses of $5,000 or less. Report the net profit or (loss12) from Schedule C to Schedule SE, line 2, and Form 1040, line 12.

Remember: Track your business expenses throughout the year. Save receipts and records; keep a detailed log of business travel, including dates, business purpose, and mileage. If paper records seem burdensome, consider investing in a high-speed document scanner.

Schedule SE: Self-employed workers use this form to calculate the self-employment tax, an additional tax that covers Social Security and Medicare contributions. Take a close look at the flowchart on the form to determine whether you must file the “Short Schedule” or the “Long Schedule.” Report the tax from Schedule SE to Form 1040, line 56.

Schedule E: Partners, landlords, creative professionals, and others use this form to calculate supplemental income and expenses. The form is complicated and beyond the scope of this guide. Consult a qualified tax professional for assistance.

How to file?

Some taxpayers may feel comfortable assembling their own returns. If your income is under $60,000, you may be eligible to use tax software free of charge through the IRS Free File program.

If software is not for you, consider the IRS Volunteer Income Tax Assistance (VITA) program. Certified volunteers are standing by to help low-income taxpayers (< $51,000) with their returns. VITA sites can be found at convenient locations nationwide—including university campuses, civic centers, and public libraries.

Finally, if you need a little extra support, contact a local tax preparer. During tax season, some preparers run promotional campaigns to attract new business. Call them up, explain your situation, and see what they can do for you.

CONCLUSION

Filing as a self-employed taxpayer can be a little complicated, but it doesn’t have to be overwhelming. The steps outlined above will help you stay compliant throughout the year.

Are you facing a dispute with IRS? Have you received notice of an examination or a levy? The LITC at Indiana Legal Services, Inc. assists low income taxpayers with IRS controversies, including matters pertaining to accounts, collections, examinations, appeals, and representation before the United States Tax Court. Call us to learn more: **(800) 822-4774**. We may be able to assist you.

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