

Self Employment Tax

In addition to federal income tax, there is another tax on the Form 1040 that affects teenage micro business owners. It is called self employment tax (or just SE tax). SE tax is the same as Social Security and Medicare for self employed people (micro business owners are self-employed because they do not have an employer—a boss.).

The self employment tax rate is approximately 15.3% of your micro's profit. If a student has net income (profit) of over \$400 from a micro business, they will owe self employment tax. The \$400 threshold has not been adjusted in decades. Many teens who have micro businesses find that they may not owe federal income tax, but do owe self employment tax. (at 15.3% of their profits!).

Additionally, there are no deductions or exemptions to the self employment tax, unlike the federal income tax. This can come as a surprise to many teenagers and micro business owners.

Example: Tom Teenager had a net income (profit) of \$7,025 in 2010 from his micro business. This was Tom's only income. As we saw above, he owes \$84 in federal income tax. Tom will also owe \$993 in self employment tax (See Schedule SE, line 6 below). He owes more in self employment tax than in federal income tax!

Section A---Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.		
1a Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	0
1b If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	(0)
2 Net profit or (loss) from Schedule C, line 31 and Schedule K-1 (Form 1065), box 14, code A (other than farming). Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report	2	7,025
3 Combine lines 1a, 1b, and 2	3	7,025
4 Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax	4	6,488
5 Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$106,800 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 56. • More than \$106,800, multiply line 4 by 2.9% (.029). Then, add \$13,243.20 to the result. Enter the total here and on Form 1040, line 56. 	5	993
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	497

Amazing? Yes it is! How can you reduce or eliminate paying the self employment tax? There are three legal ways:

- Work as a household employee (discussed in Chapter Six).
- Work for your parents doing legitimate work in a business they own.
- Take every tax deduction you are legally entitled to take to reduce your net income (profit). This is where good record keeping pays off. The following section discusses legal tax deductions.

True Story: Beth started a craft business decorating flip flops with colorful cloth. She keeps her business very small because her goal is to learn a lot and have fun selling. She told me that her profit was always below the \$400 threshold for paying self employment tax. That's a tiny micro business! Beth's business may grow someday and then she will charge more so she has enough money to pay her self employment tax.

Legitimate and Legal Tax Deductions

How can you reduce the taxes that you pay? The best legal way is to take every tax deduction you are allowed. Here are several tax deductions common to teenage micro business owners.

Mileage

The miles that you drive to a job or a client, to shop for business supplies, to the bank or to consult with your accountant are all business deductions. Keep track of the date, destination and miles.

Tip: To keep things simple, I record the miles on a calendar I carry in my purse. Sometimes I have to use Google Maps to calculate the mileage if I didn't check my car's odometer on the day of the trip. Some micro owners use their Blackberries or cell phones to record mileage. The IRS requirement is that mileage records be written, actual (not estimates or guesses) and kept "contemporaneously," meaning at the same time as the trip, not months later.

Business Use of Home

There is a business deduction called Business Use of the Home that allows a portion of your rent or mortgage payment, property tax, utilities and insurance as tax deductions if a portion of the house is used *exclusively and regularly* for business. Only the owner of the home can take the deduction. Most teenagers do not own their homes; their parents are the owners, so the Business Use of the Home deduction cannot be claimed by the teenager. Your parents cannot claim the Business Use of the Home deduction for your business because the business is *yours*, not theirs. Sorry, but that's the law.

Meals

Meals with clients or for business purposes, such as at a conference, are deductible at 50% of their cost. Give your accountant the full cost of the meal and he or she will calculate the appropriate amount for tax purposes.

Clothes

If your work requires a costume or uniform, it is a legitimate business deduction. Dry cleaning the special outfits is also deductible. Ordinary clothing that you can wear on the street is not a business expense, but is considered a personal expense and not tax deductible.

True Story: A business owner purchased a suit to look more professional when he made some visits to potential clients. He didn't own a suit before he went into business. "Can I deduct it?" he asked me. No, sorry, the suit is not a business expense, but a personal expense because he can wear it on the street, for non business purposes. But I hope the suit got him the new client!

Office Supplies and Equipment

Office supplies, furniture, postage and your computer are all business deductions. Also deduct any software you purchase to run your business.

Utilities

Most micro business owners do not have utilities (gas, electric, water, etc) because they do not own a building for their business. But internet and cell phone expenses are utilities that are common in a micro business and can be a tax deduction. Internet and cell phone expenses should be split into business and personal use. The first phone line into a home is considered a personal expense and not deductible as a business expense.

Tip: "How do I calculate the personal or business use of my cell phone," a client asked me. "Use a reasonable estimate," I told her. Any reasonable method such as the percent of time spent on the computer doing business verses pleasure can be used. Or if there are four people in the family, all using the computer but only one person uses the internet for business, it would be reasonable to consider 25% of the internet fees as business expense.

Advertising

Business cards, brochures, a website and signs are all business tax deductions. If you put a sign on your car, then the cost of the sign on your car is a business expense, but not the car itself.

Education

Classes, conferences, trade journals, magazines and books you read to enhance your knowledge of your business are business deductions.

True Story: I subscribe to the Wall Street Journal. It greatly enhances my understanding of business, accounting and taxes. The subscription cost is a business deduction. I also read *Simple Scrapbooking*, but it is for pleasure, not business, and is

not a business deduction.

Tip: The cost of this book is a business deduction!

Hired Help

Independent contractors and professionals that you hire for your business are legitimate expenses, even though they are not employees. Employee wages and associated payroll tax are business expenses.

True Story: Phil hires independent contractors to do logo designs for his web hosting business. Lucas hired three friends as employees to help him cut grass in his lawn mowing business. Both these payments are business expenses.

Read more about hiring employees or independent contractors in Chapter Nine.

Taxes

There are several taxes a business might pay such as sales tax, payroll tax on employees, and property tax. These are all business expenses and allowed as tax deductions. Also, required licenses and government fees for a name registration or vendor's license are deductible. *Federal income tax and self employment tax are not considered business expenses and not tax deductions.* State and local income taxes are also not business expenses.

Read more about sales tax in Chapter Eight and payroll and state income taxes in Chapter Seven.

It is important to know what expenses can be deducted on your tax return so that you pay less in taxes! If you have any questions about what expenses can be deducted on your tax return, ask your local CPA.

Important Points

- Federal income tax must be paid by micro business owners.
- Micro business profit is reported on Schedule C of the Form 1040.
- Self employment tax is the same as Social Security and Medicare for self employed people including micro business owners.
- There are several business deductions that can lower what you pay in taxes.