

## Module 14: Self-Employment Income and Self-Employment Tax

# Tax Tutorial

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In this tax tutorial, you will learn about self-employment income and the [self-employment tax](#).

Self-employed individuals are independent contractors, not employees.

- Self-employed individuals control the methods and means by which they perform services for others.

For a business owned by just one person, self-employment income, expenses, and profit or loss are reported on Form 1040, [Schedule C, Profit or Loss From Business](#) or [Schedule C-EZ, Net Profit from Business](#).

- Self-employment profit increases the income that is subject to tax.
- Self-employment loss reduces the income that is subject to tax.

The self-employment tax is

- calculated on [Schedule SE, Self-Employment Tax](#).
- reported on [Form 1040, U.S. Individual Income Tax Return](#).

The self-employment tax increases the total tax.

One-half of the self-employment tax reduces the income that is subject to tax.

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## Module 14: Self-Employment Income and Self-Employment Tax

### Employee and Independent Contractors

Workers can be classified as employees or independent contractors.

#### Employees

- perform services for the employer. The employer directs or controls when, where, and how the employee performs the work.
- include teachers, restaurant workers, factory workers, and managers of corporations.
- receive from their employers Form W-2, Wage and Tax Statement, which reports employee earnings.

#### Independent Contractors

- perform services for others. The recipients of the services do not direct or control the means or methods by which the independent contractors accomplish their work. The recipients do control the results of the work; they decide whether the work is acceptable.
- are self-employed.
- may include carpenters, artists, and consultants.
- may receive [Form 1099-MISC, Miscellaneous Income](#), from the recipient of the services. Form 1099-MISC reports payments made to the self-employed worker.

An individual can be an employee as well as a self-employed independent contractor.

- Lucille works full-time as a teacher (employee). On the weekends she works in her own business as a graphic artist (self-employed).

An activity is a **business** if

- its primary purpose is for income or profit, and
- the activity occurs continuously and with regularity.

Generally, a hobby is not a business.

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### Quick Check!

Answer the following multiple-choice questions about self-employment income and the self-employment tax by clicking on the correct answers. To assess your answers, click the *Check My Answers* button at the bottom of the page.

1 ) Which worker is classified as an independent contractor?

- A. A worker at a fast-food restaurant No answer given: the correct answer is C. Restaurant workers, managers at manufacturing companies, and salespeople in department stores are all employees. Employers direct their work.
- B. A manager at a bicycle manufacturing company
- C. A landscape gardener who works for herself and provides services to several corporate customers
- D. A salesperson in a department store

2 ) Which statement is true?

- A. Employee earnings are reported on Form 1099-INT. No answer given: the correct answer is B. Payments made to independent contractors are reported on Form 1099-MISC. An individual can be an employee of a business as well as a self-employed, independent contractor for another business activity. An activity is a business if its primary purpose is for income or profit and the activity occurs continuously and with regularity. An intermittent activity engaged in primarily for pleasure is considered a hobby.
- B. Payments made to independent contractors are reported on Form 1099-MISC.
- C. An individual can be an employee or an independent contractor but not both.
- D. An intermittent activity engaged in primarily for pleasure is considered a business.

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### Self-employment Profit and Income

Self-employment profit is self-employment income minus self-employment expenses when self-employment income is greater than self-employment expenses.

Self-employment loss is self-employment income minus self-employment expenses when self-employment income is less than self-employment expenses.

Self-employed income is reported separately from wages, salaries, and tip income.

For a business owned by just one person, self-employment income and expenses are reported on Schedule C, *Profit or Loss From Business*.

- Some businesses can use Schedule C-EZ, which is a simplified way to report self-employment profit.

All self-employment income must be included when computing self-employment profit or loss. The recipient of the services may complete [Form 1099-MISC, Miscellaneous Income](#), and give it to the self-employed worker. The 1099-MISC is required when the payment from any one payer is \$600 or more for a calendar year.

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### Self-employment Expenses

Self-employment expenses may include:

- advertising
- car and truck expenses
- commissions paid
- insurance
- interest
- legal and professional services
- office expenses
- rent or lease expenses
- repairs and maintenance
- supplies
- taxes
- business travel
- business meals and entertainment
- utilities, including telephone expenses

**Tax Tip:** *Be sure to get more information about the rules for specific business expenses.*

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### Example

Nancy Ellis, an interior designer, is an independent contractor who provided design services to two businesses: Printing Corporation and Environmental Processes.

Each business issued a Form 1099-MISC for Nancy Ellis.

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. <b>Printing Corporation</b> <b>1 Oak Creek Avenue</b> <b>Any Town, US 10000</b>		1 Rents \$	2 Royalties \$	3 Other income \$	4 Federal income tax withheld \$	5 Filing boat proceeds \$	6 Medical and health care payments \$	7 Nonemployee compensation \$ <b>15,250.00</b>	8 Substitute payments in lieu of dividends or interest \$	9 Payer made direct sales of \$2,000 or more of consumer products to a buyer (recipient for resale is <input type="checkbox"/> ) \$	10 Crop insurance proceeds \$	11	12	13 Excess golden parachute payments \$	14 Gross proceeds paid to an attorney \$	15a Section 409A deferrals \$	15b Section 409A income \$	16 State tax withheld \$	17 State/Payer's state no. \$	18 State income \$
PAYER'S federal identification number <b>10-9753211</b>		RECIPIENT'S identification number <b>037-00-2080</b>		19		20		21		22		23		24		25		26		
RECIPIENT'S name <b>Nancy Ellis</b> Street address (including apt. no.) <b>12 West Pine Street</b> City, state, and ZIP code <b>Anytown, US 10000</b>		Account number (see instructions)		27		28		29		30		31		32		33		34		

Form 1099-MISC (keep for your records) Department of the Treasury - Internal Revenue Service

- Nancy was paid \$15,250 for services rendered to Printing Corporation and \$30,115 for services performed at Environmental Processes.

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Nancy uses Schedule C to compute self-employment profit.

SCHEDULE C (Form 1040)		<b>Profit or Loss From Business</b> (Sole Proprietorship)		OMB No. 1545-007a
Department of the Treasury Internal Revenue Service (99)		Partnerships, joint ventures, etc., must file Form 1065 or 1065-B. Attach to Form 1040, 1040NR, or 1041. See Instructions for Schedule C (Form 1040).		Attachment Sequence No. 09
Name of proprietor <b>Nancy Ellis</b>		Social Security number (SSN) <b>987 00 2080</b>		<b>2007</b>
A	Principal business or profession, including product or service (see page C-2 of the instructions) <b>Interior Design</b>	B Enter code from pages C-6, 9, & 10 <b>541510</b>		
C	Business name, if no separate business name, leave blank. <b>Environment by Ellis</b>	D Employer ID number (EIN), if any		
E Business address (including suite or room no.) City, town or post office, state, and ZIP code				
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify)				
G Did you "materially participate" in the operation of this business during 2007? If "No," see page C-8 for limit on losses <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No				
H If you started or acquired this business during 2007, check here <input type="checkbox"/>				
<b>Part I Income</b>				
1	Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-5 and check here <input type="checkbox"/>	1	<b>45,365</b>	<b>00</b>
2	Returns and allowances	2		
3	Subtract line 2 from line 1	3	<b>45,365</b>	<b>00</b>
4	Cost of goods sold (from line 42 on page 2)	4		
5	Gross profit. Subtract line 4 from line 3.	5	<b>45,365</b>	<b>00</b>
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-3).	6		
7	Gross income. Add lines 5 and 6	7	<b>45,365</b>	<b>00</b>
<b>Part II Expenses. Enter expense for business use of your home only on line 30.</b>				
8	Advertising	8		
9	Car and truck expenses (see page C-4)	9	<b>120</b>	<b>00</b>
10	Commissions and fees	10		
11	Contract labor (see page C-4)	11		
12	Depreciation	12		
13	Depreciation and section 179 expense deduction (not included in Part II) (see page C-4)	13		
14	Employee benefit programs (other than on line 19)	14		
15	Insurance (other than health)	15		
16	Interest:			
16a	a Mortgage (paid to banks, etc.)	16a		
16b	b Other	16b		
17	Legal and professional services	17	<b>10,000</b>	<b>00</b>
18	Office expense	18		
19	Pension and profit-sharing plans	19		
20	Rent or lease (see page C-5):			
20a	a Vehicles, machinery, and equipment	20a		
20b	b Other business property	20b		
21	Repairs and maintenance	21		
22	Supplies (not included in Part II)	22	<b>9,000</b>	<b>00</b>
23	Taxes and licenses	23		
24	Travel, meals, and entertainment:			
24a	a Travel	24a		
24b	b Deductible meals and entertainment (see page C-6)	24b		
25	Utilities	25		
26	Wages (less employment credits)	26		
27	Other expenses (from line 48 on page 2)	27		
28	Total expenses before expenses for business use of home. Add lines 8 through 27 in columns.	28	<b>19,120</b>	<b>00</b>
29	Tentative profit (loss). Subtract line 28 from line 7	29		
30	Expenses for business use of your home. Attach Form 8829	30		
31	Net profit or (loss). Subtract line 30 from line 29. • if a profit, enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 19 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041, line 3. • if a loss, you must go to line 32.	31	<b>26,245</b>	<b>00</b>
32	If you have a loss, check the box that describes your investment in this activity (see page C-6). • if you checked 32a, enter the loss on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 19 (statutory employees, see page C-6). Estates and trusts, enter on Form 1041.			
		32a	<input type="checkbox"/> All investment is at risk.	
		32b	<input type="checkbox"/> Some investment is not	

- Line 1 shows Nancy's self-employment income of \$45,365 (\$15,250 plus \$30,115) from Forms 1099-MISC, box 7.
- Lines 8 through 27 show Nancy's self-employment expenses, which total \$19,120.
- Line 31 shows Nancy's self-employment profit, \$26,245.

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### Self-employment Tax

The self-employment tax is similar to the social security tax and Medicare tax for employees.

The self-employment tax is calculated on Schedule SE, Self-Employment Tax.

The self-employment tax is paid on self-employment profit.

- The self-employment tax rate is 15.3 percent of net earnings from self-employment.
- Taxpayers pay self-employment tax on 92.35 percent of their self-employment profit up to net earnings of \$97,500.

The self-employment tax increases the total tax on Form 1040.

One-half of the self-employment tax decreases the income that is subject to income tax.

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### Example

Katrina owns a housecleaning business. Last year, her self-employment profit was \$21,657. The net earnings subject to self-employment tax were \$20,000 (\$21,657 multiplied by .9235). Her self-employment tax was \$3,060 (\$20,000 multiplied by .153). One-half of her self-employment tax was \$1,530.

Katrina's income that is subject to tax

- increased by \$21,657, the self-employment profit.
- decreased by one-half of the self-employment tax, \$1,530.

Katrina's total tax increased by \$3,060, the self-employment tax.

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### Example

Continue to review the tax forms for Nancy Ellis.  
Schedule SE is used to compute the self-employment tax.

**Section A—Short Schedule SE.** Caution. Read above to see if you can use Short Schedule SE.

1	Net farm profit or (loss) from Schedule F, line 30, and farm partnerships, Schedule K-1 (Form 1005), box 14, code A . . . . .	1		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1005), box 14, code A (other than farming); and Schedule K-1 (Form 1005-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-3 for other income to report . . . . .	2	26,245	00
3	Combine lines 1 and 2 . . . . .	3	26,245	00
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	24,237	00
5	Self-employment tax. If the amount on line 4 is: • \$97,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 58. • More than \$97,500, multiply line 4 by 2.9% (.029). Then, add \$12,000 to the result. Enter the total here and on Form 1040, line 58 . . . . .	5	3,708	00
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	1,854	00

- Line 2 shows Nancy's self-employment profit from Schedule C, line 31.
- Line 5 shows Nancy's self-employment tax, \$3,708.
- Line 6 shows one-half of the self-employment tax, which decreases the income that is subject to tax.

Self-employment profit or loss and the self-employment tax are reported on Form 1040.

- Line 12 shows Nancy's self-employment profit from Schedule C, line 31. This increases the income that is subject to tax.
- Line 27 shows one-half of the self-employment tax from Schedule SE, line 6. This amount decreases the income that is subject to tax.
- Line 58 shows the self-employment tax from Schedule SE, line 5. This increases the total tax.

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### Lesson Summary

Self-employed individuals are independent contractors, not employees.

- Self-employed individuals control the methods and means of performing services for others.

For a business owned by just one person, self-employment income, expenses, and profit or loss are reported on Schedule C, Profit or Loss From Business.

- Self-employment profit increases the income that is subject to tax.
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