10 Tax Benefits For The Self-Employed

By Ed Konar, CPA February 4, 2015

Being self-employed means taking on risks and costs that you don't have when you work for someone else. You're responsible for getting customers and generating income, for constantly proving the value of your product or service. You also have to pay the phone and Internet bills you incur to get and keep those customers, the travel expenses to meet with them and the liability insurance in case they sue you.

Numerous lines of tax code have been written to soften the blow of having to cover these extra costs. And you should claim every business tax deduction you qualify for: Your business's profitability depends on minimizing your costs and maximizing your resources. In this article, we'll explain some common tax deductions available to the self-employed.

Self-Employment Tax Deduction

The self-employment tax refers to the employer portion of Medicare and Social Security taxes that self-employed people must pay. Everyone who works must pay these taxes, which for 2015 are 7.65% for employees and 15.30% for the self-employed. Here's how the rates break down:

– 6.2% Social Security tax each for employee and employer on the first $118,500 in wages

– 1.45% Medicare tax each for employee and employer with no wage limit

You will owe an additional Medicare tax of 0.9% in the following situations:

Filing Status	Income
Single	$200,000
Married filing jointly	$250,000
Married filing separately	$125,000

The income thresholds apply not just to self-employment income, but to your combined wages, compensation and self-employment income. So if you have $100,000 in self-employment income and your spouse has $160,000 in wage income, you'll have to pay the additional Medicare tax of 0.9% on the $10,000 by which your joint income exceeds the $250,000 threshold.

Paying extra taxes to be your own boss is no fun. The good news is that the self-employment tax will cost you less than you might think because you get to deduct half of your self-employment tax from your net income. Essentially, the IRS treats the "employer" portion of the self-employment tax as a business expense and allows you to deduct it accordingly. What's more, you only pay self-employment tax on 92.35% of your net business income – what's left over after you subtract your other business expenses.

Remember, you're paying the first 7.65% no matter whom you work for. And when you work for someone else, you're indirectly paying the other 7.65% because that's money your employer can't afford to add to your salary. At least when you're self-employed you get to deduct part of the tax expense.

Home Office

The home office deduction is one of the more complex deductions. In short, the cost of any workspace that you use regularly and exclusively for your business, regardless of whether you rent or own it, can be deducted as a home office expense. You are basically on the honor system, but you should be prepared to defend your deduction in the event of an audit. One way to do this is to prepare a specific map of your workspace, with the correct measurements, in case you are required to submit this information to substantiate your deduction.

The expenses you can deduct for your home office include the business percentage of deductible mortgage interest, home depreciation, property taxes, utilities, homeowner's insurance and home maintenance that you pay during the year. For example, if your home office occupies 15% of your home, then 15% of your annual electricity bill becomes tax deductible.

You have two choices for calculating your home office deduction: the standard method and the simplified option, and you don't have to use the same method every year. The standard method requires you to calculate your actual home office expenses. The simplified option lets you multiply an IRS-determined rate by your home office square footage. To use the simplified option, your home office must not be larger than 300 square feet, and you cannot deduct depreciation or home-related itemized deductions.

The simplified option might be a clear choice if you're pressed for time or don't have good records of your deductible home office expenses. However, because the simplified option is calculated as $5 per square foot, with a maximum of 300 square feet, the most you'll be able to deduct is $1,500. If you want to make sure you're claiming the largest home office deduction you're entitled to, you'll want to calculate the deduction using both the regular and simplified methods, making the "simplified" method anything but if you choose the standard method, calculate the deduction using IRS form 8829, Expenses for Business Use of Your Home.

Internet and Phone

Regardless of whether you claim the home office deduction, you can deduct your business phone, fax and Internet expenses. The key is to only deduct the expenses directly related to your business. If you have only one phone, you shouldn't deduct your entire monthly bill, which includes both personal and business use. You should only deduct costs that specifically relate to your business. If you have a second phone line that you use exclusively for business, however, you can deduct 100% of that cost. By the same token, you would only deduct your monthly Internet expenses in proportion to how much of your time online is related to business – perhaps 25% to 50%.

Health Insurance Premiums

If you are self-employed, pay for your own health insurance premiums, and were not eligible to participate in a plan through your spouse's employer, you can deduct all of your health, dental and qualified long-term care insurance premiums. You can also deduct premiums that you paid to provide coverage for your spouse, your dependents and your children who were younger than 27 at year-end, even if they aren't dependents.

Meals

A meal is a tax-deductible business expense when you are traveling for business or entertaining a client. The meal cannot be lavish or extravagant under the circumstances, and you can only deduct 50% of the meal's actual cost, if you keep your receipts, or 50% of the standard meal allowance, if you keep records of the time, place and business purpose of your travel but not your actual meal receipts.

Entertainment

Wouldn't it be great to get box seats to see your favorite sports team and write off the cost as a business expense? You might be able to, but tread carefully: The IRS has numerous restrictions on claiming the business entertainment tax deduction. For starters, you must conduct business with the person you are entertaining during, immediately before or immediately after the event. If your entertainment expense meets all the tests, it's still only 50% deductible. Make sure you're prepared for an audit by keeping meticulous records of what business activity you conducted, when, with whom, and how it directly relates to the entertainment expense. Keep your receipts, too.

Travel

Meals and entertainment are often intertwined with another tax deductible expense: business travel. To qualify, it must last longer than an ordinary workday, require you to get sleep or rest, and take place away from the general area of your tax home (usually, outside the city where your business is located).

Further, to be considered a business trip, you should have a specific business purpose planned before you leave home, and you must actually engage in business activity – such as finding new customers, meeting with clients or learning new skills directly related to your business – while you are on the road. Handing out business cards at a bar during your friend's bachelor party won't make your trip to Vegas tax deductible. Keep complete and accurate records and receipts for your business travel expenses and activities, as this deduction often draws attention from the IRS.

Deductible travel expenses include the cost of transportation to and from your destination (such as plane fare), the cost of transportation at your destination such as a car rental, Uber fare or subway tickets), lodging and meals. You can’t deduct lavish or extravagant expenses, but you don’t have to choose the cheapest options available, either. You, not your fellow taxpayers, will be paying the bulk of your travel costs, though, so it’s in your interest to keep them reasonable.

100% of your travel expenses for business are deductible, except for meals and entertainment, which are limited to 50%. If your trip combines business with pleasure, things get a lot more complicated; in a nutshell, you can only deduct the expenses related to the business portion of your trip – and don’t forget that the business part needs to be planned ahead.

Car

When you use your car for business, your expenses for those drives are tax deductible. Make sure to keep excellent records and don’t try to claim personal car trips as business trips. You can calculate your deduction using either the standard mileage rate (determined annually by the IRS) or your actual expenses.

The standard mileage rate is the easiest because it requires minimal record-keeping and calculation. Just write down the business miles you drive and the dates you drive them. Then, multiply your total annual business miles by the standard mileage rate (56 cents per mile for 2014; 57.5 cents per mile for 2015). This amount is your deductible expense.

To use the actual expense method, you must calculate the percentage of driving you did for business all year as well as the total cost of operating your car, including gas, oil changes, registration fees, repairs and car insurance. If you spent $3,000 on car operating expenses and used your car for business 10% of the time, your deduction would be $300.

Interest

Interest on a business loan from a bank is a tax-deductible business expense. Credit card interest is not tax deductible when you incur the interest for personal purchases, but when it interest applies to business purchases, it is tax deductible. That said, it's always cheaper to spend only the money you already have and not incur any interest expenses at all. A tax deduction only gives you some of your money back, not all of it, so try to avoid borrowing money.

Publications and Subscriptions

The cost of specialized magazines, journals and books directly related to your business is tax deductible. For example, a daily newspaper would not be specific enough to be considered a business expense, but a subscription to National Homebuilders would be tax deductible if you are in the home building business.

Education

Any education expenses you want to deduct must be related to maintaining or improving your skills for your existing business; the cost of classes to prepare for a new line of work isn't deductible. If you're a real estate consultant, taking a course called "Real Estate Investment Analysis" to brush up on your skills would be tax deductible, but a class on how to teach yoga would not be.

The Best Self-Employed Tax Deduction of All

One deduction in particular can make going into business for yourself particularly profitable: the deduction for self-employed retirement plans. Contributions to SEP-IRAs, SIMPLE IRAs and solo 401(k)'s reduce your tax bill now and help you rack up tax-deferred investment gains for later. For the 2014 tax year, you could feasibly contribute as much as $17,500 in deferred salary ($23,000 if you're 50 or older) plus another 25% of your net self-employment earnings after deducting one-half of self-employment tax and contributions for yourself, up to a maximum of $52,000 total for both contribution categories, with a self-employed 401(k), for example. Contributions limits vary by plan type and the IRS adjusts the maximums annually. In 2015, for example, the solo 401(k) contribution limit increases to $53,000.

The Bottom Line

Most small business tax deductions are more complicated than this brief overview describes – we are talking about the tax code, after all – but now you have a good introduction to the basics. Remember, any time you're not sure whether a cost is a legitimate business expense, ask yourself, "Is this an ordinary and necessary expense in my line of work?" This is the same question the IRS will ask when examining your deductions if you get audited. If the answer is no, don't take the deduction. And if you're not sure, seek professional help with your business tax return from a CPA so you don’t give the IRS more than you’re required to.