

A Reprint from *Tierra Grande*

CALCULATING SELF-EMPLOYMENT TAX



Real estate brokers and salespersons operating as independent contractors are considered self-employed for tax purposes, rather than employees. Self-employment status applies whether the broker owns a firm or is associated with one owned by others.

One key distinction is that self-employed taxpayers must pay taxes on their net self-employment income at tax rates which are twice the FICA (social security and Medicare) rates applicable for employees. Both self-employment taxes and regular income taxes are paid on net self-employment income.

Brokers need to anticipate their self-employment tax liability to accurately compute quarterly estimated tax payments. Tax penalties may be imposed if estimated payments are not sufficient to cover both the regular income tax and the self-employment tax.

To compute net self-employment income, subtract business expenses (e.g., automobile, advertising, 50 percent of meals and entertainment) from gross commissions. The tax form used for this computation is Schedule C. Net income computed on Schedule C is included in adjusted gross income on the front page of Form 1040 for income tax calculations. Schedule C net income is also included on Schedule SE, the self-employment tax computation form. Both Schedules C and SE are attached to Form 1040 for filing purposes.

Annual inflation adjustments increase the self-employment tax each year. Moreover, recent tax legislation has removed the upper limit on part of the tax. The table illustrates how the self-employment tax is computed. The example as-

sumes a broker's net income is \$125,000. Net income is automatically reduced by 7.65 percent to calculate the adjusted amount of net income potentially subject to self-employment tax.

As the table shows, the self-employment tax is composed of two parts — OASDI (social security taxes for old age, survivor's and disability insurance) and MHI (Medicare health insurance). The cap, or maximum wage base, for OASDI is \$87,900 for 2004. In contrast, the limit was \$76,200 in 2000. Employee wages, if any, are subtracted from the OASDI maximum as FICA taxes would have already been withheld by the employer. Under current tax law, there is no limit on the MHI portion of the tax, and it is unaffected by employee wages.

The self-employment tax rate for OASDI is 12.4 percent. This rate is applied to the smaller of the adjusted maximum base or adjusted net income from self-employment. The MHI rate is 2.9 percent and is applied to all adjusted net income regardless of its size. Note that adjusted net income for the broker in the example is \$115,437. Because this amount exceeds the \$87,900 OASDI maximum, the OASDI 12.4 percent rate is applied only to \$87,900, resulting in OASDI tax of \$10,900. In contrast, the MHI 2.9 percent rate is applied to the entire \$115,437, producing

an MHI tax of \$3,348. The broker's total self-employment tax is \$14,248 (\$10,900 plus \$3,348).

Although the self-employment tax raises taxes for most brokers, its cost is reduced somewhat because one-half of the tax becomes a deduction for regular income tax purposes. For example, the broker with \$125,000 net income and \$14,248 self-employment tax is allowed a \$7,124 deduction for purposes of computing taxable income.

Assuming this broker is in the 28 percent marginal tax bracket for regular income tax purposes, the deduction provides tax savings of \$1,995 (28 percent of \$7,124). Thus, the net increase in tax liability associated with the self-employment tax becomes \$12,253 (\$14,248 less \$1,995), reflecting an effective self-employment tax rate of nearly 10 percent in this example (9.8 percent is the actual effective tax rate, equal to \$12,253 divided by \$125,000).

As demonstrated here, the self-employment tax can be complicated. For specific tax advice, consultation with an accountant or tax attorney is recommended. ♦

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COMPUTATION OF SELF-EMPLOYMENT TAX

Net income from self-employment	\$125,000	
Less 7.65% × \$125,000	9,563	
Adjusted net income from self-employment	<u>\$115,437</u>	
	OASDI (FICA)	MHI (Medicare)
2004 Maximum tax base	\$87,900	No maximum base
Less: wages up to base	0	
Adjusted maximum base	<u>\$87,900</u>	
Lesser of adjusted maximum base or adjusted net income from self-employment	87,900	\$115,437*
× Tax rate	12.4%	2.9%
Self-employment tax	<u>\$10,900</u>	<u>\$3,348</u>
Total self-employment tax = \$14,248	(\$10,900 + \$3,348)	

*The entire adjusted net income from self-employment is taxable. There is no maximum base (i.e., no upper limit) on the MHI (Medicare) portion.



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