The Freelancer's Essential 12-Step Guide to Avoiding Tax Trouble

One of the things that makes would-be freelancers nervous to quit their day jobs is the whole issue of paying taxes. When we're employees, our company handles most of our tax responsibility for us, deducting required amounts so we never miss the money.

As freelancers, this responsibility falls squarely on our shoulders. But tax-phobia shouldn't keep you from pursuing the freelance life.

There is some paperwork you'll need to do, but it's not overwhelming. You can do this. With a small amount of forethought and planning, you can reduce your tax burden and make sure you get all the tax breaks allowed for freelancers.

Just a note up front — my experience is with paying U.S. taxes, and it's U.S. tax-code issues I'm referencing below. If you're in another country, be sure to consult your local tax authorities.

1. Register Your Business

The first step to claiming a freelancer's tax deductions is to officially establish your business. This usually involves registering your business name with local authorities — depending on where you live, this might mean your state, city, county, and/or province. (Beyond tax reasons, this will protect you from someone else trying to start a local business using the same name.)

Check with your secretary of state or department of labor for information on how to sign up your business. States are getting pretty helpful with this, and for the most part you should be able to do everything online.

When you are registering, it's worth taking the

In the U.S., your state will issue you a Unified Business Identifier (UBI) number. Local city or county authorities may also require you to register with them as well. Fees for this are generally modest.

time to think about what business structure you want to use.

Pay the small fee, get a business license and hang onto your copy. As your business grows, you may owe state or local taxes that will be tracked under this business license.

When you are registering, it's worth taking the time to think about what business structure you want to use. Most one-person businesses register as sole proprietors, in part because it is the easiest and cheapest business type to register. But know that as a sole proprietor, your personal assets are vulnerable if you're sued by a client or subcontractor in your business.

This year, I went through the expense and hassle of re-registering as an LLC, or Limited Liability Corporation. Reforms have made it possible for one-person businesses to use this form of incorporation, which shields your personal assets from business lawsuits.

2. Get an EIN

Once you've taken care of registering your business locally, move on to registering your business at the federal level.

In the U.S., new business owners can register and receive a Federal Tax-ID number or Employer Identification Number (EIN). It's not required, but it is recommended.

One advantage of having an EIN is that when you fill out tax forms with clients, you won't have to hand out your Social Security number. This helps prevent fraud and theft of your SS#.

Besides being useful for tax tracking, that EIN can help you build your business. There are types of freelance gigs, such as federal contract work, that you won't be able to bid on without an EIN.

The fact that you took the time to get an EIN helps make your case to the Internal Revenue Service that you are a serious business owner, not a hobbyist.

This is critical because if the IRS decides you have a hobby and *not* a business, it will disallow all of your business expenses. You don't want that, right? So get an EIN.

3. Put Money Away

As I mentioned up top, when you were an employee, your employer handled withholdings for you. The tax money you owed disappeared from your paychecks before you got them, and it was fairly easy to predict what you needed to pay.

That all changes when you freelance — your income is less predictable, and you also have variable expenses you might deduct

That all changes when you freelance — your income is less predictable, and you also have variable expenses you might deduct from gross income to reduce your taxes. Most importantly, it is up to you to put aside and remit taxes you owe.

The first year you freelance, it will be hard to predict what you'll owe. You ordinarily won't pay tax until the end of the first year. If you have nothing saved up come April, you may be in trouble (more on that below).

To avoid being unable to pay your taxes, do a rough estimate *from gross income to reduce your taxes.*

of your tax rate and put money aside out of each paycheck. Look at your previous year's tax return and find the rate you paid previously. Use that as a rough guide until you know more about what you'll pay.

For a typical, middle-class American, that will mean putting aside between 15 percent and 25 percent of what you make. When in doubt, err on the side of saving more.

4. Know Your Deductions

Allowed expenses change a bit every year, but there are a few basic deductions freelancers should be sure to track:

- Travel expenses
- Vehicles and mileage
- Office supplies
- Equipment purchases
- Healthcare premiums
- Childcare costs
- Parking and tolls
- Professional help (attorney, accountant, etc.)
- Entertainment and meals
- Professional organizations and subscriptions
- Needed services (telecom, Internet, maid service, electricity, etc.)
- Rent or mortgage payments

Most freelancers don't stock physical products, but if you do, the cost of that inventory is an expense for your business, too.

One deduction that's been controversial for home-based business owners is the home office deduction. Claiming this deduction has long been said to be a sure-fire ticket to an IRS tax audit. But it's a myth.

I've been taking the home office deduction for six years now, and it's never posed a problem. If you don't have any other place of work and you do work from a home office, claim it.

The IRS does like to see a dedicated room in your house for the office rather than a computer tucked in the corner of your bedroom, I'm told.

Know that if you own your home, you will owe a tax on the gain in value of your home office portion of your dwelling whenever you sell your house. But it still defers a hunk of tax owed into the future.

5. Track Expenses

As a business owner, there are expenses you can deduct from your gross income. Less gross income means you pay less tax.

It's key to track and claim every expense to which you are entitled! Don't pay a dime more than you have to because you didn't bother to keep receipts.

Tax-collecting agencies want documentation that you really made these expenditures. Whether you keep receipts in a file folder, a shoebox, use online tools such as Shoeboxed, or a full-on accounting suite such as Freshbooks, develop a system for hanging onto this information.

If you are ever audited, expenses without receipts or logs will be disallowed. Worse, expenses you don't track may get forgotten and not taken at tax time.

6. Gimme Shelter

Aside from business expenses, there is one other way to reduce your taxes — contribute to accounts that tax-shelter your income.

The best-known example is Individual Retirement Accounts or IRAs, which sock your money away for retirement. Contribute to your IRA, and that money is deducted from your gross income.

Currently, the standard amount you can deposit in your IRA is $5,000 per year under age 50.

Currently, the standard amount you can deposit in your IRA is $5,000 per year under age 50. If you're paying 25 percent tax, that's a quick $1,250 less federal tax you'll pay.

Another type is the Health Savings Account or HSA. This type of medical account allows you to deposit thousands tax-free to pay for out-of-pocket medical expenses through the year. Last year, I sheltered more than $5,000 by depositing it in my HSA, for instance.

Also be on the lookout for tax credits you might take that could reduce your total tax. For instance, companies that employ veterans or purchase fuel-efficient vehicles have been able to claim substantial tax credits in recent years. Tax credits rock because they directly reduce your tax owed — a $1,000 tax credit takes that amount straight off your tax bill.

7. Show a Profit

At tax time, you'll tell the IRS and local agencies how much you made, and how much you'd like to take in expenses. Ideally, there should be a profit left at the end of this calculation.

If you don't have a profit, you might consider not submitting all your expenses, in order to put your freelance business in the black.

Why is this important?

The IRS likes to see businesses make money. It's a requirement that you show a profit in at least two of every five years.

The more unprofitable your freelancing is, the dimmer view the IRS takes of whether you are really in business. If the IRS decides you've got a hobby, it may disallow multiple years of business expenses you've taken, and assess penalty and late fees on top of it.

Don't let this happen! Be careful to show a profit to the IRS, even if it means forgoing some of your deductions.

8. Make Estimated Tax Payments

After your first year, the IRS will expect you to make estimated quarterly tax payments rather than waiting to pay it all at year-end. (Your state or local authorities may require you to file quarterly as well, as your business grows.)

A tax pro can help you figure out what to pay each quarter, based on your projected income for the coming year and previous year's tax bracket. If you expect flat income, you can divide your first-year total by four and estimate your payments.

9. Pay Contractors and Employees

If you end up hiring employees, or employing subcontractors to work on your projects, you have another set of tax responsibilities.

Just as you fill out tax forms and supply your tax-ID numbers to clients you freelance for, if you hire workers, you have that same responsibility. Provide contractors with tax forms and be sure to capture their tax-ID numbers so you can report these expenses to the IRS.

If you are hiring an employee, you will withhold and remit to state and federal agencies their employment tax due.

Get sloppy with this paperwork and you may lose out on thousands of dollars of deductions.

If you are hiring an employee, you will withhold and remit to state and federal agencies their employment tax due. There's a serious paperwork and tax burden here, but on the plus side you might be entitled to some tax breaks for hiring workers.

Is your hire an employee or contractor? If you expect the worker to show up at a set place for a set period of time to use your computer to do work, the IRS is going to likely view them as an employee.

Contractors have their own EIN or UBI number, their own business cards, and send invoices for their fee. They do their work with their own tools and when and where they like.

10. Avoid Penalties and Fees

Whether you hire a pro to draw up your tax forms, buy TurboTax or similar do-it-yourself tax software, or labor through the forms on your own, file your taxes on time.

Failure to file on time can result in a hefty penalty. By the same token, misclassifying an employee as a contract worker can result in fines and fees, too.

11. When Income Disappears

Under current U.S. law, employers must report contractors they paid $600 or more over the course of a year.

What does that mean to you? If you do a small, one-time $300 or $400 job for a client, they will not notify the IRS or send them your tax information.

If you do work for foreign clients, they are not obligated to comply with U.S. tax-reporting rules. So the IRS will also not be notified of that income.

In these cases, you're on your honor to report the income as an ethical American taxpayer. Will you? If not, you'll join other small-business tax cheats whom the IRS estimates failed to report revenue on which they should have paid $122 billion in tax in 2006, IRS reports.

Also, remember that income you don't report can't help you show a profit against your expenses. I know you're gonna do the right thing here.

12. If You Can't Pay

With the fluctuating nature of freelance income, it's not uncommon for a freelancer to discover at year-end that they owe an unexpectedly large tax bill — and don't have the cash.

If this is you, don't panic. Begin by filing on time, even if you don't have your full payment. Send even $10, on time. This will avoid late-filing penalties and show your goodwill.

The IRS offers several options for those who can't pay:

- **Noncollectible status.** If your cash-flow problems are temporary, you can have your account placed in "currently not collectible" status. You'll have to prove your monthly income covers your essential expenses, and that any assets such as home equity are inaccessible right now. You will still owe the tax later, when your finances improve.
- **Short-term payoff.** If you'll have the money you need shortly, you can keep costs down by arranging to pay your taxes due in up to five monthly payments.
- **Installment plan.** A Payment Agreement gives you up to two years to pay off the debt in monthly installments. Interest and fees will add up fast, so you'll save by paying it off quickly. You can apply online.
- **Settlement offer.** If you can show that you'll likely never be able to pay off your tax debt, you can apply for an Offer in Compromise. The offer will propose settling the debt by paying a smaller amount than the total owed, spread over monthly installments.

Whatever you do, don't run and hide. Present yourself as someone who's eager and willing to work with the IRS to resolve your tax debt, and they'll be more likely to help you.

NOTE: I am not a tax professional, though I reported on business-tax issues for many years. Consult a professional if you have questions.

Are you ready for tax time? Leave a comment and tell us how you track expenses and income.

Disclaimer

You should always seek independent financial advice and thoroughly read terms and conditions relating to any insurance, tax, legal, or financial issue, service, or product. This article is intended as a guide only.

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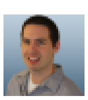
1.  *Brent*
   October 24th

   Very useful information, thank you! I will be bookmarking this for tax time. I particularly like the list of tax write offs that you provide! Thanks

   Reply

2.  *[Kevin McCoy]*
October 24th

RE: the home office deduction – here are some tests that you can look at to see whether it is allowable or not. http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Home-Office-Deduction

Another neat (and often forgotten thing) about the home office deduction isn't the actual deduction itself, but that business mileage starts when you leave the driveway or parking lot. Without the home office it might otherwise be considered non-deductible commuting. This is sort of confusing, so check with your tax adviser!

Reply

3.  *Carol Tice*
October 24th

Thanks for adding that link, Kevin!

Reply

4.  *Caitlin*
October 30th

Nice article! It looks like I am right on track, but it's all stuff I had to learn on my own. I would definitely recommend this reading to anyone just starting out on a freelance gig.

Reply

5.  *Mariette*
October 30th

Good article, but there are two points that need clarifying:

LLC stands for Limited Liability Company, NOT corporation. Filing for an LLC does not incorporate your business. Unless you also file articles of incorporation, an LLC will be taxed as a sole proprietor for an individual, and a general partnership for more than one person.

Self-employed people are not limited to $5,000 for their IRA contribution – that's for employees. Self - employed people may have a self-employed retirement plan such as a SEP IRA or self-employed 401(K) and can contribute up to about 20% of their net profits, up to $49,000.

This is not to be construed as tax advice.

Reply

6.  *Matt*
November 21st

One thing that was not mentioned here is to use your LLC to employ yourself. Basically you hire a payroll service to deduct taxes weekly or bi-weekly when you run payroll. Even though you are paying yourself, it keeps your taxes in-order just as if you were working for someone else, you get a W2. You now become ‘legit’. Who do you work for? You say.. Company Name.. an yes, I am the owner. All you have essentially done is create a company, an entity that has hired and employed you. Doesn’t matter that you are the only employee. This can really help people who have a hard time putting money away to make estimated tax payments.

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