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Self- Employment Tax

For use in preparing
1996 Returns

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Important Changes

Tax rates and maximum net earnings for self-employment taxes. The self-employment tax rate on net earnings remains the same for 1996 and 1997. This rate, 15.3%, is a total of 12.4% for social security (old-age, survivors, and disability insurance), and 2.9% for Medicare (hospital insurance).

The maximum amount subject to the social security part for 1996 is \$62,700. For 1997, that amount increases to \$65,400. All your net earnings are subject to the Medicare tax.

Certain benefits for retired ministers exempt from self-employment tax. Retirement benefits, including a parsonage allowance, received under a church plan are not subject to self-employment taxes. See *Retired ministers* under *Net Self-Employment Income*, later.

Certain fishermen must pay self-employment tax. The rules for deciding whether fishermen are self-employed or are employees have been clarified. See *Fishing crew members* under *Who Must Pay Self-Employment Tax*, later.

Newspaper carriers and distributors classified as direct sellers. Certain newspaper distributors and carriers are direct sellers for work performed after 1995. See *Newspaper carriers and distributors* under *Who Must Pay Self-Employment Tax*, later.

Introduction

This publication explains what income is subject to self-employment tax (SE tax) and how to figure the amount of SE tax.

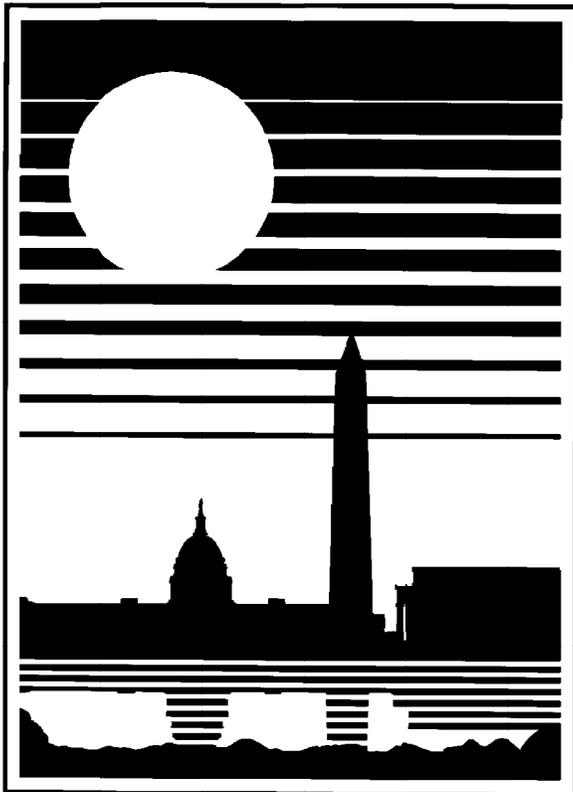
The SE tax is a social security and Medicare tax for individuals who work for themselves. It is similar to the social security and Medicare taxes withheld from the pay of wage earners.

Useful Items

You may want to see:

Publication

- 15 Circular E, Employer's Tax Guide



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FAX

- From your FAX machine, dial ▶ (703) 487-4160.
- See *How To Get More Information* in this publication.

- 15-A** Employer's Supplemental Tax Guide
- 225** Farmer's Tax Guide
- 334** Tax Guide for Small Business
- 505** Tax Withholding and Estimated Tax
- 517** Social Security and Other Information for Members of the Clergy and Religious Workers
- 541** Partnerships
- 911** Direct Sellers

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- Sch C (Form 1040)** Profit or Loss From Business
- Sch C-EZ (Form 1040)** Net Profit From Business
- Sch EIC (Form 1040A or 1040)** Earned Income Credit
- Sch SE (Form 1040)** Self-Employment Tax

See *How To Get More Information*, near the end of this publication for information about getting these publications and forms.

General Information

The following information on social security benefits and coverage, and on reporting the SE tax, may be helpful.

Social security benefits. Social security benefits are available to self-employed persons just as they are to wage earners. Your payments of SE tax contribute to your coverage under the social security system. Social security coverage provides you with retirement benefits, disability benefits, and medical insurance (Medicare) benefits.

You must be *insured* under the social security system before you begin receiving social security benefits. You are insured if you have the required number of quarters of coverage. A "quarter of coverage" means a period of 3 calendar months during which you were paid a certain amount of income subject to social security tax.

For 1996, you receive a quarter of social security coverage, up to four quarters, for each \$640 (\$670 for 1997) of income subject to social security. Therefore, for 1996, if you had income of \$2,560 that was subject to social security taxes (self-employment and wages), you will receive four quarters of coverage. Note that no quarters of coverage will be credited if you have less than \$400 of annual net earnings.

For an explanation of the number of quarters of coverage you must have to be insured, and of the benefits available to you and your family under the social security program, consult your nearest Social Security Administration office.

Social security number. You must have a social security number to pay SE tax. If you do not have a number, apply for one on Form SS-5, *Application for a Social Security Card*. You can get this form at any Social Security office or by calling 1-800-772-1213.

If you have a social security number from the time you were an employee, do not apply again.

If you have a number but lost your card, file Form SS-5 showing where and about when you first applied for it. You will get a card showing your original number, not a new one.

If your name has changed since you received your social security card, complete Form SS-5 to report a name change.

Estimated tax. You may have to pay estimated tax. This depends on how much income and SE taxes you expect for the year and how much of your income will be subject to withholding tax. The SE tax is treated, and collected, as part of the income tax.

If you are also an employee, you may be able to cover your estimated income and SE tax payments by having your employer increase the amount of income tax taken out of your pay.

You may have to pay a penalty if you do not pay the correct installment of estimated tax by its due date. For more information, get Publication 505.

Reporting self-employment tax. Figure your SE tax on Schedule SE. Then report the tax on line 45 of Form 1040, and attach Schedule SE to Form 1040. If you file a joint return, the tax is figured separately on the SE income of you and your spouse. However, you are both liable for the total SE tax due on the return.

Self-employment tax deduction. You can deduct half of your SE tax as a business expense in figuring your adjusted gross income. This is an income tax adjustment only. It does not affect either your net earnings from self-employment or your SE tax.

To deduct the tax, enter on Form 1040, line 25, the amount shown on the "Deduction for one-half of self-employment tax" line of the Schedule SE.

Who Must Pay Self-Employment Tax

You must pay SE tax if:

- 1) You were self-employed and your net earnings from self-employment (excluding any church employee income) were \$400 or more, or
- 2) You performed services for a church as an employee and received income of \$108.28 or more.

However, if you are a member of the clergy or a religious worker, you may not have to pay SE tax. See *Religious Exemptions*, later.

You are self-employed if you carry on a trade or business as a sole proprietor, an independent contractor, a member of a partnership, or are otherwise in business for yourself.

You do not have to carry on regular full-time business activities to be self-employed. Part-time work, including work you do on the side in addition to your regular job, may also be self-employment.

A **trade or business** is generally an activity carried on for a livelihood or in good faith to make a profit. The facts and circumstances of each case determine whether or not an activity is a trade or business. Regularity of activities and transactions and the production of income are important elements. You do not need to actually make a profit to be in a trade or business as long as you have a profit motive. You do need, however, to make ongoing efforts to further the interests of your business.

The SE tax rules apply even if you are fully insured under social security or have started receiving benefits.

Aliens. Resident aliens are generally subject to the same rules as U.S. citizens. Nonresident aliens generally do not pay SE tax. Residents of the Virgin Islands, Puerto Rico, Guam, or American Samoa, however, are subject to the tax. For SE tax purposes, they are not nonresident aliens.

If the nonresident alien is a citizen of a country that is a party to a social security (totalization) agreement with the United States, the U.S. self-employment income may or may not be exempt from SE tax. It is exempt to the extent the income is subject to the tax for similar purposes under the social security system of the foreign country. See *International social security agreements* later.

Dealers in options and commodities. Dealers in options and commodities must treat as net earnings from self-employment gains and losses from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options), or property related to those contracts, such as stock used to hedge options. See sections 1256 and 1402(i) of the Internal Revenue Code.

Executors or administrators. When you administer a deceased person's estate, your fees are earnings from self-employment if you are:

- 1) A professional fiduciary,
- 2) A nonprofessional fiduciary (personal representative), and:
 - a) The estate includes an active trade or business that you actively participate in, and
 - b) Your fees are related to the operation of that trade or business, or
- 3) A nonprofessional fiduciary of a single estate that requires extensive managerial activities on your part for a long period of time, provided these activities are enough to be considered a trade or business.

A nonprofessional fiduciary reports fees that are earnings from self-employment on Schedule C or C-EZ. If the fees are not earnings from self-employment, report them on line 21 of Form 1040.

Fishing crew members. Certain members of the crew on a boat that catches fish or other water life are self-employed if:

- 1) They do not get any money for their work (other than their share of the catch or of the proceeds from the sale of the catch), unless the pay meets all of the following conditions:
 - a) The pay is not more than \$100 per trip,
 - b) The pay is received only if there is a minimum catch, and
 - c) The pay is solely for additional duties (such as mate, engineer, or cook) for which additional cash pay is traditional in the fishing industry.
- 2) They get shares of the catch or shares of the proceeds from the sale of the catch,
- 3) Their shares depend on the amount of the catch, and
- 4) The operating crew normally numbers less than ten individuals. (An operating crew is considered as normally made up of fewer than 10 if the average size of the crew on trips made during the last four calendar quarters is fewer than 10.)

The exception to the rule in (1), and the rule stated in the second sentence in (4), are effective for payments after 1984. However, these items do not apply for payments after 1984 and before 1995, if the payer treated the payments, when made, as subject to social security and Medicare taxes.

Crew members who meet these conditions are considered self-employed and must pay SE tax. Also, they generally need to make estimated tax payments. For more information, get Publication 595, *Tax Highlights for Commercial Fishermen*.

Independent contractor. People such as lawyers, contractors, subcontractors, public stenographers, auctioneers, who follow an independent trade, business, or profession in which they offer their services to the general public are generally not employees. However, whether those people are independent contractors or employees depends on the facts in each case. The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done. Income earned by an independent contractor is SE income.

You are not an independent contractor if you perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if you are given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed. If an employer-employee relationship exists (no matter what the relationship is called), you are not an independent contractor.

For more information in determining whether you are an independent contractor or an employee, get Publication 15-A.

Newspaper carriers and distributors. There are new rules for determining the employment status of newspaper carriers and distributors. Effective for services you perform after 1995, you are a direct seller, and are treated as self-employed for federal tax purposes, if all of the following are met:

- 1) You are in the business of delivering/distributing newspapers or shopping news, including directly related services such as soliciting customers and collecting receipts,
- 2) Substantially all your pay for these services directly relates to sales or other output rather than to the number of hours worked, and
- 3) You perform the delivery services under a written contract between you and the service recipient that states you will not be treated as an employee for federal tax purposes.

This rule applies whether or not you hire others to help you make deliveries. It also applies whether you buy the papers from the publisher or are paid based on the number of papers you deliver.

If you do not meet the above direct seller rules, you may be an employee subject to having taxes withheld from your pay. As an employee, you would not have to pay self-employment tax on this income. Wages newspaper carrier employees receive for delivering newspapers or shopping news to customers are subject to withholding for social security and Medicare taxes, if the carrier is 18 or over. See Publication 15-A for more information about who is an employee.

Carriers and vendors under age 18. Carriers or distributors (not including those who deliver or distribute to any point for subsequent delivery or distribution), and vendors (working under a buy-sell arrangement), under the age of 18 are not subject to self-employment tax.

Notary public. Fees received for services performed as a notary public are not subject to SE tax.

Public officials. Public officials generally do not pay SE tax on what they earn in their official positions. Public office includes any elective or appointive office of the United States or its possessions, the District of Columbia, a state or its political subdivisions, or a wholly owned instrumentality of any of these.

Payments received by an elected tax collector from state funds on the basis of a fixed percentage of the taxes collected is not income from self-employment.

However, public officials of state or local governments must pay SE tax on their fees if they are paid solely on a fee basis and if their services are eligible for, but not covered by, social security under a federal-state agreement.

Real estate agents and direct sellers. Income received by a licensed real estate agent or a direct seller may be SE income. A licensed agent or direct seller generally is treated as self-employed if:

- 1) Substantially all the pay for services as a real estate agent or direct seller is directly related to sales or other output rather than hours worked, and
- 2) The services are performed under a written contract that provides that the agent or seller will not be treated as an employee for federal tax purposes.

For more information, see Publication 15-A. Direct Sellers should also see Publication 911.

Trailer park owners. Rent received by trailer park owners who provide trailer lots, facilities, and services is rent from real estate. It is not included in SE income unless the services provided by the owners are substantial and for the convenience of tenants. Providing the services, such as city sewerage, electrical connections, and roadways, are services required to maintain space for tenant occupancy and not services for the convenience of tenants. Although the operation and maintenance of a trailer park laundry facility is a service provided for the convenience of tenants, it is not, by itself, substantial.

If, however, the owners provide services for tenants that are beyond those required for occupancy and are substantial in nature, the owner's earnings are included in SE income. Services for tenants that are beyond those required for occupancy include supervising and maintaining a recreational hall provided by the park, distributing a monthly newsletter to tenants, operating a laundry facility, and helping tenants buy or sell their trailers.

Retired insurance agents. The income paid by insurance companies to retired insurance agents that is based on a percentage of commissions received before retirement is SE income. Also, the income for renewal and deferred commissions for sales made before retirement is SE income.

However, renewal commissions paid to the survivor of an insurance agent is not SE income.

Sole proprietor. If you own and operate your own business as a sole proprietor, the income from your business is SE income. If your spouse works with you in your business, see *Partners*, later.

Statutory employees. If you earned wages as a statutory employee, the box titled "Statutory employee" in box 15 of Form W-2, *Wage and Tax Statement*, will be checked. You do not pay SE tax on those earnings because social security and Medicare taxes (FICA taxes) were withheld. Do not file Schedule SE if you have no other earnings from self-employment. However, you should file a separate Schedule C (or Schedule C-EZ) to report only the income and expenses related to your earnings as a statutory employee.

Statutory employees include full-time life insurance agents, certain agent and commission drivers and traveling salespersons, and certain homemakers.

U.S. citizens working in U.S. for foreign government or international organization.

If you are a U.S. citizen employed in the United States by a foreign government, a wholly owned instrumentality of a foreign government, or an international organization, you are subject to the SE tax if your employer does not deduct social security and Medicare taxes from your income.

International social security agreements.

The United States has social security (totalization) agreements with many countries to eliminate dual taxes under two social security systems. Under these agreements, you must generally pay social security and Medicare taxes to only the country you live in.

The United States now has social security agreements with the following countries: Austria, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom. Additional agreements are expected in the future. For more information, contact:

Social Security Administration
Office of International Policy
P.O. Box 17741
Baltimore, MD 21235

Partners

If you are a member of a partnership that carries on a trade or business, your distributive share of its income or loss from the trade or business is included in your income from self-employment. Guaranteed payments from your partnership should be included, along with your share of earnings or losses, when you figure your net earnings from self-employment.

For information on partnerships, get Publication 541.

Inactive partner. An inactive partner figures income from self-employment by including the distributive share of partnership income or loss and any guaranteed payments.

Limited partner. A limited partner figures SE income by excluding the distributive share of partnership income or loss. But guaranteed payments, such as salary and professional fees received for services performed during the year, are included as SE income.

Retired partner. A retired partner pays no SE tax on retirement income received from the partnership under a written plan if:

- 1) The retired partner receives life-long periodic payments,
- 2) The retired partner's share of the partnership capital was fully repaid to the retired partner,
- 3) The retired partner performs no services for the partnership during the year, and

- 4) The partnership owes the retired partner nothing but the retirement payments.

Husband and wife partners. You and your spouse may operate a business as a partnership. If you and your spouse join together in the conduct of a business and share in the profits and losses, a partnership has been created. You and your spouse must report the business income on a partnership return, Form 1065. Attach Schedules K-1 to Form 1065 to show each partner's share of the net income and file separate Schedules SE (Form 1040) to report each partner's SE tax.

However, if your spouse is your employee, not your partner, you must pay social security and Medicare taxes for him or her. For more information, see Publication 15, *Circular E, Employer's Tax Guide*.

Investment club partnership. A member's share of income from an investment club partnership is not SE income if the club limits its activities to:

- 1) Investing in savings certificates, stock, or securities, and
- 2) Collecting interest or dividends for its members' accounts.

In this situation, the partnership is not engaged in a trade or business.

Different tax years. If your tax year is not the same as your partnership's, report your share of partnership income or loss on your return for the year that includes the end of the partnership tax year.

Example. You file your return on a calendar year basis, but your partnership uses the fiscal year ending January 31. You must include on your return for calendar year 1996 your distributive share of partnership earnings and your guaranteed payments for the fiscal year ending January 31, 1996.

Death of a partner. When a partner dies, his or her distributive share of partnership income (or loss) is figured through the end of the month in which the death occurs. This is true even though the decedent's estate or heirs may succeed to rights in the partnership. The partnership income for the year is treated as though earned in equal amounts each month.

Example. ABC Partnership operates a business. Its tax year ends on December 31. A partner dies on August 18. The deceased partner's (and his or her estate's) distributive share of partnership income for the year of death is \$12,000. That partner's SE income from the partnership is \$8,000 (8/12 of \$12,000).

Religious Exemptions

In most cases, ministers, Christian Science practitioners, and members of religious orders who have not taken a vow of poverty have to pay SE tax on their net earnings. But they can

get an exemption from SE tax on certain earnings by filing Form 4361, *Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners*.

Members of religious orders who have taken a vow of poverty are automatically exempt for amounts received while working for a church or an integral agency of the church. However, amounts received for performing services for an organization other than the church cannot be exempted from the tax.

For more information on getting an exemption, get Publication 517.

Members of recognized religious sects opposed to insurance.

If you belong to a recognized religious sect that is opposed to insurance, you may qualify for an exemption from the SE tax. To qualify, you must be conscientiously opposed to accepting the benefits of any public or private insurance that makes payments because of death, disability, old age, retirement, or medical care, or that provides services for medical care. If you buy a retirement annuity from an insurance company, you will not be eligible for this exemption. Religious opposition based on sect teachings is the only legal basis for the exemption. In addition, your religious sect (or division) must have existed since December 31, 1950.

To get the exemption, you must file in triplicate Form 4029, *Application for Exemption From Social Security and Medicare Taxes and Waiver of Benefits*, and waive all social security benefits.

Employee of a church or church-controlled organization.

If you work for a church or a qualified church-controlled organization that elected exemption from social security and Medicare taxes, you will have to pay SE tax if you are paid \$108.28 or more in a year by the church or organization.

However, you can elect to be exempt from these taxes if you are a member of a qualifying religious sect. See *Members of recognized religious sects opposed to insurance*, above. Both you and your employer must receive an approved copy of the application for exemption from social security coverage before the exemption can take effect. Employees use Form 4029 to apply for an exemption.

Self-Employment Income

Different types of income can be SE income. The source of your income and your involvement in the activity from which your income is received will determine whether it is SE income.

Gains and losses. A gain or loss from the disposition of property that is neither stock in trade nor held primarily for sale to customers is not included when figuring SE income. It does not matter whether the disposition is a sale, exchange, or an involuntary conversion.

For example, gains or losses from the disposition of the following types of property are not included:

- 1) Investment property.
- 2) Depreciable property or other fixed assets used in your trade or business.
- 3) Livestock held for draft, dairy, breeding, or sporting purposes and not held primarily for sale, regardless of how long the livestock were held or whether they were raised or purchased.
- 4) Standing crops sold with land held more than one year.
- 5) Timber, coal, or iron ore held for more than one year, if an economic interest was retained, such as a right to receive coal royalties.

A gain or loss from the cutting of timber is not included if the cutting is treated as a sale or exchange.

Dividends. Dividends on securities are not SE income unless you are a dealer in securities who is not holding the securities for speculation or investment.

Interest. Interest is not SE income unless you receive it in your trade or business. This includes interest on accounts receivable or from bonds, notes, etc., if you are a dealer in stocks or securities. But the interest is not SE income if the stocks or securities are held for speculation or investment.

Lost income payments. If you are self-employed and reduce or stop your business activities, any payment you receive for the lost income of your business from insurance or other sources is SE income. If you are not working when you receive the payment, it still relates to your business (even though it is temporarily inactive) and is SE income.

If there is a connection between any payment you receive and your trade or business, the payment is SE income. A connection exists if it is clear that the payment would not have been made but for your conduct of the trade or business.

Part-time business. Income from an activity you carry on part-time is SE income. For example, in your spare time you fix televisions and radios. You have your own shop, equipment, and tools. You get your customers from advertising and word-of-mouth. The income you earn from your repair shop is SE income.

Real estate rent. Rent from real estate and personal property leased with real estate is not SE income. However, if you receive rent as a real estate dealer, include the rental income and related deductions in figuring SE income.

Hotels, apartments, etc. Rents received for the use or occupancy of hotels, boarding houses, or apartment houses are not rentals from real estate if services are provided for the occupants. These rental payments are included in figuring net income from self-employment. Services generally are provided for

the occupants if they are primarily for their convenience and not services normally provided with the rental of rooms for occupancy only. Maid service, for example, is a service provided for the convenience of the occupants. However, heat and light, the cleaning of stairways and lobbies, and the collection of trash are not services primarily for the occupants' convenience.

Research grants. If you receive payments under a research grant from a governmental foundation, but you are not under the control of either the grantor foundation or the grantee institution, you are an independent contractor. The payments you receive are SE income.

U.S. possession self-employment income. SE income from activities in a U.S. possession is subject to SE tax, even if your possession income is exempt from U.S. income tax.

Form to file. If you must file Form 1040, report all of your SE income on Schedule SE. This is true even if your possession income is not otherwise reported on Form 1040. If you do not have to file Form 1040, use Form 1040-SS (or Form 1040-PR if appropriate) to report your SE income. The following are treated as U.S. possessions:

- Guam
- American Samoa
- The Virgin Islands
- The Commonwealth of the Northern Mariana Islands
- Puerto Rico (You may file either Form 1040-PR or Form 1040-SS.)

For more information on U.S. citizens in U.S. possessions, get Publication 570, *Tax Guide for Individuals With Income From U.S. Possessions*.

Wages, salaries, and tips. Wages received for services performed as an employee and covered by social security or railroad retirement are not SE income. Tips received for work done as an employee are also excluded from SE income.

Corporate Payments

Whether income received from a corporation is SE income depends on the reason for the payment.

Corporate director. Fees received for performing services as a director of a corporation are SE income. It does not matter whether the fees are for going to directors' meetings or for serving on committees.

Corporate employee. Even if you own most or all of the stock of a corporation, your income as an employee or officer of the corporation is not SE income.

S corporations. If you are a shareholder in an S corporation, your share of the corporation's taxable income is not SE income, even though you include it in your gross income for income tax purposes.

If you are a shareholder and also an officer of an S corporation and perform substantial services, you are an employee of the S corporation. Your payment for services is subject to withholding for social security and Medicare taxes and is not SE income, regardless of what the S corporation calls the payments.

Schedule SE

Use Schedule SE (Form 1040) to figure your SE tax. Most taxpayers can use *Short Schedule SE* (Section A) to figure their SE tax. However, certain taxpayers must use *Long Schedule SE* (Section B). See Figure 1 to find out which one to use.

You must file Schedule SE if:

- 1) You were self-employed, and your net earnings from self-employment (excluding church employee income) were \$400 or more, or
- 2) You performed services for a church as an employee and received income of \$108.28 or more.



Even if you do not have to file Schedule SE, it may be to your benefit to file it and use either optional method in Part II of Section B.

Forms. Report the SE tax on line 45 of Form 1040. If you have to pay SE tax, you must file a Form 1040 (with Schedule SE attached) even if you do not otherwise have to file a federal income tax return.

Joint returns. You cannot file a joint Schedule SE (Form 1040) even if you file a joint income tax return. Your spouse is not considered self-employed just because you are. If your spouse has SE income, it is independently subject to the SE tax and should be reported on a separate Schedule SE. If you file a joint return and you both have SE income, each of you must complete a separate Schedule SE (Form 1040); attach both schedules to the joint return. See *Huband and wife partners*, earlier, under *Partners*.

Community income. If any of the income from a trade or business other than a partnership is community income under state law, it is subject to SE tax as the income of the spouse carrying on the trade or business. The identity of the person carrying on the trade or business is determined by the facts in each case.

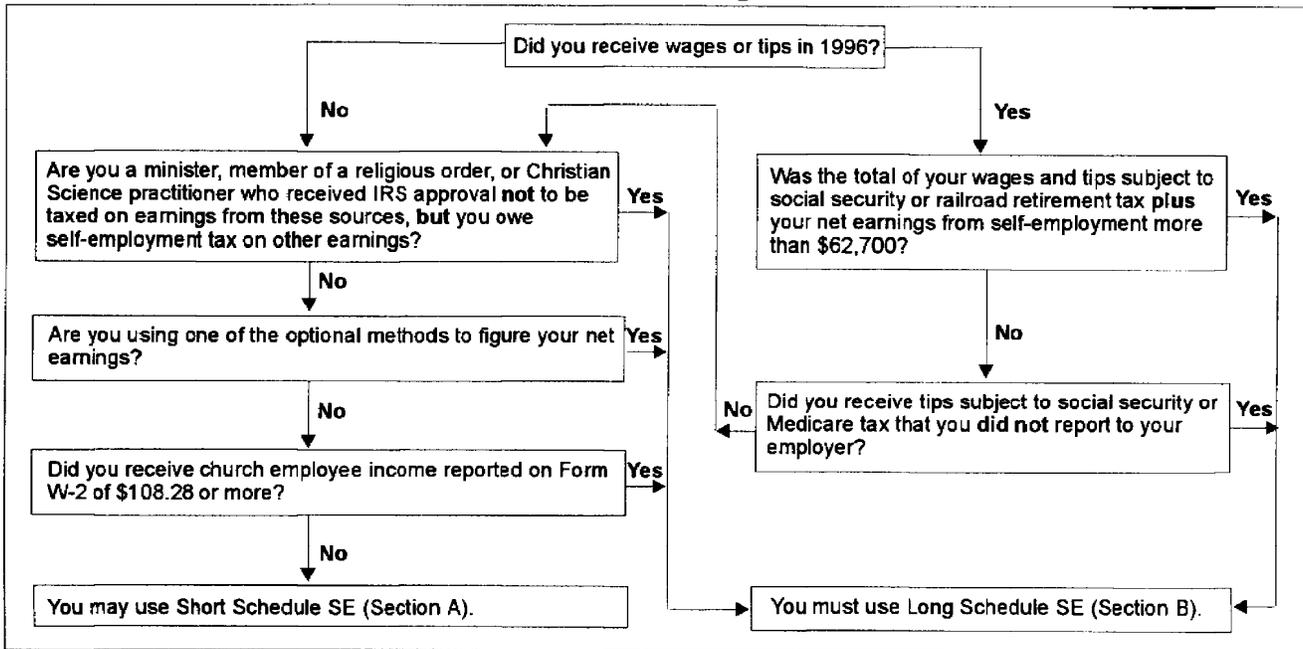
Figuring Self-Employment Tax

There are three steps to figure the SE tax you owe.

- 1) **Figure your net self-employment income.**

Net SE income usually includes all business income less all business deductions allowed for income tax purposes. See

Figure 1. May I Use Short Schedule SE or MUST I Use Long Schedule SE?



Self-Employment Income, and Optional methods, later.

2) Figure the amount that is subject to the tax.

Whether you have to pay SE tax on any part of your net earnings from self-employment generally depends on the total of your net earnings for the year, and on the total of any wages or tips you earn for the year. See *Minimum amount*, and *Maximum amount*, later.

3) Multiply that amount by the tax rate.

The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax). It is the same for net earnings figured under each method.

Fiscal year. If you use a tax year other than the calendar year, you must use the tax rate and maximum income limit in effect at the beginning of your tax year. Even if the tax rate or maximum income limit changes during your tax year, you should continue to use the same rate and limit throughout your tax year.

Optional methods. You can generally use the optional methods (discussed later) when you have a loss or a small amount of net income from self-employment and:

- 1) You want to receive credit for social security benefit coverage,
- 2) You incurred child or dependent care expenses for which you could claim a credit (this method will increase your earned income, which could increase your credit), or
- 3) You are entitled to the earned income credit (this method will increase your earned income, which could increase your credit).

Net Self-Employment Income

You must figure your net income from self-employment by using the same accounting method you use for income tax purposes. You must claim all allowable deductions when figuring net SE income. Your net SE income is used to figure your net earnings from self-employment. See *Net Earnings From Self-Employment*, later.



Making false statements to get or to increase social security benefits may subject you to penalties.

Your net SE income is shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C-EZ (Form 1040), line 36 of Schedule F (Form 1040), and line 15a of Schedule K-1 (Form 1065).

More than one business. If you have more than one trade or business, you must combine the net income from each business to determine your net SE income. A loss you incur in one business will reduce your gain in another business. Net these gains and losses for purposes of the SE tax. Keep separate records for each business and file the appropriate form or schedule for each separate business.

Example. You are the sole proprietor of two separate businesses. You operate a restaurant that made a net profit of \$25,000 last year. You also have a cabinetmaking business that had a net loss of \$500 last year. You file Schedule SE showing net SE income of \$24,500. You must also file a Schedule C for each business—a Schedule C for the restaurant showing your net profit of \$25,000, and another Schedule C for the cabinetmaking business showing your net loss of \$500.

Church employee. If you are an employee of a church or church-related organization that elected exemption from social security and Medicare taxes, your net SE income is the gross income you received for your services, without any deductions.

Retired ministers. The retirement benefits you receive from a church plan and the rental value of any parsonage allowance provided to you after you retire are not subject to self-employment tax, even if the rental value of the parsonage or parsonage allowance is not excludable from income for income tax purposes.

In general, a “church plan” means a plan established and maintained for its employees by a church or convention or association of churches that is tax-exempt.

Recaptures and credits. If you recaptured any depreciation, including any section 179 deduction, because the business use of certain property was reduced to 50% or less, these recaptured amounts are subject to the SE tax. This does not include amounts recaptured on the disposition of property. For more information, see the instructions for Form 4797, *Sales of Business Property*.

If you claimed the work opportunity tax credit, use your reduced wage and salary expense deduction to determine your net SE income.

Deductions and exemptions. Your SE income should not be reduced by certain deductions you used to figure income tax. Specifically, do not use:

- 1) Deductions for personal exemptions for yourself, your spouse, or dependents,

- 2) The standard deduction or itemized deductions,
- 3) The net operating loss deduction,
- 4) Nonbusiness deductions including contributions on your behalf to a pension, profit-sharing plan, annuity plan, Keogh or SEP plan, and
- 5) The self-employed health insurance deduction.

Example. You own a grocery store that had the following items for the year:

Gross profit on sales	\$87,400
Salaries	30,000
Rent	6,000
Heat, light, and air conditioning	2,400
Other expenses	1,900
Gain on refrigerator sale	350
Fire loss on store building	1,200
Net operating loss carryover	1,000

To figure taxable income, consider all the above items. But to figure **net self-employment income**, use only the following:

Gross profit on sales	\$87,400
Expenses:	
Salaries	\$30,000
Rent	6,000
Heat, light, and air conditioning	2,400
Other expenses	1,900
Total expenses	40,300
Net operating profit	\$47,100

The \$47,100 is your net SE income. The refrigerator sale, the fire loss, and the net operating loss carried over from a previous year are not included in the calculation.

Net Earnings From Self-Employment

The SE income subject to SE tax is called net earnings from self-employment.

Minimum amount. You must have \$400 or more of net earnings from self-employment to be subject to the tax. For this purpose, net earnings are figured on line 4 of Schedule SE, Section A or line 4c of Schedule SE, Section B. If your net earnings are less than \$400, you do not have to file Schedule SE (Form 1040) or pay the tax, unless you performed services for a church as an employee and received income of \$108.28 or more.

Maximum amount. No more than \$62,700 of your combined wages, tips, and net earnings in 1996 is subject to any combination of the 12.4% social security part of SE tax, social security tax, or railroad retirement (tier 1) tax.

All your combined wages, tips, and net earnings in 1996 are subject to any combination of the 2.9% Medicare part of SE tax, social security tax, or railroad retirement (tier 1) tax.

If your wages and tips are subject to either social security or railroad retirement (tier 1)

tax, or both, and total at least \$62,700, you do not have to pay the 12.4% social security part of the SE tax on any of your net earnings. However, you must pay the 2.9% Medicare part of the SE tax on all your net earnings.

How to figure net earnings. There are three ways to figure net earnings from self-employment.

- 1) The regular method,
- 2) The farm optional method, and
- 3) The nonfarm optional method.

See *Figure 2. Can I Use the Optional Methods?*

Regular Method

Multiply your net SE income by 92.35% (.9235). See *Short Schedule SE*, line 4, or *Long Schedule SE*, line 4a.

Nonfarm Optional Method

By using the nonfarm optional method, you can continue paying SE tax for your social security coverage when your net profit for the year is small or you have a loss. But you may not use this method to report an amount less than your actual net earnings from self-employment.

Use the nonfarm optional method only for SE income that does not come from farming. You may use this method if you meet all the following tests.

- 1) Your net nonfarm profits as shown on line 31 of Schedule C (Form 1040), line 3 of Schedule C-EZ (Form 1040), and line 15a of Schedule K-1 (Form 1065), are less than \$1,733.
- 2) Your net nonfarm profits are less than 72.189% of your gross nonfarm income.
- 3) You are self-employed on a regular basis. This means that your actual net earnings from self-employment were \$400 or more in at least 2 of the 3 tax years before the one for which you use this method.
- 4) You have not previously used this method more than 4 years (there is a 5-year lifetime limit). The years do not have to be one after another.

Gross Income of \$2,400 or Less

If your gross income from all nonfarm trades or businesses is \$2,400 or less and you meet the four tests in the preceding paragraph, you may report two-thirds of the gross income from your nonfarm self-employment as net earnings from self-employment.

Example 1. Ann Green had actual net earnings from self-employment of \$800 in 1994 and \$900 in 1995 from her craft business. She thus meets the test for being self-employed on a regular basis. Her earnings in 1996 are as follows:

Gross income	\$2,100
Net profits	\$1,200

Because her actual net profits are less than \$1,733 and less than 72.189% of her gross nonfarm income, Ann may either use her actual net earnings or she may use the optional method to report \$1,400 (two-thirds of \$2,100).

Example 2. Assume that in Example 1 Ann has a gross income of \$1,000 and her net profits are \$800. She must use her actual net profits. She may not use the optional method because her actual net profits are not less than 72.189% of her gross income.

Example 3. Assume that in Example 1 Ann has a net loss of \$700. In this situation, she may use \$1,400 (two-thirds of \$2,100) as her net earnings under the optional method.

Example 4. Assume that in Example 1 Ann has a gross income of \$525 and net profits of \$175. In this situation, she would not pay any SE tax under either the regular method or the optional method because she would not meet the minimum net income requirement of \$400.

Gross Income of More Than \$2,400

If your gross income from all nonfarm trades or businesses is more than \$2,400 and you meet the four tests for using the nonfarm optional method, you may report \$1,600 as your net earnings from nonfarm self-employment.

Example 1. John White runs an appliance repair shop. His net earnings from self-employment in 1993 were \$8,500; in 1994, \$10,500; and in 1995, \$9,500. He thus meets the test for being self-employed on a regular basis. His earnings in 1996 are as follows:

Gross income	\$12,000
Net profits	\$ 1,200

Because his net profits are less than \$1,733 and less than 72.189% of his gross nonfarm income, John may either use \$1,600 as his net earnings from self-employment, or he may report \$1,200 under the regular method.

Example 2. Assume that in Example 1 John's net profits are \$1,800. He must use the full \$1,800 figured under the regular method. He may not use the optional method because his actual net nonfarm profits are not less than \$1,733.

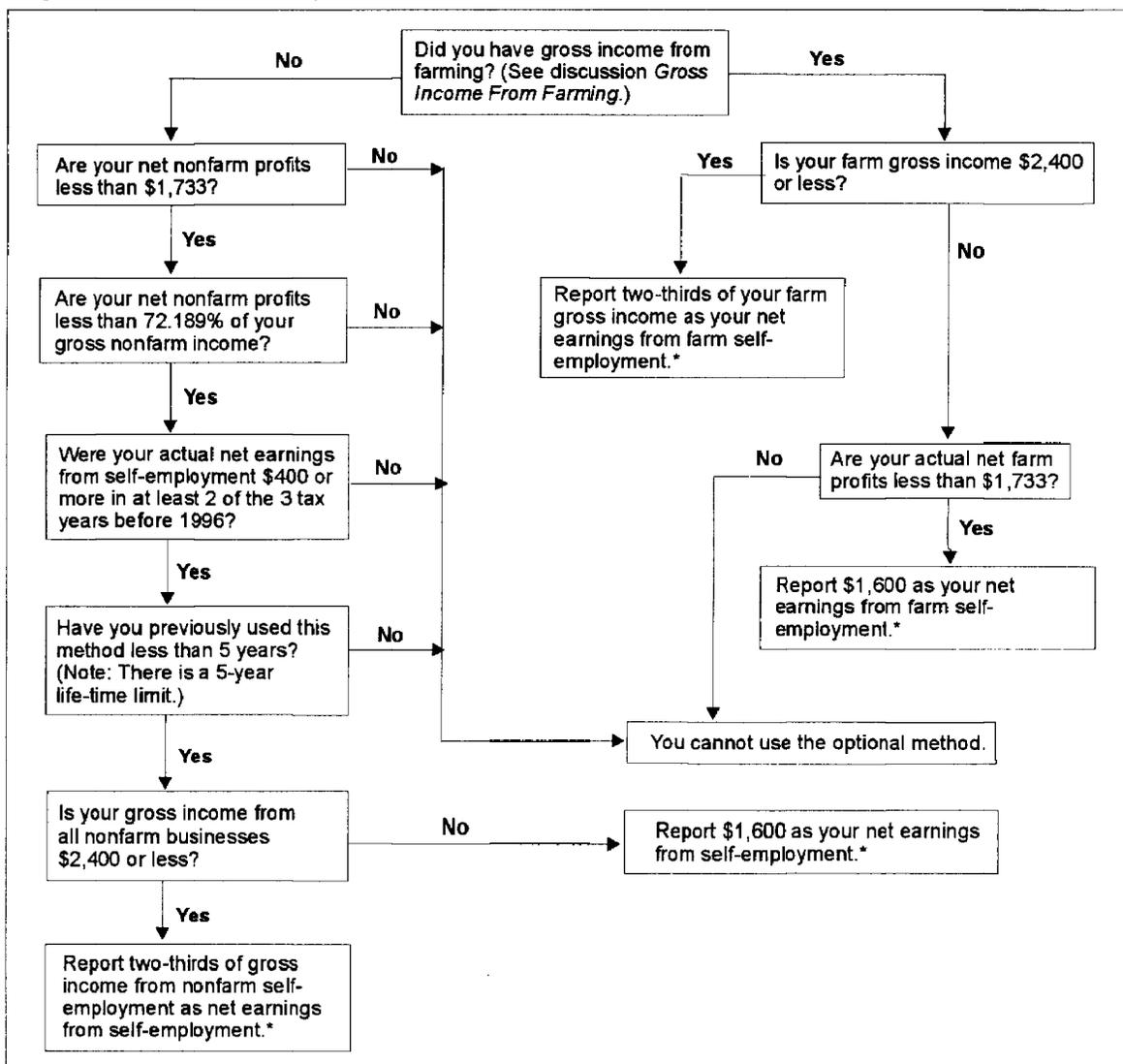
Example 3. Assume that in Example 1 John has a net loss of \$700. He may use the optional method and report \$1,600 as his net earnings from self-employment.

Farm Optional Method

If you are in the farming business, either as an individual or as a partner, you may be able to use the farm optional method to figure your net earnings from farm self-employment. Like the nonfarm method, this method also allows you to continue paying SE tax for your social security coverage when your net profit for the year is small or you have a loss.

There are fewer restrictions for using this method than for using the nonfarm optional method. There is neither a test of regular self-

Figure 2. Can I Use the Optional Methods?



* If you use both optional methods, see *Using Both Methods* for limits on the amount to report.

employment nor a requirement that your actual net farm profits be less than 72.189% of your gross income. There is also no limit on the number of years you may use this method.

Gross Income of \$2,400 or Less

If your gross income from farming is \$2,400 or less, you may report two-thirds of your gross income as your net earnings from farm self-employment.

Gross Income of More Than \$2,400

If your gross income from farming is more than \$2,400 and your actual net farm profits are less than \$1,733, you may report \$1,600 as your net earnings from farm self-employment. But if your gross income from farming is more than \$2,400 and your actual net farm profits are \$1,733 or more, you cannot use the optional method.

Gross Income From Farming

Farming income includes what you receive from cultivating the soil or raising or harvesting any agricultural commodities. It also includes income from the operation of a livestock, dairy, poultry, bee, fish, fruit, or truck farm, or plantation, ranch, nursery, range, orchard, or oyster bed. This includes income in the form of crop shares if you materially participate in production or management of production.

If you receive government commodity program payments on land you rent out, do not include these payments unless you meet the material participation test. For more information, get Publication 225.

Cash method of accounting. If you file your return using the cash method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 11 of Schedule F.

Accrual method of accounting. If you file your return using an accrual method and are not a member of a farming partnership, your gross income from farming will ordinarily be the amount shown on line 51 of Schedule F.

Gross income from a farm partnership. Your gross income under the farm optional method includes your distributive share of a partnership's gross income from farming.

To determine your distributive share of gross income from a farm partnership:

- 1) Figure the partnership's gross income from farming.
- 2) Subtract any guaranteed payments to partners for services or the use of capital if the payments are determined without regard to partnership income.
- 3) Determine your share of what is left. The gross income that remains after steps (1) and (2) is divided among the partners in

the same way they share the ordinary income or loss of the partnership unless the partnership agreement provides otherwise.

The result determined in (3) above is your distributive share of the partnership's gross income from farming. If you have no other gross income from farming, including guaranteed payments discussed next, use this distributive share of gross income to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Guaranteed payments. Any guaranteed payments you receive from a farm partnership that are determined without regard to partnership income are gross income from your farming (not the partnership's). Use the total of these payments, your distributive share of gross income from a farm partnership, and any other gross income you receive from farming, to determine whether you can use the farm optional method to figure your net earnings from self-employment.

Using Both Methods

You may not combine farming income with nonfarm income to figure your net earnings under either of the optional methods. If you use both optional methods, you must add together the net earnings figured under each method to arrive at your total net earnings from self-employment. You may report less than actual total net earnings but not less than actual net earnings from nonfarm self-employment alone when using both methods. If you use both optional methods, you may report no more than \$1,600 as your combined net earnings from self-employment.

Example 1. You are a self-employed farmer. You also operate a retail grocery store. Your 1996 gross income, actual net earnings from self-employment, and optional farm and optional nonfarm net earnings from self-employment are as follows:

	Farm	Nonfarm
Gross income	\$1,200	\$1,500
Net earnings.....	900	500
% of gross income	800	1,000

You may figure your 1996 net earnings from self-employment in any of the four combinations shown below:

	1	2	3	4
Actual farm net earnings	\$ 900	—	\$ 900	—
Optional farm net earnings	—	\$ 800	—	\$800
Actual nonfarm net earnings	500	500	—	—
Optional nonfarm net earnings	—	—	1,000	1,000
Net earnings	<u>\$1,400</u>	<u>\$1,300</u>	<u>\$1,900</u>	<u>\$1,600*</u>

*Limited to \$1,600 because both the farm optional and the nonfarm optional methods are used.

Example 2. Assume that in Example 1 your gross income, actual net earnings from self-employment, and optional farm and optional nonfarm net earnings from self-employment are as follows:

	Farm	Nonfarm
Gross income	\$2,600	\$1,000
Net earnings	400	800
% of gross income	1,733	667

Your 1996 net earnings from self-employment may be either of the amounts figured below:

	1	2
Actual farm net earnings	\$ 400	—
Optional farm net earnings	—	\$1,600*
Actual nonfarm net earnings	800	800
Optional nonfarm net earnings	—	—
Net earnings	<u>\$1,200</u>	<u>\$2,400</u>

*Limited to \$1,600.

You may not use the nonfarm optional method for 1996 because your actual net earnings from nonfarm self-employment (\$800) are not less than 72.189% of gross nonfarm income (.72189 × \$1,000 = \$721.89).

Figuring the Tax

Although the rate is the same for net earnings figured under each method, the way the SE tax is figured is determined by the method you use to determine your net SE earnings.

Tax Rates

The SE tax rate is 15.3% (12.4% social security tax plus 2.9% Medicare tax).

Regular Method

Use Schedule SE (Form 1040) to figure your SE tax as follows.

- 1) If your net earnings from self-employment plus any wages and tips are not more than \$62,700, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply your net earnings by the 15.3% (.153). The result is your SE tax.

2) If you had no wages, your net earnings from self-employment are more than \$62,700, and you do not have to use *Long Schedule SE*, use *Short Schedule SE*. On line 5, multiply the line 4 net earnings by the 2.9% (.029) Medicare tax and add the result to \$7,774.80 (12.4% of \$62,700). The total is your SE tax.

3) If your net earnings from self-employment plus any wages and tips are more than \$62,700, you must use *Long Schedule SE*. Subtract your total wages and tips from \$62,700 to find the maximum earnings subject to the 12.4% social security part of the tax. If more than zero, multiply the amount by 12.4% (.124). The result is the social security tax amount. Then multiply your net earnings from self-employment by 2.9% (.029). The result is the Medicare tax amount. The total of the social security tax amount and the Medicare tax amount is your SE tax.

Example 1. During 1996, you have \$30,000 in net SE income and receive no wages subject to social security and Medicare taxes. Multiply the \$30,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$27,705. Your SE tax is 15.3% (0.153) of \$27,705, or \$4,238.87.

Example 2. During 1996, you have \$20,000 in net SE income and receive \$15,000 in wages subject to social security and Medicare taxes. Multiply the \$20,000 by 0.9235 on *Short Schedule SE* to get your net earnings from self-employment of \$18,470. Your SE tax is 15.3% (0.153) of \$18,470, or \$2,825.91.

Example 3. During 1996, you have \$70,000 in net SE income and receive no wages subject to social security and Medicare taxes. Multiply the \$70,000 by 0.9235 on *Short Schedule SE* to get your net earnings of \$64,645. Since only \$62,700 of your earnings is subject to the social security part of the SE tax, your tax for this part is \$7,774.80 (12.4% of \$62,700).

Since all of your net earnings are subject to the Medicare part of the SE tax, multiply \$64,645 by 2.9% (.029) on *Short Schedule SE* for the Medicare part. The result is \$1,874.71. Add this to \$7,774.80 for a total SE tax of \$9,649.51.

Example 4. During 1996, you have \$70,000 in net SE income and receive \$10,000 in wages subject to social security and Medicare taxes. Figure your net earnings on *Long Schedule SE*, line 4a to be \$64,645. Next, subtract your wages of \$10,000 from \$62,700, the maximum income subject to the social security part of the SE tax. The result is \$52,700. Since only \$52,700 of your earnings is subject to the social security part of the SE tax, your tax for this part is 12.4% (.124) × \$52,700, or \$6,534.80.

Since all your net earnings are subject to the Medicare part of the SE tax, multiply all your net earnings from self-employment, \$64,645, by 2.9% (.029) on *Long Schedule SE* for the Medicare part. The result is

\$1,874.71. Add this to the \$6,534.80 figured above for total SE tax of \$8,409.51.

Nonfarm Optional Method

After you determine your net earnings from self-employment under the nonfarm optional method, check to see whether your earnings meet the minimum income requirement of \$400. If they do, multiply the net earnings figure by the 1996 tax rate (15.3%). The result is the amount of SE tax you owe.

Farm Optional Method

If your net earnings from self-employment under the farm optional method are \$400 or more, multiply the net earnings figure by the tax rate for 1996 (15.3%). The result is the SE tax you owe.

Optional earnings less than actual earnings. If your net earnings under the farm optional method are less than your actual earnings, you can still use the farm optional method. For example, your actual net earnings from self-employment are \$425 and your net earnings figured under the farm optional method are \$390. You owe no SE tax if you use the optional method, because your net earnings are below \$400.

Effect on Taxes

If you use either or both optional methods, you must figure and pay the SE tax due under these methods, even if you would have had a

smaller tax or no tax using your actual SE income or loss under the regular method.

The optional methods may be used only to figure your SE tax. To figure your income tax, include your actual SE income in gross income, regardless of which method you use to figure SE tax.

Example of Schedule SE

Susan J. Brown is sole proprietor of a dress shop, "Milady Fashions." Her Schedule C (Form 1040) shows a net profit of \$35,100 in 1996. Her completed Schedule SE (Form 1040) with *Short Schedule SE* filled out is shown on the next page.

If Susan were the sole proprietor of more than one business, she would have combined the profits and losses from all of them and completed only one Schedule SE. If, in addition to operating her dress shop, she had worked for wages and the total of her wages and her SE income was more than \$62,700, she would have filled out *Long Schedule SE*.

Susan's Schedule SE does not have her husband's name on it. Because her husband has no interest in her business, he does not pay SE tax on this income. If her husband has SE income of his own, he will file a separate Schedule SE.

The line numbers shown below in bold type refer to the line numbers on the sample filled-in *Short Schedule SE* on the next page.

Line 1. Since Susan has no farm income, she leaves line 1 blank.

Line 2. Susan enters the net profit from her Schedule C, \$35,100.

Line 3. Since Susan has no farm income, she enters the same amount on line 3.

Line 4. Susan multiplies the \$35,100 by 0.9235 to get her net earnings and enters \$32,414.85.

Line 5. Susan now figures her SE tax. She multiplies the \$32,414.85 on line 4 by the tax rate (15.3%) on line 5. She enters this amount, \$4,959.47, on line 5. This is the SE tax she owes. She enters the amount on line 45 of Form 1040.

Line 6. She multiplies \$4,959.47 on line 5 by .50. She enters \$2,479.74 here and on Form 1040, line 25.

**SCHEDULE SE
(Form 1040)**

Self-Employment Tax

OMB No. 1545-0074

1996

Attachment
Sequence No. 17

Department of the Treasury
Internal Revenue Service (99)

▶ See instructions for Schedule SE (Form 1040).

▶ Attach to Form 1040.

Name of person with self-employment income (as shown on Form 1040)

SUSAN J. BROWN

Social security number of person with self-employment income ▶

123:00:6789

Who Must File Schedule SE

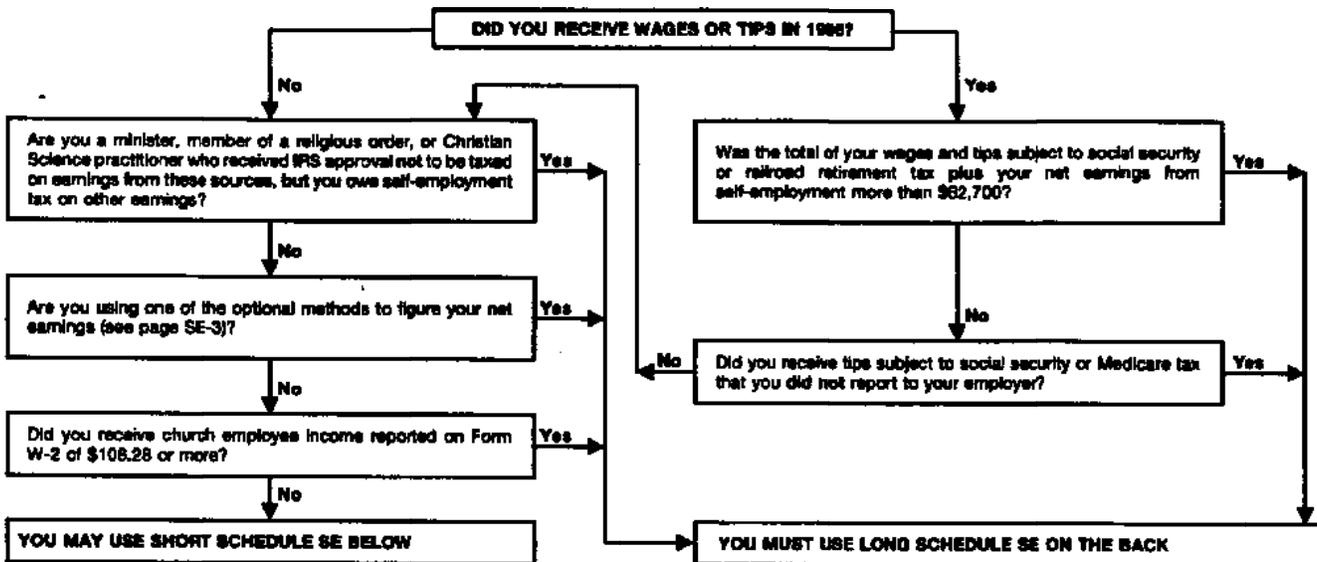
You must file Schedule SE if:

- You had net earnings from self-employment from other than church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more, OR
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order is not church employee income. See page SE-1.

Note: Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner and you filed Form 4361 and received IRS approval not to be taxed on those earnings, do not file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 45.

May I Use Short Schedule SE or MUST I Use Long Schedule SE?



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 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a		
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; and Schedule K-1 (Form 1065), line 15a (other than farming). Ministers and members of religious orders see page SE-1 for amounts to report on this line. See page SE-2 for other income to report.	35,100	
3	Combine lines 1 and 2	35,100	
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	32,414	85
5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> • \$62,700 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 45. • More than \$62,700, multiply line 4 by 2.9% (.029). Then, add \$7,774.80 to the result. Enter the total here and on Form 1040, line 45. 	4,959	47
6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 25		2,479 74

For Paperwork Reduction Act Notice, see Form 1040 instructions.

Cat. No. 11358Z

Schedule SE (Form 1040) 1996

How To Get More Information



You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). Or, write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and a modem, you can also get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details. If space permitted, this information is at the end of this publication.

Tax Questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number or you can call 1-800-829-1040.

Telephone help for hearing-impaired persons. If you have access to TDD equipment, you can call 1-800-829-4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

