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FISCAL & EXPATRIATE SERVICES

US Expats: *Freelancers and Social Security*

Many expats and "IT" nomads mistakenly believe that the first ±$100,000 of income are tax free in the US under the Foreign Earned Income Exclusion (FEIE). This is only partially true. The FEIE does let you exclude income from taxation. However, it does not get you out of paying self-employment tax on foreign income when working abroad as a freelancer, independent contractor or sole proprietor (non-resident aliens are not subject to US self-employment tax).

1. Taxes for the self-employed abroad

Generally speaking, self-employed individuals pay income tax and self-employment tax (SE tax). If you qualify for the FEIE, you can exclude foreign earned income up to $104,100 (2018) from US income tax. But you still have to pay self-employment tax. Being self-employed, you must pay SE tax on your entire net profit, even the amount you can exclude from income tax.

The SE tax is a Social Security and Medicare levy for individuals who work for themselves. If you work for a company in the US as an employee, the Social Security and Medicare tax is automatically taken out of your monthly paycheck. As a freelancer, however, you are responsible for calculating and paying SE yourself on a regular basis.

The IRS considers you self-employed if you work for yourself, whether full-time or part-time, even if you are not registered as a sole proprietor. Even if you have a US LLC, but did not elect to have it taxed as a corporation, you must pay SE tax, because LLC *passes through* income to you as the owner. (To avoid SE tax, you must elect to have your LLC taxed as an S Corp).

2. Tax filing thresholds for the self-employed

Some expat freelancers may think that they don't earn enough to have to file a tax return. However, the approximately $10,000 income threshold for filing also does not apply to the self-employed. If you are a freelancer, the IRS requires you to file a tax return if your annual net earnings are more than $400.

3. Self-Employed vs Employee

The main differences between income as an employee and income from self-employment are as follows: 1) how income tax works and 2) how income is reported. An employee receives a W-2 form, whereas a contractor receives a 1099 form.

The same kind of work, like computer programming, could generate two different types of income. A remote employee for a US company will receive a W-2. If you do programming work for a US company as a contractor, he should receive a 1099-MISC form for that work. Make sure you understand if your company considers you an employee and provides a W-2, or if they treat you as a contractor and issue a 1099-MISC.

Differences between a contractor (1099) and an employee (W-2)

Here are three types of questions to distinguish between the two:

Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job? If the answer is "yes," s/he is likely a W2. If the workers are free to manage their own schedule and work process, they are more likely a 1099.

Financial: Does the employer control the business aspects of the worker's job? This includes how the worker is paid, whether expenses are reimbursed, and who provides tools or supplies. If the company controls how the worker is paid and pays for expenses and supplies, s/he is likely a W2. If the worker has to send an invoice to get paid and/or cover their own expenses, they are more likely a 1099.

Type of relationship: Do you have a written employment contract (versus project or an independent contractor agreement) or employee-type benefits, e.g. health insurance, vacation pay? Will the working relationship continue for the foreseeable future if the work is done correctly and is the work performed is a key aspect of the business? If the company provides an employee with benefits and believes the employee is there for the long-term, s/he is likely a W2. Only ONE of these questions has to be met for the employee to be considered a W2 employee.

4. Form 1099 for self-employment income

1099-MISC forms are a bit more complicated than a W-2. First of all, you may not receive a 1099-MISC for all the income you earned. There may even be double-reporting. You can't rely on 1099-MISC forms alone to report your self-employment income for tax. Instead you have to keep track of your own self-employment income and all related expenses.

1099-MISC forms only list your gross earnings. Unlike W-2s, there are no taxes withheld on your behalf. Be aware that in some cases (for example with Airbnb), the amount on the 1099 may include commissions paid to the company that issued the form, instead of just your earnings net of that commission. Keep in mind that 1099s can contain errors. Always check them against your own records and request a corrected form if you find a mistake.

Who issues a form 1099?

If you earn more than $600 as an independent contractor for a US company, then the company must issue you a 1099-MISC form. (Just like with a W-2, a copy of the 1099 will be sent to the IRS.) But even if the company fails to give you a 1099, or you earn less than $600 per year with a single company, you still have to disclose the income.

PayPal and other electronic payment processors will also send out a 1099 form, called 1099-K, if you meet certain thresholds. According to PayPal, they issue a form 1099-K to sellers who exceed the IRS thresholds, i.e., when they receive over $20,000 in gross payment volume for the sale of goods or services AND receive over 200 separate payments in the same calendar year. If you don't receive a 1099 form from them, you need to use your own records to report the income. Many affiliate sites also issue 1099 forms. You can expect that every place that asks for your SSN or tax information, when signing up, could send you – and the IRS – a tax form.

When you receive a 1099-MISC form from a company you worked for and were paid electronically, for example via PayPal, there is a risk that the same payment is also included in a 1099-K from PayPal. You should compare all 1099-MISC and 1099-K forms carefully against your own records. Even without a 1099 form, you need to report your foreign self-employment income on your US tax return.

5. Reporting self-employment income earned abroad

If you teach English online for a Chinese company, do web design or copy-writing for international clients, are an independent fashion designer, etc., you may not receive any official tax document. That doesn't mean that the income is not subject to US self-employment tax. To report your income, you can use any official or semi-official document or your own spreadsheet. You want to keep track not only of the income you earned made, but also of your expenses and any foreign tax you may have paid on that income.

If your payments come through PayPal, you can go into the history section and download the history from January 1 to December 31 of the tax year. You can do the same for bank accounts and other financial providers you use for receiving payments. This exercise will be much easier if you have separate accounts for your business. Mixing business and personal finances is never a good idea.

6. Self-employment tax rate

The self-employment tax rate is 15.3% for the first $128,400 of net income (2018). On income above this level, you have to pay only 2.9% Medicare tax, but no further social security tax. For self-employment tax, you cannot exclude any income you earn while abroad. You must pay self-employment tax on all of your net profit, including the amount excluded under the FEIE (Foreign Earned Income Exclusion).

Let's say you work abroad as a freelancer and qualify for the Foreign Earned Income Exclusion. Your foreign earned income is $80,000 and your business deductions total $20,000, so your net profit is $60,000. You don't have to pay federal income tax because you can exclude all of your foreign income. But you have to pay 15.3% self-employment tax on all $60,000 of your net profit.

7. Quarterly estimated payments

Since self-employed don't have tax deducted from their monthly paycheck, they have to make estimated quarterly payments.

Here's how to calculate quarterly estimates:

1. *Calculate your net earnings:*
   Add up all (expected) income for the year and then subtract all business expenses to calculate your estimated net earnings. Accounting software or at least a simple spreadsheet helps with keeping track of all income and expenses.

2. *Estimate your taxes and pay quarterly estimated taxes*
   Take your estimated net earnings for the year, multiply it by 0.15 for the total self-employment tax, then divide by 4 to get the quarterly payments.

If during the year you realize that you will likely make more than estimated, you need to adjust your quarterly payments. You should also adjust if you think you will make less than expected. Once the year is over and you know your actual income and expenses, you can file your annual tax return and receive a refund if you overpaid. Quarterly payments are due on April 15, June 15, September 15, and January 15.

sources: www.irs.gov; www.onlinetaxman.com

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