Tax essentials for sole proprietors

Many small businesses start out as sole proprietorships. This structure is simple and inexpensive to establish and maintain — and it gives the owner direct access to profits without having to take formal distributions. But it also makes your taxes more complicated than when you were a W-2 employee. Here are some federal tax issues to consider if your business operates as a sole proprietorship.

Reporting income and expenses

You'll report income and expenses from your business activities on Schedule C of your personal return (Form 1040). The net income will be taxable to you regardless of whether you withdraw cash from the business. Your business expenses are deductible against gross income, not as itemized deductions. If you have losses, they'll generally be deductible against your other income, subject to special rules related to hobby losses, "excess" business losses incurred by noncorporate taxpayers, passive activity losses and losses from activities in which you weren't "at risk."

Sole proprietors may be eligible for certain deductions that generally aren't available to other individual taxpayers. For instance, you may qualify for an above-the-line self-employed health insurance deduction for premiums paid for medical, dental and qualifying long-term care coverage, subject to certain limitations. This means your deduction for medical insurance won't be subject to the rule that limits itemized deductions for medical expenses.

In addition, you may be entitled to deduct home office expenses if:

- A home office is your principal place of business (including when you perform management or administrative tasks there and have no other fixed place to perform them),
- You use your home as a place to meet or deal with customers, clients or patients in the normal course of business, or
- You store inventory or product samples at home.

In general, to qualify, the area must be used regularly and exclusively for business purposes.

The home office deduction may include an allocable part of mortgage interest or rent, insurance, utilities, repairs, maintenance and, if you own the home, depreciation. Alternatively, you can use a simplified method based on the square footage of the qualifying space. You may also be able to deduct travel expenses from your home office to another work location.

Be sure to keep complete records of your income and expenses. Proper documentation is needed to claim all the tax breaks to which you're entitled. Certain expenses, such as automobile, travel, meals, and home office expenses, require extra attention because they're subject to special recordkeeping rules or deductibility limits.

Claiming the QBI deduction

Another special tax break that you might qualify for as a sole proprietor is the Section 199A qualified business income (QBI) deduction. It generally equals 20% of QBI, not to exceed 20% of taxable income. QBI generally is defined as the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business. QBI doesn't include certain investment items or reasonable compensation paid to an owner for services rendered to the business.

This deduction is taken "below the line," meaning it reduces taxable income, rather than being taken "above the line" against your gross income. However, you can take the QBI deduction even if you don't itemize deductions and instead claim the standard deduction.

One word of caution: The QBI deduction is subject to additional limits at higher income levels. For 2026, these limitations generally begin to apply when taxable income (calculated before any QBI deduction) exceeds $201,750 ($403,500 for married couples filing jointly). For 2026, these limitations are fully phased in once taxable income exceeds $276,750 ($553,500 for joint filers). Contact us to learn more about the limitations that apply to your situation.

The One Big Beautiful Bill Act (OBBBA) made the QBI deduction permanent. Starting in 2026, the OBBBA also expands the income ranges over which the limitations phase in, potentially allowing larger deductions for some taxpayers. And it provides a new minimum deduction of $400 for taxpayers who materially participate in an active trade or business if they have at least $1,000 of QBI from it. The minimum deduction will be annually adjusted for inflation after 2026.

Paying self-employment taxes

One downside of owning your own business is that you must pay self-employment taxes. These taxes are the equivalent of federal payroll taxes for employees, but self-employed people must pay both the employer's and employee's share of them. They're imposed in addition to income tax, but you can deduct half of your self-employment tax as an adjustment to income.

For 2026, you must pay self-employment tax (Social Security and Medicare) at a 15.3% rate on your net earnings from self-employment up to $184,500, and Medicare tax only at a 2.9% rate on the excess. An additional 0.9% Medicare tax is imposed on self-employment income in excess of $250,000 for joint filers, $125,000 for married taxpayers filing separate returns and $200,000 in all other cases. The additional Medicare tax threshold isn't adjusted for inflation.

Establishing a tax-advantaged retirement plan

You might also want to consider setting up a qualified retirement plan. The advantages are that amounts contributed to it are deductible at the time of the contributions and aren't subject to income tax until they're withdrawn.

One option is a Simplified Employee Pension (SEP) plan, which requires minimal paperwork. You generally can set up a SEP and make deductible contributions for the tax year as late as the due date of your income tax return for the year, including extensions. The contribution amounts are discretionary, and the annual limits are high. But, if you have employees, they generally must be included in the plan, provided they work enough hours and meet other qualification requirements.

If you don't establish a qualified retirement plan, you may still be able to contribute to a traditional IRA. But your annual contribution limit will generally be significantly lower.

Making quarterly estimated payments

The U.S. tax system is considered "pay as you go." So, you'll probably have to make estimated tax payments each quarter. Estimates should include both federal income tax and self-employment taxes. Estimated payments are generally calculated using Form 1040-ES.

Quarterly payments are generally due on April 15, June 15 and September 15 of the current year and January 15 of the following year. If a due date falls on a weekend or legal holiday, the deadline generally moves to the next business day. Paying enough by each deadline is critical; if you fall behind, you'll likely owe interest and penalties.

Applying for an EIN

Sole proprietors don't automatically need an employer identification number (EIN). You can generally use your Social Security number for federal tax purposes — unless you hire employees. You might also need an EIN if your business:

- Owes employment or excise taxes,
- Withholds certain taxes on payments to a nonresident alien,
- Establishes certain retirement plans, or
- Changes its legal structure, such as incorporating or forming a partnership.

Additionally, you might consider obtaining an EIN voluntarily for banking or administrative purposes. An EIN is available at no cost through the IRS website. To apply, you'll need to provide identifying information, including a valid Social Security number or other taxpayer identification number, and details about the business. Eligible U.S. applicants generally receive the EIN immediately after completing the online application. You can also submit Form SS-4 by fax or mail.

We can help

Even though your business may be small, tax compliance and planning are a big deal. These are just highlights of *federal income* tax issues sole proprietors face. State and local income, sales, payroll, and other tax requirements may also apply. Contact us if you'd like additional information regarding the tax aspects of your business, or if you have questions about the reporting or recordkeeping requirements.