

Doing Business as an Independent Contractor – Is It For You?

By Lori Anne Oliwa



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According to the National Association for the Self-Employed (NASE), an increasing number of companies are enlisting the services of independent contractors, also known as subcontractors, free agents or "freelancers." A person is considered self-employed by the IRS if he or she is conducting business as an independent contractor. Being classified as such comes with a unique set of financial obligations in terms of taxes, insurance coverage, and legal requirements. Speaking with the appropriate professionals in advance is the best way to avoid pitfalls and ensure the business is operating properly.

Beth Christian, an attorney, advised that a person doing freelance work should first review whether or not they are in fact an independent contractor under IRS requirements. She noted that while the IRS looks at a number of factors in determining whether or not someone is an employee or an independent contractor, the central factor is control. "Merely labeling someone as an independent contractor is meaningless." Unfortunately, some businesses try to use the independent contractor label to avoid certain tax and other obligations that they may have in connection with their relationship with an individual.

"If a business controls where and when you do the work and the manner in which your work is performed, it is likely that they should be treating you as an employee rather than an independent contractor," stated Christian. She also emphasized the importance of a written agreement. "It is always best to spell out the details of the work to be performed - the length of the engagement, what you expect to be paid, and the payment terms - in a contract. If you don't have anything committed to writing, you are left with a lot less ammunition in the event of a dispute," she stated. In addition, selection of a proper business form is crucial, according to Christian. She noted that an individual starting a freelance business should consider forming a limited liability company or a corporation, which can provide insulation from personal liability and may afford tax advantages. Christian also emphasized a review of the homeowner's and automobile policies to ensure coverage for business use, as well as reviews of local zoning and business registration requirements. "Focusing on these details at the outset will pay dividends later on," she stated.

Independent contractors are subject to self-employment tax, which is comprised of Social

Security and Medicare taxes (FICA). The self-employment tax is comparable to the taxes withheld from the wages of W-2 employees and amounts paid by employers on their employees. Employees pay 7.65% in FICA taxes, but employers withhold the amount directly. In addition, the employer "matches" the FICA withholding. Employees obviously have the benefit of a "match" from their employers. An independent contractor - being independent - does not have an employer to "withhold" the amount or to "match" the contribution.

Kathryn Winthrop, a certified public accountant has a recommendation to reduce the impact of self-employment tax. "I recommend that subcontractors set aside in a savings account each month at least 15% of the net income (income less expenses) they have received to cover the self-employment tax," Winthrop stated. "The self-employment tax for 2008 is 15.3% of the first \$102,000 of net income. Self-employment tax payments should be made quarterly along with estimated income taxes. Subcontractors are often shocked at tax time at how much they owe, unless they have been paying estimated taxes throughout the year," she added.

The self-employed cannot directly deduct the cost of their health insurance premiums, according to Winthrop. Instead, the cost is deducted from adjusted gross income and is not considered an "ordinary and necessary" expense. "The tax inequity faced by the self-employed when purchasing health insurance lies in the fact that they do not receive a business deduction for health insurance premiums. The self-employed are the only business entity that does not receive a full deduction of health care costs," stated NASE National Tax Advisor Keith Hall. Independent contractors can, however, deduct office expenses on IRS Schedule C that are incurred in earning income.

The burden of having to provide healthcare for one's self or others can be costly. Subcontractors who are not covered through a spouse, association, or trade union need to enter the individual market. "If you do need to buy individual health insurance, the medical underwriter's spotlight will be tightly trained on you. Any pre-existing condition can nix the application, boost the cost of premium, or cause the underwriter to exclude coverage of some conditions altogether," according to NASE. The purchase of disability insurance should also be considered to guarantee income continuation in the event of an accident or disability. Life insurance will provide for heirs and dependents.