

INDEPENDENT CONTRACTOR PROS AND CONS

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What are the differences between being an Independent Contractor with income reported on a 1099 versus an employee with income reported on a W-2?

Employee Benefits

Employers often provide liability, life, health, and disability insurance as part of a group benefit plan. An independent contractor must purchase each of these on their own, which is typically more expensive. Employers are required to pay unemployment (FUTA) taxes on their employees' wages and maintain worker's compensation coverage for their employees. Independent contractors lack these benefits during periods of unemployment or compensation for disabilities incurred while performing their contracted duties. Independent contractors lack the potential job security of an employee and are also responsible for costs associated with maintaining their own training, equipment, tools, and oversight.

Tax Difference

Independent contractors are responsible for paying their own income tax and may be required to make estimated tax payments throughout the year. Compared to employees, independent contractors must pay for both the employer's portion and the employee's portion of the Social Security and Medicare taxes.

Consider \$200,000 of earned income for 2022:

	Employees		Independent Contractors	
First \$168,600 of Income	\$12,897	7.65%	\$25,795	15.30%
Last \$31,400 of Income	\$455	1.45%	\$910	2.90%
Total on \$200,000	\$13,353	6.68%	\$26,706	13.35%

Employee: 7.65% in FICA taxes (using 2024 rates) on the first \$168,600 of earned income and plus 1.45% on income above that. Independent Contractor: 15.3% in FICA taxes on the first \$168,600 of earned income and plus 2.9% on all income above that.

There are ways to mitigate this FICA tax. Instead of the independent contractor receiving 1099 income, the income goes to a business entity such as an LLC or Corporation owned by the independent contractor. A W-2 salary can then be received from their own business entity, allowing FICA taxes to only impact the salary coming from the business entity. The remaining money can then be distributed to the contractor as a K-1 distribution and does not result in any FICA tax.

Please contact your tax advisor for more information on this strategy.

The second tax difference is business expense deductions. Employees may deduct unreimbursed business expenses only if those expenses are itemized and exceed 2% of their AGI. Independent contractors may deduct all qualifying business and receive a dollar-for-dollar deduction for these expenses from the very first dollar. Consider an income earned of \$200,000. An employee would have to spend \$4,001 in business expenses to get a \$1 deduction, whereas every dollar the independent contractor spends in qualifying business expenses is deductible.

Retirement Plan Differences

Employers often offer employees a retirement benefits that includes a fully or partially funded retirement plan such as a 401(k) plan. It is common for employers to match employee contributions up to a certain level of elective deferrals. Access to employer sponsored plans may limit an employee's ability to utilize other potential retirement savings and investment plans. Independent contractors have more options available but must set up and fully fund their own retirement accounts.

The benefit for employees is that they may receive an employer match but are limited to thresholds such as \$23,000 (in 2024) per year for 401(k), 403(b), and 457(b) contributions. Furthermore, there are limitations to the employer's plan provisions such as vesting schedules, eligibility requirements, and limited investment options. It is not unusual for some solo or small physician practices to have a 1 year waiting period before employee contributions are permitted. Or worse yet, the solo or small practice does not offer a pre-tax savings option at all.

In summary, independent contractors can implement any or a combination of several types of retirement plans to include solo 401(k), SEP (Simplified Employee Pension), Defined Benefit Pension Plan, and Money Purchase Plan. Not only are there no limitations from the employer (vesting, fund options, etc...), but the IRS allows the independent contractor to contribute both as an employee and employer, contributing up to \$69,000 pre-tax in their SEP in addition to \$23,000 in their Individual 401 (k).

Although independent contractors will pay more in FICA taxes and be required to procure their own health and disability benefits, they do not have to meet a 2% threshold in order to take their first dollar of business expenses as a deduction and they can potentially put more money away in their pre-tax savings plan thus pulling back their taxable income.

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