Anjali:	00:08	Hi everyone. Thanks for tuning in to today's episode of Money Checkup where we take a deep dive into matters related to money, business and personal finance. I'm your host Anjali Jariwala, CPA and Certified Financial Planner. In today's episode, I'm going to walk through things to consider when you're an independent contractor, also known as in at 1099 including the difference between an independent contractor and an employee tax planning, opportunities to consider including, you know, whether to set up a legal entity. And then I'll wrap up by going through the qualified business income deduction for pass through entities, which was a new tax deduction that came up with the new tax law that was effective as a 1/1/2018 so let's start with what exactly is the difference between an independent contractor and an employee. So as an employee, you usually receive benefits from your employer, things like health care coverage, uh, ability to contribute to an employer sponsored retirement plan and more including, you know, life insurance, disability, things like that. You will also have tax withholding done for you. What withholding is, is that it's tax that your employer actually takes out of your pay stub each pay period and they remitted back to the IRS on your behalf. The reason why is the IRS actually requires everyone to pay in their taxes throughout the year. If you don't do it, you may get hit with penalties and interest. When you file your tax return.
Anjali:	01:43	On the contrary and independent contractor is not going to have any withholding done on his or her behalf. You're contractors, you are not considered an employee of the company and they can essentially, you know, let you go at any time. So because of this, you actually usually need to do estimated tax payment, which requires sending in four payments throughout the course of the year. So you have to both save them money to send it in and do some basic estimates in calculation so you can send in roughly the correct amount. Otherwise, as I mentioned before, there may be underpayment penalties. A quick way to do estimated tax payments is to safe harbor them. So what safe harbor means is essentially you pay in either a 100% of your current year tax liability or 110% of your prior year. And that's for high income earners. The amounts are slightly lower if you're not deemed a high income earner. So you could look at your prior year tax return, see what the tax amount was, multiply it by 110% and then make sure you pay that either all in the first quarter, which is due by April 15th or evenly throughout the year.
Anjali:	02:52	Further as it is 1099 income earner, you don't receive benefits such as the employer subsidized health care. So I tell clients who are looking at a W2 position versus a 1099 to negotiate a

higher pay to offset the fact that you're going to be paying for your own benefits. And technically it's cheaper for the employer to have you because they're not paying in a lot of additional costs that they would as an employee. So the next piece of an employee versus a 1099 independent contractor is social security and Medicare. So social security taxes, 12.4% but there is a wage cap on it. The wage cap is about $128,000 for this year. Medicare taxes, another tax that has no wage cap and that is 2.9% and then if your income is above a certain level of $200,000 for an individual or $250,000 for a married couple, there's an additional Medicare tax of 0.9% that's usually assessed on your tax return. Unless you're already making above that amount than your employer's going to put that into your payroll as well. So as an employee, you're required to pay 50% of the social security and Medicare tax and your employer actually pays the other 50% I as an independent contractor, you actually have the burden of paying the full 15.3% so these taxes are going to be in addition to your federal, state and local income taxes. So that could be a fairly sizable tax burden. So it's something to also look at and consider when you're in a position where you're debating between an employee position or a 1099 position. So when you paid the entire 15.3% this is known as self employment tax, and you do get a deduction for one half of the amount you pay. So there is a little bit of an offset.

Anjali: 04:44 Sometimes people will ask, why be an independent contractor? It seems like you pay more tax and you may not get any benefits from your employer. And the reason why is there's a lot of tax planning opportunities that exist for independent contractors. So when you received the income as an independent contractor, it's reported on the form 1099 instead of a W2 so you're essentially considered a business owner and because you're a business owner, you can offset your income with business expenses. So let's say for example, you're required to drive to multiple hospitals for your shifts. You may be able to deduct the mileage or even the entire cost of your car. Other Business expenses. If you're, you know, a healthcare professional may include association dues, you know, cost of your boards, medical licenses and more so you have to kind of look carefully before making these deductions. And if you're unsure, you know, always consult with a CPA to determine which expenses are eligible. The nice part about these expenses is that you can offset your income by these expenses and reducing the amount of income will essentially reduce the amount of self employment tax you pay. The new tax law that went into effect as of January 1st, 2018 actually got rid of unreimbursed employee expenses, which is usually on schedule

A as an itemized deduction. So I had a handful of clients who incur a lot of costs as an employee that they're not reimbursed for and they were able to get a deduction for that. But the new tax law that essentially got rid of that, so the 1099 independent contractor, that's a really good way to be able to take a lot of those business deductions to offset that income you're earning.

Anjali: 06:21 The other nuance with being an independent contractor is healthcare premiums. So if you're an independent contractor, we usually aren't getting any sort of benefits. You may have to get your own health care policy, which can be pretty expensive anywhere from a few hundred dollars as an individual up to over a thousand if you're a family of two or more, since medical costs are rising and you're paying for that out of pocket, that's usually a deduction that you can take on page one of your tax return if you're an independent contractor.

Anjali: 06:54 The other great benefit of being an independent contractor is potentially being able to put more away into your retirement plan. So as an employee you're usually eligible to contribute to some sort of tax deferred retirement plan such as a 401(k) or a 403b, and the maximum contribution for an employee is 19,000 for 2019 that limit has gone up since 2018 by $500 and your employer may also provide some sort of match or profit sharing contribution for you as well. When you're an independent contractor, you can actually set up your own retirement plan. Usually the most common ones are a sep IRA or a solo 401(k) for your business. So the maximum contribution for these plans is actually 56,000 for 2019 the way these plans work is that it's made up of two parts. There's an employee deferral and a profit sharing. The profit sharing is capped at 25% of your income. So as a business owner a year, essentially both the employee and the employer. So you could put away your employee deferral of 19,000 and you know the remaining 36,000 or so, if that makes up 25% of your profit share. This you usually are not able to do. If you're an employee, you can usually only do the employee deferral amount because the profit share is usually done on the employers side. That may be different if you're a partner or a practice owner, but usually if you're just a regular W2 employee a year kind of kept us to how much you can put in.

Anjali: 08:25 So a quick example just to help everyone follow. Let's assume we have Julie, which is an emergency medicine physician, and she earns 300,000 as an independent contractor. She offsets that 300,000 with business expenses of 50,000 so her net profit in the business is 250,000 Julie then sets up an individual 401k for her business and contributes 19,000 as an employee. Since she's also the owner of the business, she can contribute another

25% of her 250,000 profit. But obviously there is a cap at 56,000 for the year, so she can put away up to that amount to essentially hit the max for the year. So thus Julie is able to put away 56,000 into a retirement plan, which she receives a tax deduction for. If she were an employee, she would probably be limited to just depositing the 19,000 of her income into the retirement plan. And then she'd have to rely on any sort of employer match to have that amount be higher.

Anjali: 09:25 So the other nuance with being an independent contractor and that I get a lot of questions on is what is an S corp election and should someone make that election? So when setting up a business, it's important to set up a legal structure for your business. The most common ones are limited liability companies, LLCs and corporations. So I always suggest that people check their state's rules because many states do not permit certain professions to set up an LLC. For example, California is a state that does not allow medical professionals to set up an LLC. So they're actually required to set up a professional services corporation, which is a corporation, not an LLC. So the main difference between an LLC and a corporation is how the income is reported and who pays the tax on the profit. The net profit of an LLC is reported on the owner's individual tax return because an LLC is considered a flow through entity. So anything reported at the LLC level essentially will flow through to your individual tax return. This differs from a corporation. The corporation itself is a separate taxable entity. So the corporation is actually going to pay tax on any of the profits. And then if the owner takes some of that profit as a distribution, it's taxed to the owner again as a dividend. So the corporation has two layers of taxation. So it's important to really think about which legal structure makes the most sense for you and and the type of business you have. The S corporation is, is somewhat of a hybrid between the LLC and a corporation. With an s corp, it's purely a tax election, so it's not a legal entity. So you still need to set up either an LLC or corporation and then you make this election as part of your tax filings. So with the S corporation, it works similarly to an LLC in that the income passes through to the owner's individual tax return. So if you, let's say are in California and you have your corp, your regular Corp, you couldn't make an S corp election. And so instead of it being a separate taxable legal entity, it becomes a flow through and reported on your individual tax return. Just like an LLC. The main benefit of an S corporation is self employment tax savings. Mainly it's for Medicare, which if you remember earlier in Medicare is 2.9% and then if you're a high income earner it could be an additional 0.9% so as an LLC, all of your profit is subject to self employment tax, which is social security and Medicare. But as an S corporation, only the portion that you report as a salary is subject to the self employment tax.

Anjali: [12:03] That means you can shield some of your income from self employment tax. I always caveat this by saying that this area is usually highly scrutinized by the IRS, so it's important to select a salary that's reasonable for your specialty. This is where reliance on a CPA is really important, who has experience with this because they can usually set that reasonable salary for you and then you know, have some sort of inflation adjustments. So it does go up every year. The amount of salary and wages reported. For most high income earners, it's probably going to exceed that social security wage base, which is about 128,000 so the true savings is, is really that in Medicare tax at 2.9% in potential 0.9% and then the other thing to keep in mind when you're an S corporation is that circling back to the retirement plan contribution, when you're doing your profit share piece, which is 25% if you're an S corp, the 25% is based off of your salary, not the entire net profit of the business. So for many of my clients, we want to kind of set that salary to a level that's reasonable, but also where we can make sure we're maximizing that four one k plan for them if it makes sense.

Anjali: [13:19] So let's go through other items in regards to this. One question that comes up is if someone's earning income as a W2 and an independent contractor, should they still do an S corp election? So this does come up regularly. I've seen it in my practice and just people emailing me about this. And the answer really depends on how much is allocated to each bucket. So when you earn income as an employee, you're going to pay your employee portion of social security and Medicare tax and then your employer is going to cover the other half. But if you also earn income as an independent contractor and make that S corporation election and take that reasonable salary, you're going to be subject to Medicare and social security tax on that income as well. So these taxes are assessed by jobs. So you're essentially going to pay social security tax on an amount that could be higher than the potential wage limit of 128,000 so when you're an employee, you actually receive a credit if you overpay your social security tax. But there is no credit as an employer. So remember when you're, you know that 1099 year, the business owner, so you essentially wear the hat of both the employee and the employer. So you're paying in both portions of social security and Medicare. So that employer piece one half of that amount, you may not get a credit for if you're overpaying it. So usually an additional calculation is needed to see whether the S corporation makes sense or if you're better off sticking to being a sole proprietor or an LLC. When you're a sole proprietor and you're filling out your self employment tax form, there's actually going to be an item on the form in which it asks you how much wages have you already paid into social security and Medicare. And you'll actually report that. So you won't overpay if you're just a sole proprietor and LLC, but you may overpay if you've made that S corp election. So that's where having a CPA look at that and run the numbers is helpful. In my experience. If someone's kind of split 50 50 or you know they have more w two income than 1099 it usually doesn't make sense to make that S corp election and better to just keep it as a sole proprietor. You still are going to receive the benefit of being able to hopefully offset some of that income with deductions. But you may not get the, the full medicare tax savings with an S corp election and it's outweighed by the fact that you're an over pay on social security and that that percentage is higher.

Anjali: [15:50]

So that wraps up the tax planning around being an independent contractor. So I did want to walk through the qualified business income deduction for pass through entities. I've received a lot of questions over the past year on this topic and the IRS finally issued their regulations towards the end of 2018 so there was a lot of uncertainty as to how exactly the mechanics of this would work. So let's start with what exactly is the qualified business income deduction. I'm going to call like QBI going forward. So the deduction is up to 20% of your qualified business income from a business operating as a sole proprietor, a partnership and S corporation estate or trust. So note that this is for pass through entities. So corporations are not part of this definition. The new tax law provided corporations with a more favorable tax rate of 21%. So if your taxable income exceeds 315,000 for a married couple filing a joint return or 157500 for all other taxpayers, this deduction is going to have limitations than tax law also provides a 20% deduction for REIT dividends when that has no income limitation set for it. So REIT investments tend to be highly inefficient. So many people like to keep those in tax deferred accounts such as a 401k or an IRA or a Sep IRA. But this new deduction of 20% of the dividends presents an interesting opportunity to consider putting it in a taxable account. But once again, a REIT is going to kick off all other types of tax implications as well. Um, not just dividends, so some ordinary income and capital gains, things like that. So it'll come down to looking at the numbers to see if it makes sense and where exactly you put that in terms of your investment accounts. So if your taxable income exceeds those thresholds I mentioned the deduction may be limited and the limitations are based on a few things. The first is the type of business, the amount of W2 wages paid. And then the final limitation is your unadjusted basis of property used in a trader business.

Anjali:	[18:07]	So what is a qualified trader business? So a qualified trader business is any trader business except a specified service trade or business. So a specified service trade or business is going to be a trader business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts consulting, athletics, financial services, investing, trading, dealing in certain assets or any trade or business where the principle asset is the reputation or scale or of one or more of its employees are owners. So a pretty broad definition here. The one caveat is that the specified service trade or business does not apply to architects and engineers. Not sure why those two got the little special treatment there, but it is what it is. So this specified service trade or business is important because this is one of the exceptions for the deduction. So if your taxable income is above 315,000 for married filing joint return, or the 157500 this specified service trade or business limitation is going to apply, which I'm gonna explain next.
Anjali:	[19:17]	So what happens with the deduction is that it's 20% of your qualified business income and what the qualified business income is. It's your net amount of qualified items of income. So looking at all the income of your business and then offsetting it with any expenses or losses attributable to that business. This calc is done on a business by business level, but the threshold amounts that I mentioned the 315000, 157500 is based on taxable income. So if you're filing a joint return than your spouse's items are going to also be included. So that's something to keep in mind when you're thinking about this deduction. The QBI also does not include reasonable compensation paid to the taxpayer by the business. So this would be your S corporation wages, or if you're a partner, guaranteed payments that are made to you.
Anjali:	[20:09]	So how exactly is the deduction computed? So the deduction is actually 20% of your qualified business income. So if your taxable income is above those threshold amounts, it's going to be further limited based on the limitations I described earlier. So let's talk about the first one, which is your specified service trader business. So if you're an SSTB, there is no limitation if your taxable income is below the threshold amount. So if you're taxable income is below three 315000 or 157500 you get the full 20% deduction, no limitation applies. There is a phase in range that applies for specified service trade or businesses. So if the phase in, if you're a married couple filing, a joint return is

315,000 to 415,000 and if any other filing status, it's 157500 to 207,500 so once you're above that phase out amount, the 415-- or the 207,500 no deduction is going to be allowed to. You're, you're pretty much out of luck. So any high income earner, even if you have a pass through business and you're above those amounts, you you pretty much aren't going to get any benefit from this new tax deduction. So if you're within the range though, you may receive some of the benefit, the lower you are to the 315000 the closer you'll be to getting the full 20% and then the closer you are to the high end of the amount, the 415,000 the smaller your deduction is going to be. So if you're not a specified service trade or business, there is another piece of the limitation that may apply. So this limitation is going to apply for both specified to trade or businesses. If you're in the phase out range, which is that 315,000 to 415,000 or the 157500 to 207500 so this limitation is based on the greater of half of the W2 wages that are attributable or paid to your trader business or 25% of the W2 wages plus 2.5% of unadjusted basis of qualified property used in the business.

Anjali: 22:23 So unadjusted basis is essentially your purchase price of the property that you're using in your trade or business. Usually property that you acquire in your business may be depreciated over a specific life, so that amount may continue to go down. But for purposes of this tax calculation, you're just taking the unadjusted basis. So even if you're a specified service trade or business and you're in that phase out range, you may still get some of the benefit based on the wages and the property that you may have in your business. If you're not as specified service trade, or business. Then once you're above the threshold amount, so that 315,500 or 157500 this is the limitation that will apply. The main stipulation between the two is that the specified service trader business is not going to get any deduction, wants the income is above 415,000 or 275,000 but if you're not in this kind of service business that you may still get the benefit because this wage and an adjusted basis of property that's been put into place is still available to you.

Anjali: 23:32 So that pretty much wraps up planning for 1099 and the new qualified business income deduction. Thanks for listening. I

Anjali: 23:41 f you enjoyed today's episode, please leave us a review on iTunes. If you have a burning question you'd like my expertise on, please visit www.fitadvisors.com and submit your question on my podcast page.