

Steve Leimberg's Income Tax Planning Email Newsletter Archive Message #126

Date:09-Jan-18

Subject: Vince D'Addona and Paul Vecchione - Section 199A's Impact on Whether to Convert to Independent Contractor Status

"New Code Section 199A sets up a Freakenomics situation where two people working for the same employer doing exactly the same job functions and making exactly the same amounts could have vastly different federal income tax liabilities. It hasn't gone unnoticed in the popular press that for the first time since the United States adopted an income tax, a higher rate would be applied to employee wages and salaries than to income earned by independent contractors and the owners of partnerships and S corporations.

That said, the benefits for employees moving to independent contractor status may be tangible, and this newsletter reviews a number of the factors that go into that decision. It also reviews a new tool that can help advisors who have been asked by clients what they should do.

With tax filing season right around the corner, many advisors have been working overtime to get up to speed on the changes in the tax bill, and haven't had time to get into the weeds on this particular issue. In the weeks and months ahead, this is one of many questions advisors may be asked to help clients with, so the stakes for 'getting it right' are significant."

Vince D'Addona and **Paul Vecchione** provide members with commentary that analyzes the impact Section 199A will have on a question many in the workforce may be pondering after the tax bill: should I remain as an employee or convert to independent contractor status.

Vincent M. D'Addona MSFS, CLU®, ChFC®, CExP®, RICP®, AEP® (Distinguished) is an advisor at **Strategies for Wealth** with 37 years of experience providing services in three core areas: Estate Planning, Exit Planning for the owners of closely held businesses and Investment Coaching. He was inducted into the NAEPC Estate Planning Hall of

Fame® in 2017. He is a nationally known practitioner with The Living Balance Sheet® and serves on the Living Balance Sheet design team and is a Living Balance Sheet faculty member. Vince has served as workshop sub-committee chair for the AALU 2010 annual meeting, in addition to being a featured speaker in 2005. Vince is a Life and Qualifying member of MDRT, Court of the Table for 28 years and Top of the Table for 14 years, and has spoken at the MDRT National Meeting. Vince is a member of the Forum400, AALU, Financial Planning Association, the National Association of Insurance and Financial Advisors, and the National Association of Estate Planning Councils. He has served as president of the New York City Chapter of the Society of Financial Services Professionals, and on the boards of the New York City Association of Insurance and Financial Advisors and the New York Estate Planning Council.ⁱ

Paul Vecchione is a **Partner of EisnerAmper Insurance & Financial Services, LLC** and head of their succession planning practice. For more than a decade Paul has specialized in both personal and corporate financial engineering. Paul's areas of concentration are pension and retirement planning, executive benefits and estate & succession planning. As a Partner of the firm, Paul has assisted in transitioning several clients' closely held businesses, and has guided CEOs and Human Resource Directors through the maze of corporate and employee benefit planning, handling the most complex issues and budgetary concerns. Paul has chaired AALU's Qualified Plans Committee for three years, and is a member of AALU's Business Insurance and Estate Planning Committee. EisnerAmper is one of the largest accounting firms in the nation with nearly 1,300 employees, including 180 partners. The firm offers responsive accounting, tax and consulting services with an entrepreneurial focus, providing clients with smart, analytical insights delivered in an approachable style.

Here is their commentary:

EXECUTIVE SUMMARY:

New Code Section 199A sets up a Freakenomics situation where two people working for the same employer doing exactly the same job functions and making exactly the same amounts could have vastly different federal income tax liabilities. It hasn't gone unnoticed in the popular press that for the first time since the United States adopted an income tax, a higher rate would be applied to employee wages and salaries than to income earned

by independent contractors and the owners of partnerships and S corporations.ⁱⁱ That said, the benefits for employees moving to independent contractor status may be tangible, and this newsletter reviews a number of the factors that go into that decision. It also reviews a [new tool](#) that can help advisors who have been asked by clients what they should do.

COMMENT:

Section 199A presents workers with an interesting question: should I remain as an employee or convert to independent contractor status? With tax filing season right around the corner, many advisors have been working overtime to get up to speed on the changes in the tax bill, and may not have had time to get into the weeds on this particular issue. In the weeks and months ahead, this is one of many questions advisors may be asked to help clients with, so the stakes for “getting it right” are significant.

So, how does one begin the task of analyzing this complex question, and what factors should advisors and clients consider? A [new tool](#) developed by Leimberg Information Services, Inc., can help advisors with the quantitative part of the analysis.

The [tool](#) computes federal income and employment taxes for an employee by taking into account an employee’s wages, any qualified retirement plan salary deferrals, and other employer provided benefits. The tool also computes federal income and employment taxes for an independent contractor based on the independent contractor’s revenue, deductible business expenses, the deduction for half of self-employment taxes, the self-employed health insurance deduction, any qualified retirement plan contributions the independent contractor makes on his/her behalf, and the new section 199A deduction that the independent contractor may be allowed to take as a business owner.

The tool compares the employee’s taxes to the independent contractor’s taxes to determine who pays less federal income and employment taxes based on the inputs. Additionally, the tool will calculate the amount of employer provided benefits that may be given up by converting to independent contractor status based on the inputs into the tool, as advisors and clients may want to factor those into any decision on whether or not to convert.

Below is a screenshot of the [tool](#) and the input screen.

W-2 Employee vs. Independent Contractor Analysis

Filing Status

Married Filing Joint ▼

Annual W-2 Items

W-2 Wages (W-2 Box 1) ①	500,000
Qualified Retirement Plan Salary Deferrals	18,000
Employer Qualified Retirement Plan Matching & Profit Sharing Contributions	5,000
Qualified Defined Benefit Plan ①	0
Employer Contributions to Non-Qualified Deferred Compensation Plan ①	20,000
Employee Cost of Health Insurance ①	5,000
Other Pre-Tax Employee Benefits ①	1,000
Other After-Tax Employee Benefits ①	500

Annual Independent Contractor Items

1099 Receipts	500,000
Cost of Health Insurance for Sole Proprietor	8,500
Deductible Business Expenses	15,000
Sole Proprietor's Qualified Retirement Plan Contribution	28,000

IRC 199A Deduction

(Input from 199A Calculator) 50,000

W-2 Employee Federal Tax Analysis

Income Taxable Earnings	\$500,000
Federal Income Tax Payable	\$126,379
Employee Share of Employment Taxes Payable	\$18,354
Total Federal Income Taxes and Employment Taxes Payable	\$144,733

Independent Contractor Federal Tax Analysis

Net Taxable Income from Business	\$383,154
Federal Income Tax Payable	\$85,988
Self-Employment Taxes Payable	\$30,692
Deductible Part of Self-Employment Taxes	\$15,346
Total Federal Income Taxes and Employment Taxes Payable	\$116,680

Who Pays Less Federal Income and Employment Taxes?

Independent Contractor

Lost Employer Benefits If Become Independent Contractor ①

\$30,000

Non-Tax Factors Impacting the Decision

Even if an employer is willing to allow an employee to convert to independent contractor status, there are many non-tax factors that influence this decision. For example, employees generally have access to unemployment insurance, workers' compensation, are protected by anti-discrimination laws, and may have other federal and state law benefits that are not afforded to independent contractors. Clients and advisors may want to take those laws and protections into consideration when determining whether it is more advantageous to be an employee or an independent contractor. Group benefits that may be available through an employer that are not available as an independent contractor may also be taken into consideration.

Worker Classification: It's Not As Simple As Saying "I'm an Independent Contractor"

The general rule is that an individual is an independent contractor if the payer has the right to control or direct only the result of the work, not *what* will be done and *how* it will be done. Small businesses should consider all evidence of the degree of control and independence in the employer/worker relationship. Whether a worker is an independent contractor or employee depends on the facts in each situation.

Factors Traditionally Used to Classify Workers

To better determine how to properly classify a worker, the IRS generally looks at three criteria: 1) Behavioral Control, 2) Financial Control and 3) Relationship of the Parties.

Behavioral Control

A worker is an employee when the business has the right to direct and control the work performed by the worker, even if that right is not exercised. Behavioral control categories are:

- Type of instructions given, such as when and where to work, what tools to use or where to purchase supplies and services. Receiving the types of instructions in these examples may indicate a worker is an employee.
- Degree of instruction, as more detailed instructions may indicate that the worker is an employee. Less detailed instructions reflect less control, indicating that the worker is more likely an independent contractor.
- Evaluation systems to measure the details of how the work is done points to an employee. Evaluation systems measuring just the end result point to either an independent contractor or an employee.
- Training a worker on how to do the job—or periodic or on-going training about procedures and methods—is strong evidence that the worker is an employee. Independent contractors ordinarily use their own methods.

Financial Control

Does the business have a right to direct or control the financial and business aspects of the worker's job? In this regard, the IRS looks at the following factors:

- Significant investment in the equipment the worker uses in working for someone else.
- Unreimbursed expenses, as independent contractors are more likely to incur unreimbursed expenses than employees.
- Opportunity for profit or loss is often an indicator of an independent contractor.
- Services available to the market. Independent contractors are generally free to seek out business opportunities.
- Method of payment. An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time even when supplemented by a commission. However, independent contractors are most often paid for the job by a flat fee.

Relationship Between the Parties

The type of relationship depends upon how the worker and business perceive their interaction with one another. This includes:

- Written contracts which describe the relationship the parties intend to create. Although a contract stating the worker is an employee or an independent contractor is not sufficient to determine the worker's status.
- Benefits. Businesses providing employee-type benefits, such as insurance, a pension plan, vacation pay or sick pay have employees. Businesses generally do not grant these benefits to independent contractors.
- The permanency of the relationship is important. An expectation that the relationship will continue indefinitely, rather than for a specific project or period, is generally seen as evidence that the intent was to create an employer-employee relationship.
- Services provided which are key activities of the business. The extent to which services performed by the worker are seen as a key aspect of the regular business of the company.

Consequences of Misclassifying an Employee

Classifying an employee as an independent contractor with no reasonable basis for doing so makes employers liable for employment taxes. Certain employers that can provide a reasonable basis for not treating a worker as an employee may have the opportunity to avoid paying employment taxes.ⁱⁱⁱ

Note that the IRS's Voluntary Classification Settlement Program (VCSP) offers certain eligible businesses the option to reclassify their workers as employees with partial relief from federal employment taxes. The IRS tries to help employers determine the status of their workers by using Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. IRS Publication 15-A, Employer's Supplemental Tax Guide, is also an excellent resource.

Workers who believe an employer improperly classified them as independent contractors can use Form 8919 to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. The IRS Small Business and Self-Employed Tax Center also has resources for small businesses as well as self-employed independent contractors.

Conclusion

As demonstrated above, it may not be as simple as changing one's title from employee to independent contractor status, as there are various tests that need to be met if a worker isn't to be classified as an employee. If there is no substantial change in the individual's work function and/or the employer's control over the individual's work, the individual may still be classified as an "employee" for tax purposes and state and federal law purposes even though the individual purports to be an independent contractor. And advisors must weigh the many non-tax factors that influence the decision. Finally, it cannot be overlooked that not all employees will have the ability to even try to convert to independent contractor status because the current employer may prefer having an employee versus an independent contractor and/or the employee may not have the leverage to request such a change.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Vince D'Addona

Paul Vecchione

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ⁱⁱ [Patricia Cohen, "Tax Plans May Give Your Co-Worker a Better Deal Than You" New York Times, Dec. 9, 2017.](#)

ⁱⁱⁱ See [Publication 1976, Section 530.](#)