Independent Workforce Issue Brief

Tax Challenges

Overview

Independent workers face complex and burdensome tax rules. Independent workers pay more taxes than traditional employees because the tax code overlooks them in some instances, and directly targets them in others. Freelancers pay higher social security and income taxes than standard employees. They have limited access to the pre-tax health care financing available to standard employees. Many must keep detailed records, set aside money, and make tax payments each quarter because they don't have access to a streamlined system of tax payment like payroll deductions from a regular paycheck.

Self-Employment Taxes

Self-Employment Tax is a social security and Medicare tax imposed on freelancers and other self-employed workers.[1] It is identical to the social security tax withheld from the pay of most workers, but because they are required to contribute both the employer and the employee portions of the social security tax, the self-employed pay at a rate of 15.3% of net earnings — double the amount paid by traditional employees

The high social security tax rate is a significant expense for many independent workers. Is it reasonable to require the self-employed to pay double social security taxes because they can be considered both the employer and the employee, despite the fact that they are a single worker? As the number of self-employed workers grows, it may become time to consider strategies aimed at equalizing the social security tax burden across all workers.

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Estimated Taxes

Independent workers who meet the legal definition of self-employment are required to pay income taxes in quarterly installments since tax is not withheld from a paycheck on a regular basis. Estimated taxes create a bookkeeping challenge, and for many, require the help of a tax professional. The added expense of such professional help can be difficult to manage for many low- to middle-income earners.

Unincorporated Business Tax

The New York City Unincorporated Business Tax is a 4% income tax that anyone operating an unincorporated business in New York City must pay in addition to regular federal, state, and city income taxes. For many workers in NYC, the UBT is unfair double taxation, as income is taxed as both business income and personal income. However, individuals that live in NYC do receive a credit on their personal NY tax return for a portion of the UBT tax they pay.

Many of those subject to the UBT aren't traditional businesses, or even whom we think of when we talk about small business owners. Unincorporated businesses include freelancers, temps, and consultants. They are fine artists, designers, massage therapists, computer programmers, writers, and many other independent professionals. These individuals often function more like employees than businesses. Unfortunately, however, they pay taxes as if they are both.

Unincorporated businesses must pay UBT once they earn more than $55,000 a year in net income, though the full impact of the tax does not take effect until an individual makes more than 90,000 a year in net income. The tax is phased in gradually to be 4% once the net income is above $90,000 (for 2005). Due to the high cost of living in New York, and the resulting higher earnings, many independent workers are subject to this tax.

EXAMPLE 1

The Impact of UBT and Self-Employment Tax

Consider the following hypothetical example of Tom, a 36-year-old graphic designer whose net income after deductions was $95,000 in 2005. Tom is liable for approximately $3800 in UBT for 2005, or nearly $300 a month in additional taxes. His social security tax taxes are approximately $14,000 for 2005, twice what he would pay as an employee. In short, Tom paid nearly $11,000 in taxes, over 10% of his income, that he would not have paid if he were an employee rather than a freelancer.

Tax Deductions for Health Insurance Premiums

Independent workers who are considered self-employed qualify to deduct the full cost of their health insurance plans on their federal income tax return.[2] Some states also allow such a deduction. Unfortunately, the income used to pay for health insurance is still subject to social security taxes, which are doubled for these workers. While a traditional employee can receive the full value of his health insurance plan from his employer with no additional tax liability, a self-employed worker must pay social security taxes on his income before purchasing health insurance.

EXAMPLE 2

Unequal Tax Treatment of Health Insurance Premiums Hurts the Self-Employed

Joe is a full-time standard employee. As part of his benefits package, his employer pays for his health insurance on his behalf, at a cost of $500 a month. This benefit is worth $6000 a year, but the IRS does not count it as income, and Joe does not pay any additional taxes on its value.

Sally is a full-time freelancer. She nets about $50,000 a year. She does not receive health insurance from an employer. If Sally were to purchase a plan priced at $500 a month (which would likely be much less comprehensive Joe's plan, given the higher prices in the individual market), she would have to do so after paying social security taxes. If she could use pre-tax dollars she would save approximately $900 per year in social security tax.

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Both Sally and Joe have health insurance plans valued at $6,000 a year. Joe, however, doesn't have to pay income taxes on the value of his plan. Sally pays social security taxes, and possibly state and local taxes, on her income before she can purchase health insurance. This disparity is arbitrary and unreasonable. Like traditional employees, independent workers should not have to pay taxes on income used to purchase health insurance.

Using a Health Savings Account (HSA) is one way to counterbalance this disparity. An HSA account allows self-employed individuals to pay for medical expenses (up to a specified ceiling) with pre-tax dollars as long as they also have an accompanying high deductible health insurance plan. The money spent on premiums for the high deductible plan is subject to taxes as discussed above.

Certain independent workers are classified as employees, though they receive no employer-sponsored benefits. Among them are those who hold several part-time jobs and those who work in long-term temporary positions ("permatemps").

These workers are not eligible to access the health insurance tax deductions designed for the self-employed. Because these individuals are not considered self-employed, they are stuck in the gap between employer-sponsored benefits and alternatives designed for the self-employed. These workers can't purchase health insurance with pre-tax dollars, because they don't qualify for either an employer plan or the self-employment tax deduction.

EXAMPLE 3

Lack of Health Insurance Deduction Hurts Independent Workers Classified as Employees

Let's return to the example of Sally. If she works as a "permatemp", at a graphic design firm, rather than as a freelance graphic designer, she can't take a deduction for her health insurance expenses.[3] The federal deduction would save her approximately $1800 a year. If she could purchase her health insurance with dollars that have not been assessed for federal or social security taxes, she would save approximately $2250 a year.

Conclusion

Independent workers should not have to pay more taxes than traditional workers because of an arbitrary distinction between traditional and alternative work arrangements. The independent workforce deserves more equitable tax treatment and a streamlined tax code.

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Sources

IRS Information on Self-Employment Tax:
http://www.irs.gov/businesses/small/article/0,,id=98846,00.html

IRS Information on Estimated Taxes:
http://www.irs.gov/businesses/small/article/0,,id=110413,00.html

IRS Information on the Self-Employed Health Insurance Deduction:
http://www.irs.gov/publications/p334/index.html

IRS Information on Employees Versus Independent Contractors:
http://www.irs.gov/businesses/small/article/0,,id=99921,00.html

New York City Information on UBT:
http://www.nyc.gov/html/dof/html/business/business_tax_ubt.shtml

Footnotes

[1] Self-employment tax is paid on income from self-employment that is reported on Schedule C of IRS form 1040, the personal income tax return. Workers whose employers/ clients report their earnings on 1099 forms, rather than W-2s, typically pay self-employment tax.

[2] If, however, a self-employed worker is eligible to participate in an employer-sponsored plan through a spouse, he cannot take the deduction regardless of participation in that plan.

[3] As a 'permatemp' Sally is considered an employee rather than self-employed, so she can't take the self-employed health insurance deduction. To the extent that Sally's insurance expenses exceed 7.5% of her Adjusted Gross Income she is eligible to take a federal income tax deduction for medical expenses if she itemizes deductions.

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Howard Samuels, CPA, MST
Jonathan Henry

Freelancers Union
45 Main Street, Suite 710
Brooklyn, New York 11201
718-532-1515

www.freelancersunion.org