

AIGA

Independent Contracting

by
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Many designers work as independent contractors. This guide provides an overview of the legal and tax basics that independent contractor designers need to know.

What Is an Independent Contractor?

For tax and most other legal purposes, there are only two types of workers: employees and independent contractors. Independent contractors are in business for themselves. Employees work for someone else's business. Independent contractor designers may use a variety of descriptive labels, including:

- » *Self-employed*
- » *Freelancer*
- » *Creative professional*
- » *Consultant*
- » *Business owner*

These labels are often used interchangeably. None has any legal significance except for “independent contractor.”

Independent Contractors vs. Employees

Although they may perform the same type of work, employees and independent contractors inhabit different tax and legal universes. Here are some of the main differences:

Differing tax treatment: Independent contractors are treated very differently from employees for tax purposes. One of the most significant differences is that no taxes are withheld from your pay when you are an independent contractor. In contrast, employers must withhold federal and state income tax, as well as Social Security and Medicare tax, from their employees' pay and send it the IRS and state tax agencies. Instead of having their tax withheld, independent contractors must pay estimated taxes four times per year directly to the IRS and their state tax agency (see below). Independent contractors can deduct any necessary expenses related to their business. Employee's work-related deductions are severely limited. Some deductions available to independent contractors may not be taken by employees.

No job benefits for independent contractors: Although not always required by law, employers typically provide their employees with health insurance, paid vacations, and paid sick leave. More generous employers may also provide retirement benefits, bonuses, and even employee profit sharing. Independent contractors get no such benefits—for example, they must pay for their own health insurance. Independent contractors are also not entitled to unemployment insurance benefits or employer-provided workers' compensation coverage. Because they need not be provided with such benefits, it is often cheaper for clients to hire independent contractors than employees.

Few or no labor law protections for independent contractors: A wide array of federal and state laws protects employees from unfair exploitation

by employers. These include wage and hour laws, minimum wage laws, and requirements for family and medical leave. These labor law protections typically do not apply to independent contractors. Thus, for example, a designer who is an employee may be legally entitled to time-and-a-half for overtime, but a designer who is an independent contractor won't be.

Independent contractors pay their own work expenses: Employees' job-related business and traveling expenses are ordinarily paid by the employer. Employers also normally provide their employees with an office or space in which to work, and the equipment they need to do the job. If assistants are required to help do the work, the employer pays for them. Typically, independent contractors pay their own business expenses, although the client may reimburse them for some work-related expenses—this is always a matter for negotiation. An independent contractor usually provides his or her or her own workplace and equipment, and recruits and pays for any assistants.

Independent contractors are not dependent on one client: Although employees can have more than one job at a time, employers can require loyalty and prevent employees from taking some alternative jobs. Independent contractors market their services to the general public and usually work on a project basis. They typically have multiple clients and are not economically dependent upon, or under the control of, one client.

Independent contractors can't quit or be fired at will: Ordinarily, an employee may quit or be fired by the employer at any time with no legal consequences (unless discrimination or other wrongdoing is involved). An independent contractor's relationship with a client can be terminated only according to the terms of their agreement. If an independent contractor quits in breach of the client agreement, the client can sue for damages. Likewise, if a client terminates the relationship in violation of the agreement, the independent contractor can sue the client for any damages incurred.

Are You an Independent Contractor?

Initially, it's up to you and each client for whom you work to determine whether you should be classified as an independent contractor or employee. However, your determination is subject to review by the IRS and various other government agencies.

Because independent contractors often cost less than employees, some employers classify their workers as contractors even though they are really employees. If the IRS or another agency determines that a client has misclassified you as an independent contractor, the client may be required to pay substantial back taxes, fines, and penalties. No fines or penalties will be imposed on you, but you could lose some tax deductions. Even worse, your client could decide to dispense with your services.

So, how do you know if you're an independent contractor? Signing a written agreement stating that you are an independent contractor is always a good idea, but will not make you an independent contractor by itself; nor is a written contract required. Instead, you must satisfy the applicable legal test for independent contractor status.

The IRS and most other government agencies use the "right of control" test. Under this test, you're an employee if a client has the right to direct and control how you work, both as to the final results and as to the details of when, where, and how you perform the work. The employer may not always exercise this right. For example, if you're experienced and well trained, your employer may not feel the need to closely supervise you. But if the employer has the right to do so, you're still considered an employee.

In contrast, you're an independent contractor if the client does not have the right to control how you do the job. Because you're an independent businessperson who is not solely dependent on the client for your livelihood, its control is limited to accepting or rejecting the final results you achieve. Or if a project is broken down into stages or phases, the client's input is limited to approving the work you perform at each stage. Unlike an employee, you are not supervised daily.

If you consistently do all or most of the following, it's likely that any government agency would determine that you qualify as an independent contractor.

1. Retain Control of Your Work. Never permit a client to supervise or control you the way it does its employees. It's perfectly all right for the client to give you detailed guidelines or specifications for the results you're to achieve. But how you go about achieving those results should be entirely up to you. For example:

- » *Do not ask for or accept instructions or orders from the client about how to do your work.* It's fine for a client to give you suggestions, but you always have the option of rejecting such suggestions.
- » *Do not ask for or receive training from a client.* If you need additional training, seek it elsewhere.
- » *A client may give you a deadline for when your work should be completed, but you should generally establish your own working hours.*
- » *Decide on your own where you're going to perform the work—that is, a client should ordinarily not require you to work at a particular location.*
- » *Decide whether to hire assistants to help you and, if you do, pay and supervise them yourself; only you should have the right to fire your assistants.*

» *Do not obtain, read or pay any attention to a client's employee manuals or other rules for employees.* The rules governing your relationship with the hiring firm are contained solely in your independent contractor agreement, whether written or oral.

2. Opportunity for Profit or Loss. Because they are in business for themselves, independent contractors have the opportunity to earn profits or suffer losses. If you have absolutely no risk of loss, you're probably not an independent contractor. The best way to show an opportunity to realize profit or loss is to have recurring business expenses, such as office rent, website expenses, insurance, equipment and supplies. Getting paid by the project, instead of by the hour, can also help show that you have a risk of loss.

3. Operate Like an Independent Business. Operate your design activities like an independent business—for example:

- » *Maintain a separate bank account for your business*
- » *Obtain all necessary business licenses and permits*
- » *Obtain business insurance*
- » *Have a written business plan*
- » *Keep good records of your income and expenses*
- » *Do not obtain employee-type benefits from your clients such as health insurance, paid vacation, sick days, pension benefits or life or disability insurance; instead, charge your clients enough to purchase these items yourself.*

4. Make Your Services Widely Available. Independent contractors normally offer their services to the general public, not just to one person or entity. Make ongoing efforts to market your design services to the public.

5. Have Multiple Clients. Having multiple clients shows that you're running an independent business because you are not dependent on any one client for your livelihood.

6. Use Written Client Agreements. Use written independent contractor agreements for all but the briefest, smallest projects. Among other things, the agreement should make clear that you are an independent contractor and the client does not have the right to control the way you work. A written agreement won't make you an independent contractor by itself, but it is helpful—particularly if you draft it yourself.

Tax Basics for Independent Contractors

All levels of government—federal, state, and local—impose taxes on independent contractors. You need to be familiar with the requirements for each.

Federal taxes

Federal taxes will ordinarily be your largest tax burden. These consist of income taxes, and Social Security and Medicare taxes (also called self-employment taxes when paid by independent contractors).

The vast majority of independent contractors are sole proprietors. A sole proprietorship is a one-owner business. The business owner (proprietor) personally owns all of the assets of the business and controls its operation. If you're running a one-person design business and haven't incorporated or formed a limited liability company, you're automatically a sole proprietor.

When you're a sole proprietor, you and your business are one and the same for tax purposes. Businesses that are sole proprietorships don't pay taxes or file tax returns directly. Instead, you must report the income you earn or losses you incur on your own personal tax return, IRS Form 1040, which is due each year by April 15. If you earn a profit, the money is added to any other income you have—for example, interest income or your spouse's income if you're married and file a joint tax return—and that total is taxed. If you incur a loss, you can use it to offset income from other sources.

Although you are taxed on your total income regardless of its source, the IRS does want to know about the profitability of your design business. To show whether you have a profit or loss from your sole proprietorship, you must file IRS Schedule C, Profit or Loss From Business, with your tax return. On this form you list all your business income and deductible expenses.

Sole proprietors are not employees of their proprietorships; they are business owners. Their businesses don't pay payroll taxes on a sole proprietor's income or withhold income tax from their compensation. However, sole proprietors do have to pay self-employment taxes—that is, Social Security and Medicare taxes—on their net self-employment income. The Social Security tax is a flat 12.4% tax on net self-employment income up to an annual ceiling that is adjusted for inflation each year. In 2017, the ceiling was \$127,200 in net self-employment income. There are two Medicare tax rates: a 2.9% tax up to an annual ceiling of \$200,000 for single taxpayers and \$250,000 for married couples who are filing jointly. All income above the ceiling is taxed at a 3.8% rate.

Note that independent contractors and employees are each entitled to Social Security and Medicare benefits, but independent contractors must pay twice as much Social Security and Medicare taxes as do employees. This is because employers must pay 50% of such taxes on their employees' behalf.

Your business income and self-employment taxes must be prepaid four times a year in the form of estimated taxes (*see below*).

Clients don't withhold any taxes from a sole proprietor's compensation, but your clients may have to report what they pay you to the IRS (*see below*).

State taxes

All states except Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming impose income taxes on the self-employed. New Hampshire and Tennessee impose income taxes on dividend and interest income only. Most states charge a percentage of the income shown on your federal income tax return. In most states, you have to prepay your state income taxes during the year in the form of estimated taxes. These are usually paid at the same time you pay your federal estimated taxes. You'll also have to file an annual state income tax return with your state tax department. You can find a link to your state tax department's website at <https://www.taxadmin.org/state-tax-agencies>.

Local taxes

About 5,000 cities, counties, and other local jurisdictions impose their own income taxes. New York City is the most famous example. However, the bulk of such taxes are imposed by localities in just a handful of states: Indiana, Iowa, Kansas, Kentucky, Ohio, and Pennsylvania.

Some local governments also charge annual business registration fees or business taxes. Some cities and counties also impose property taxes on business equipment or furniture. You may be required to file a list of such property with local tax officials, along with cost and depreciation information. Check your local government's website to determine if it imposes such taxes.

Tax Deductions for Independent Contractor Designers

It's important to understand that you only need to pay income and self-employment tax on your net business income. This is the income you have left over after you subtract all of your deductible business expenses from the total amount you earned from your design business during the year. Business deductions are quite valuable—for example, if you're in the 25% income tax bracket, each \$100 in deductions saves you \$25 in income tax. It will also usually save you about \$15 in self-employment taxes as well.

You may deduct any expense that is:

- » *directly related to your design business*
- » *ordinary and necessary, and*
- » *not lavish or extravagant under the circumstances.*

Common deductions by designers include:

Office expenses: If you have an outside office, you may deduct the full cost. If you work from home, you may take a home office deduction provided that you use a space in your home exclusively for your design business. This enables you to deduct a portion of your mortgage or rent, utilities, maintenance, and repairs. The amount of the home office deduction is based on the percentage of your home that you use for your business.

Local travel expenses: Local travel for your design business is also deductible. Local travel may include trips to client's offices, to design classes, or to pick up supplies. You may deduct trips by car or public transportation. If you like recordkeeping, you can keep track of all your actual car expenses to figure your annual deduction. But, if you'd rather not keep track of how much you spend for gas, oil, repairs, car washes and so forth, you can use the standard mileage rate published by the IRS. When you use the standard rate, you only need to keep track of how many miles you drive for business, not how much you spend on your car. For 2017, the standard mileage rate is 53.5 cents per mile.

Business travel expenses: You may deduct all reasonable expenses you incur when traveling out of town for your design business. These expenses include airfare or other transportation costs and hotel or other lodging expenses. However, you may only deduct 50% of the cost of meals when you travel for your business.

Equipment and other long-term assets: Special rules apply when you buy property, such as computers, cameras, and other equipment, that lasts for more than one year. You should discuss these issues with a certified public accountant. You may be able to fully deduct the cost of such property in a single year. If not, you'll have to deduct the cost a little at a time over a period of years—a process called depreciation. Most property you buy for your design business would be depreciated over five years.

Software and online service subscriptions: The cost of software and online services you use for your design business is fully deductible. For example, you may deduct the cost of fonts or an Adobe Creative Cloud subscription.

Supplies: Supplies are items you purchase for your design business that you use up in less than one year—for example, art supplies. These expenses are fully deductible in a single year.

Dues: Dues that you pay to belong to professional design organizations are deductible.

Education: Design classes and lessons are deductible.

Promotional expenses: Virtually everything you spend money on to promote yourself as a designer is deductible, such as websites (including Internet connection costs), online advertising, offline advertising and listings in design publications, photos, brochures, and videos.

Legal and professional services: You can deduct fees that you pay to attorneys, accountants, consultants, and other professionals if the fees are paid for work related to your design business.

Insurance: Independent contractors, including designers, are allowed to deduct 100% of their health insurance premiums from their income taxes (up to the amount of their annual business profits). In addition, if you have a home office, you may deduct a portion of your homeowner's or renter's insurance. Professional liability and business property insurance is also fully deductible.

Meals and entertainment: The cost of a meal in a restaurant or an entertainment event like a baseball game or theatre visit might qualify as a business deduction if you have a serious business discussion before, during, or soon after the event. However, you may only deduct 50% of your business meal and entertainment costs.

Start-up expenses: You can deduct in one year up to \$5,000 in start-up expenses and organizational costs that you incur to get your design business up and running. Expenses over this amount are amortized more slowly over a 15-year period (180 months).

Eight Legal Mistakes to Avoid when You're an Independent Contractor

There are eight very common mistakes independent contractors make that can get them in tax or legal trouble. Make it a practice to avoid these.

1. Failure to Pay Estimated Taxes. Independent contractors don't have any tax withheld from their pay by their clients. Instead, they must make four estimated tax payments to the IRS each year. If you fail to pay estimated tax, you could have a whopping tax bill due on April 15 and you'll also have to pay a penalty to the IRS.

The due dates for estimated tax payments are shown in the following chart.

INCOME RECEIVED FOR THE PERIOD:	ESTIMATED TAX DUE:
Jan. 1 → March 31	April 15
April 1 → May 31	June 15
June 1 → Aug. 31	Sept. 15
Sept. 1 → Dec. 31	Jan. 15 of following year

You don't have to start making payments for any given year until you actually earn income. You can pay online or by regular mail.

Ideally, the four estimated tax payments you make each year will add up to your tax liability for the year. However, if your income varies substantially from year to year, it can be hard to estimate how much you must pay during the year. Fortunately, there is a way to avoid having to estimate how much you'll make. No matter what your income for the current year turns out to be, you won't have to pay any penalties if the estimated tax you pay is at least the smaller of:

- » 90% of your total tax due for the current year, or
- » 100% of the tax you paid the previous year or 110% if you're a high-income taxpayer (those with adjusted gross incomes of more than \$150,000 or \$75,000 for married couples filing separate returns).

Many independent contractors establish separate bank accounts to save up for taxes into which they deposit a portion of each payment they receive from clients. This gives them some assurance that they'll have enough money to pay their taxes when they are due.¹

2. Failure to Report Income on Your Tax Return. When you're an independent contractor, it's up to you to report to the IRS how much business income you earned during the year. Obviously, there is a strong temptation to underreport income. However, this can be a big mistake because you can easily get caught by the IRS. This is because your clients may be required to report to the IRS how much they paid you during the year and the IRS matches this information with the income you reported on your personal tax return. Any discrepancy will result in a dreaded IRS letter demanding more taxes from you.

When you're an independent contractor, you don't have an employer who will file IRS Form W-2 reporting to the IRS how much compensation you were paid during the year. However, this doesn't mean the IRS won't have at least some idea of how much you were paid by your clients. If a client pays you \$600 or more over the course of the calendar year by check, direct deposit to your bank, or cash, then the client must complete and file IRS Form 1099-MISC to report those payments. The 1099-MISC must be filed by January 31 with the IRS, your state tax agency, and you.

Only payments made by check, cash, or direct deposit need be reported on Form 1099-MISC by your clients. Currently, your clients have no duty to report payments they make to you electronically—for example, by PayPal.

¹ For more details on estimated taxes, please refer to [IRS Publication 505, Tax Withholding and Estimated Tax](#)

Electronic payments need to be reported to the IRS by the payment processor only if you are paid over \$20,000 and have more than 200 transactions during the calendar year.

3. Failure to Provide Clients Your Taxpayer ID Number. When you are first hired by a client, you should not be asked to complete IRS Form W-4, the form employers use to calculate employee withholding. Instead, you should make sure to provide the client with your taxpayer ID number. For most independent contractors, this is their Social Security number. You may do this by completing IRS Form W-9, Request for Taxpayer Identification Number and Certification, or you can provide the number in an independent contractor agreement. If a client does not obtain your taxpayer ID number, it is required to withhold 28% of your pay and remit it to the IRS. This is called backup withholding. You don't want that to happen.

4. Failure to Obtain Necessary Licenses and Permits. Depending upon where your design business is located, you may have to obtain state and/or local business licenses or permits. The following states require that all businesses obtain state business licenses: Alaska, Delaware, Florida, Nevada, Ohio, and Washington. Such licenses are also called general business licenses. For more information on state licenses and permits, visit the Small Business Administration website at <https://www.sba.gov/business-guide/launch/apply-for-licenses-permits-federal-state>.

Many cities, counties, and municipalities require business licenses or permits for all businesses, even one-person, home-based operations. Usually, you just have to pay a fee to get such licenses. They are simply taxes in disguise. Other cities have no license requirements at all or they have special exemptions for very small companies.

Many small business owners, particularly those who work at home, never bother to get a local business license. If your local government discovers that you're running an unlicensed business, it may fine you and bar you from doing business until you obtain the necessary license.

5. Failure to Use Written Client Agreements. It's extremely important to use written agreements with all your clients. One reason for this is that you must sign a written agreement to transfer or license the copyright in your work to a client. Written agreements can also help avoid costly misunderstandings.

A client agreement need not be long or complex. A short letter agreement may be adequate for very small projects. Longer, more comprehensive agreements are appropriate for longer, more complex projects where more time and money is involved. One example of a comprehensive agreement intended for use

between a design firm and a business client is the [*AIGA Standard Form of Agreement for Design Services*](#).

A different example, intended for use between a freelancer and a studio, is the short [*Designer Independent Contractor Agreement*](#) that accompanies this article. With respect to intellectual property rights, this form favors the studio, because the studio controls the project as well as the client account. It is not necessarily appropriate for independent contractors working directly with business clients.

At a minimum, you and the company buying your services should always set forth in writing:

- » *the services you'll perform*
- » *how much you'll be paid*
- » *the deadline for completion, and*
- » *who will own the copyright in your work.*

6. Failure to Keep Good Records. Good records are the key to claiming all the tax deductions to which you are entitled and avoiding having your deductions disallowed if you're audited by the IRS or your state tax agency. Lack of adequate records is by far the most common reason taxpayers lose deductions when they are audited.

Good records are particularly important for local and long distance travel deductions, and meals and entertainment. The IRS is particularly suspicious of these deductions because taxpayers often exaggerate their expenses. If you drive for your business, you need to keep track of your business mileage. You can use an app to do this or a paper logbook. You should keep receipts for other expenses and proof of payment, such as cancelled checks, credit card statements, or electronic funds transfer records. Many software packages and apps are available to help you with such recordkeeping, and the cost of the system you select is deductible.

7. Failure to File a Tax Return. Even if your design business loses money or you earn so little that you don't owe any tax, you should still file a tax return every year. Any losses you incur can be deducted in future years when you earn profits from your business (or have other income). You must file a return to establish the amount of such deductible losses.

8. Failure to Obtain Health Insurance. The final common mistake made by independent contractors has to do with health insurance. Attempts by Congress to repeal the Affordable Care Act (ACA, more popularly known as "Obamacare") have thus far failed. This means that the ACA remains the law of the land. It requires everyone, including independent contractors, to obtain minimally adequate health insurance. This includes health insurance you obtain through

your spouse, or your parents if you're less than 27 years of age. If these options aren't available, then you must obtain your own individual coverage for yourself and your immediate family. If you fail to do so, you'll be subject to a tax penalty of \$695 per uncovered adult (\$347.50 per child) or 2.5% of your household income, whichever is greater (but for 2017, the penalty cannot exceed \$2,085 per person).²

2. For more details about ACA requirements, please see www.healthcare.gov

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