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Working in the Gig Economy

Working multiple, often short-term, jobs creates a variety of planning issues – and opportunities

The term "Gig Economy" may seem new, but the concept has been around for decades. Gig workers should think of themselves as a business owner, which means facing a variety of issues traditional employees might not otherwise consider.

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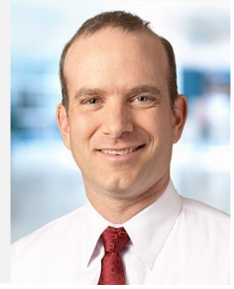

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The phrase "gig economy" may seem like a new concept – the term was just added to the Miriam Webster dictionary in early 2019 – but the concept has been around for quite a while. The term first came to prominence during the financial crisis in 2009, when unemployed individuals were looking for any kind of paying job. These workers would often accept short-term positions, typically working as a self-employed freelancer or consultant rather than as an employee.

In reality, the idea of working without a fixed schedule or place of business has been around for decades. Home-based sales businesses such as running Tupperware or Avon parties were among early versions of this work, and even jobs associated with childhood such as lawn mowing or babysitting could fall in this category.

Today the term is typically associated with jobs such as ride-share drivers or delivery services, but can also include technology consultants or the arts and entertainment fields. Because of the loose definition of gig workers, estimating the number of these workers is difficult. Some online surveys have determined that 25-30% of workers do some form of gig work over the course of a month, and a 2017 Bureau of Labor Statistics survey found that over 10% rely on this work as their primary job.[1]

Regardless of what they call it or the type of work they do, these individuals face a variety of issues that traditional employees wouldn't have to consider. This starts with how to structure themselves for tax and legal purposes, and includes unique income tax considerations and a variety of options for planning for their future retirement.

STRUCTURING THE BUSINESS

In some cases a gig worker will be considered an employee of the company they work for. In many cases, however, these workers are hired as independent contractors or consultants, making them technically self-employed. And while these workers may not think of themselves as a business owner, that's effectively what they are. As such, the first thing they need to decide is how they're going to structure their new business, and they have several options.

- Sole Proprietor – This is perhaps the most common type of business structure used today, primarily because it's the easiest to create. There are no formal legal or tax steps necessary to form a sole proprietorship – as long as there is only one owner of the business, the business defaults to a sole proprietorship. If there are multiple owners, then another option for structuring must be considered.

  For tax and legal purposes, there is no separation between the business and the owner. Any net income of the business is taxable to the owner, and the owner is also responsible for any expenses or liabilities that arise from the

[1] "Contingent and Alternative Employment Arrangements – May 2017", Bureau of Labor Statistics, www.bls.gov/news.release/pdf/conemp.pdf, June 7, 2018

business. The business can operate under the Social Security Number of the owner, although if it sets up a retirement plan or hires any employees the business must apply for an Employer Identification Number.

- Partnership – In this type of entity, the management of the business is split among multiple individuals known as General Partners (GPs) who share in the income and expenses of the partnership. The net income is not taxable to the partnership, but is taxable to each partner based generally on their ownership percentage. Because of this, partnerships are usually referred to as "pass-through" entities. GPs are each individually responsible for any liabilities of the partnership, regardless of their ownership interest.

  A partnership can also have Limited Partners (LPs). These LPs have less input on the management of the company, but their liability for any partnership debts is capped at their percentage interest in the partnership. Each partnership must have at least one GP, but there can be an unlimited number of LPs.

- C Corporation – A C Corporation is a separate legal entity that can have an unlimited number of owners, or shareholders. All the income from the C Corp is taxable to the entity, although the after-tax income may then be passed to the shareholders in the form of a dividend, which is then taxed again. This double-taxation of the income makes the C Corp the least tax-efficient business structure. However, C Corps provide the most liability protection for owners as shareholders are not personally liable for any debts of the business.

- S Corporation – An entity set up as a C Corporation can make an election to be treated as an S Corporation. An S Corp provides similar liability protection as a C Corp, but is a pass-through entity for tax purposes like a partnership. S Corps are limited in the number and type of shareholders they can have.

  Limited Liability Corporation (LLC) – Each state sets its own rules for how an LLC is created, but typically these only require creating a simple Operating Agreement, filing an application with the state and paying a fee. Owners of an LLC are called members, and an LLC can have as few as one member. In those cases, the LLC is referred to a Single Member LLC, or SMLLC. Once the LLC is created, it makes an election with the IRS as to how it will be taxed – as a sole proprietorship, partnership or corporation (and, if eligible, it can elect to be treated as an S Corp).

Many sole proprietors form an LLC for the added liability protection it offers. However, a typical LLC is created to protect one LLC member from the actions of another, a protection that isn't available to general partners in a partnership. However, with a single member LLC, that liability protection may be limited if a court were to decide there is no distinction between the LLC and its single member. While some states are modifying their rules to provide SMLLCs with more protection, gig workers should verify their own state laws or consult an attorney experienced in this area before relying on an LLC.

Because sole proprietorships are the easiest form of entity to create and can only have one owner, they are by far the entity of choice for most gig economy workers who are consultants or independent contractors. As such, the remainder of this discussion will focus solely on sole proprietorships.

RECORDKEEPING

Regardless of how the business is structured, the gig worker needs to always keep in mind that they are running a business, and because of this they need to be careful to keep the business activity separate from their personal activities. For example, maintaining a separate bank account to hold any income and to pay any expenses is always a good idea. For a sole proprietor, this account can still be in their name rather than a business, but it should be used exclusively for the business. If the owner wants to "pay" themselves out of the income from the business, then money can be transferred from the business account to a personal account.

Assets used for the business are best kept as solely business assets, at least as much as possible. Using items such as a car or computer for both business and personal uses can complicate things, especially when it comes to tax reporting.

TAX REPORTING REQUIREMENTS

A sole proprietor is considered one and the same as the owner of the business, and this treatment extends to the reporting of the business's income for tax purposes. These businesses do not need to file a separate tax return, like a partnership or corporation is required to do. Instead, the owner reports the income from the business on Schedule C, which is attached to the same Form 1040 filed by the individual. That income is combined with the taxpayer's other income to determine their total Adjusted Gross Income and Taxable Income, and is taxed using the same tax brackets and rates used by that individual or couple.

Schedule C is also used to report any expenses incurred in the business, which can then be used to reduce that income for tax purposes. The Tax Cuts & Jobs Act eliminated the deduction for business expenses incurred by an employee, but a self-employed individual can still deduct any ordinary and necessary expenses of the business. "Ordinary" expenses are commonly accepted expenses in that field of work, while "necessary" expenses are those that are helpful and appropriate for the business. Common expense items for gig workers would include:

- Advertising
- Insurance
- Interest on a loan for the business
- Legal & professional services
- Home office expenses & supplies
- Taxes & licenses, such as for a professional designation

In some cases, expenses may not be deductible at the time they're incurred. Costs to purchase inventory can only be deducted when that inventory is sold, and costs to purchase physical assets (such as a computer or car) are generally capitalized and deducted over time under the depreciation rules.

Business owners are also able to deduct the cost of owning and operating a vehicle to the extent it's used for business purposes. This means keeping detailed records of the number of miles driven for business purposes during the year, and then comparing that to the total miles driven for the year. The IRS and the courts have denied deductions for vehicle use when taxpayers have not maintained an accurate and detailed mileage log. Handwritten logs can be kept, or there are a variety of phone apps that can be used as well.

That business-to-total use ratio is then applied to the total costs of the vehicle, including depreciation fuel, maintenance, insurance, license plates, etc. to determine the net deduction. Again, detailed records, including receipts, should be maintained to document the expenses.

Rather than keeping records on the actual expenses incurred, however, business owners can instead use the "standard mileage rate" to determine their deduction. For 2019, the IRS allows a business expense deduction of $0.58 per business mile driven, which is meant to cover nearly every expense associated with the car. Expenses for tolls, parking and interest on a loan can be deducted regardless of whether the actual expense or standard mileage rate method is used.

Owners may find that deducting a portion of the actual expenses incurred will provide a larger tax benefit, but the effort needed to maintain the necessary records is often more than they're willing to do. If an owner elects to use the standard mileage rate at first, they can always switch to the actual expense method later. However, owners are not allowed to switch from actual expenses to the standard mileage method, at any time.

SELF-EMPLOYMENT TAX

In addition to any federal or state income tax on the net income from the business, a gig worker who is self-employed will also be subject to the Self-Employment (SE) Tax. This tax replicates the FICA (Federal Insurance Contributions Act) taxes that are paid by an employee. FICA taxes are withheld from an employee's wages by their employer, who then also pays an equal amount of these taxes. A self-employed individual is responsible for both the employee and employer share of these taxes, which effectively doubles the tax rates:

- OASDI Tax – This tax goes towards the Social Security Trust Fund, which pays benefits to retired or disabled workers and their families. The tax is equal to 6.2% of the first $132,900 (for 2019) of an employee's earned income. A self-employed person pays a 12.4% tax on that same amount of income.
- Medicare Tax – This separate tax goes to the Medicare Trust Fund and is used to pay the health care costs of retirees and others. Employees and employers each pay a 1.45% tax on earned income, with no limit to the amount subject to tax. Self-employed workers must pay the combined 2.90%.

In some cases a self-employed gig worker may also work as an employee somewhere. In that case, any of the wages earned as an employee that are subject to the FICA taxes reduce the amount of self-employment income subject to the OASDI tax.

- **Example**: An individual earns $100,000 in wages as an employee, all of which is subject to FICA taxes. In addition, they work as a self-employed website developer, and earned $50,000 of net income from that business. The total amount of income that is subject to the OASDI is limited to $132,900, of which $100,000 comes from the employment income. Therefore, only $32,900 of the side-business income is subject to the OASDI portion of the self-employment tax. The entire $50,000 of gig income would be subject to the 2.9% Medicare tax, however, as there is no limit on the income subject to that tax.

In addition, a separate 0.9% tax applies to any combined wages and net self-employment income for a taxpayer that exceeds $200,000. If the business owner is married, their income is combined with their spouse's income and the threshold is increased to $250,000.

The SE tax is calculated on Schedule SE while the additional 0.9% tax is calculated on Form 8959, both of which are included with the taxpayer's personal tax return. Those who pay the SE tax are able to deduct 50% of that tax amount for regular income tax purposes.

QUALIFIED BUSINESS INCOME EXCLUSION

The 2017 Tax Cuts & Jobs Act created a new form of deduction for business owners called the Qualified Business Income (QBI) exclusion. This QBI exclusion allows business owners to exclude up to 20% of their net business income from federal tax. Many states – but not all – have also adopted this provision. Owners of a sole proprietorship are eligible to take advantage of this new exclusion, although there are limitations they should be aware of.

The primary test to qualify for this exclusion is based on the taxable income reported by the taxpayer (and their spouse, if married). If the taxpayer's total taxable income in 2019 – including the gig income but also any other wage income, investment or retirement income, etc. – is less than $160,725 ($321,400 for a married couple), the owner is eligible for the full 20% exclusion. For many gig workers, this income threshold may not be a concern and they can fully benefit from the QBI exclusion.

However, once their total taxable income exceeds that level, there are other tests than can reduce, or even eliminate, the exclusion amount. These tests are based on the nature of the business itself and how much is paid to employees or spent on assets for the business. The details behind these tests are complex and will usually require an experienced accountant to verify the business owner's eligibility.

MAKING TAX PAYMENTS

For taxpayers whose income comes primarily from wages as an employee, paying their taxes is relatively easy – their employer withholds any federal or state income taxes, plus FICA taxes, and remits them right to the government. Self-employed workers don't have that same convenient way of paying their taxes, as there is no employer to withhold and remit those taxes.

Instead, most self-employed gig workers must pay these taxes on their own via estimated tax payments. These payments are due on a quarterly basis (typically each April, June, September and January 15) and are usually paid by mailing a check to the respective tax authority, although the IRS now accepts electronic payments as well.

Taxpayers who don't pay a minimum amount of tax during the course of the year are subject to an underpayment penalty. As of July 2019, the federal underpayment penalty is 5% annually, but is calculated on a daily basis. To avoid the penalty, taxpayers must target their payments to equal the lesser of two amounts:

- 90% of the current year tax liability
- 100% of the prior year tax liability (110% if the prior year AGI was more than $150,000)

Most states follow these same guidelines, as well. These payments should cover any income tax that is due on all income for the year, as well as any self-employment tax, AMT, or any other taxes that are reported on the taxpayer's Form 1040. Equal payments should be made throughout the year, although there are options for those whose income fluctuates during the year or is primarily earned at year-end.

RETIREMENT PLANNING

Traditional employees are often eligible to contribute to a retirement plan sponsored by their employer, but self-employed gig workers don't have that option. That doesn't mean saving for their retirement is any less important, however, so these workers must take it upon themselves to create and fund a retirement savings account. Fortunately, they have several options, all of which provide tax-deductible contributions and tax-deferred growth, with taxable withdrawals during retirement. Some of the more common options include:

- SEP IRA – Probably the most common retirement plan for self-employed individuals is the Simplified Employee Pension, or SEP IRA. This plan allows for a maximum contribution of 20% of the net self-employment income, up to a maximum of $56,000, plus another $6,000 if the owner is age 50 (for 2019). This plan is more costly for businesses with employees as the employer is required to contribute to accounts on their behalf as well, although the business owner can choose skip contributions (including to their own account) any year. These accounts are relatively easy to create and require no ongoing IRS reporting, and can be created and funded up to the due date of the tax return for the year of the contribution, including extensions.
- SIMPLE IRA – This type of plan may work better if the business has employees, as it allow for a smaller employer contribution but a larger employee deferral into the plan. Employees can defer up to $13,000, while employers generally have the option to either match the employee contribution or make a separate contribution equal to 2% of the employee's income. These accounts must be established by October 1 of business's tax year, although contributions can be made as late as that year's tax return due date, including extensions.
- Individual 401(k) – These plans work well for an "owner only" business, but become more complicated and expensive to maintain if there are employees covered by the plan. On the other hand, these plans allow for a total contribution of 100% of income up to a maximum of $56,000 (for 2019), so they are easier to fully fund than a SEP or SIMPLE. These plans must be established by year-end, and employer contributions can be made up to that year's tax return due date.

In addition to these plans, any individual with earned income, either as an employee or from self-employment, is eligible to contribute to a Traditional IRA. Being able to deduct that contribution will depend on whether or not they participate in an employer-sponsored plan (including those listed above) and their income level, but the contribution will always be allowed.

For business owners with lowers levels of income a Roth IRA may prove to be more beneficial. There is no deduction for the contribution, but all future withdrawals can be tax-free.

OTHER CONSIDERATIONS

Besides these tax and retirement planning considerations, self-employed gig workers should keep these other planning considerations in mind:

- Health insurance – Traditional employees often can rely on their employer to subsidize the cost of health insurance coverage for themselves and their family. Self-employed workers will need to shop for that coverage on their own, which can lead to sticker-shock when seeing the true cost of this coverage. Self-employed taxpayers can claim a tax deduction for the cost of this coverage, but they should be prepared for a higher expense than they're used to seeing as a traditional employee.
- Auto and home insurance – Using your car as a business vehicle, especially as a ride-share driver, may not be covered under your current auto insurance policy. This could also be the case if you use your home as a place of business where you store assets or inventory or where you meet with clients. Be sure to check the details of your policies, and purchase supplemental coverage if necessary.
- Liability insurance – There is no legal distinction between the owner of a sole proprietorship and their business, meaning an owner is financially responsible for any liabilities arising from the business. Forming an LLC can offer protection, but with an SMLLC that protection can be limited. Therefore, purchasing additional personal liability should high on a gig worker's priority list.

OTHER RESOURCES

The IRS provides a variety of resources to help gig workers and other self-employed small business owners, all of which are available online at www.irs.gov:

- Sharing Economy Tax Center – This site has a wide variety of information on what it means to work in the gig economy, from the tax reporting gig workers receive to how they then report that on their own tax return.
- Small Business and Self-Employed Tax Center – This site contains a wide variety of resources on how to start a business, the stages of owning a business, filing tax returns, etc.
- Publication 334, Tax Guide for Small Business – This publication provides guidance on reporting business income and expenses and how to calculate the self-employment tax.
- Publication 535, Business Expenses – This publication addresses common types of business expenses and what is, or is not, tax deductible.
- Publication 463, Travel, Gift and Car Expenses – This publication addresses other types of business expenses, in particular auto-related expenses, and provides guidance on proper recordkeeping.
- Publication 560, Retirement Plans for Small Businesses – This publication can assist a business owner in finding a retirement plan that is right for their situation.