



TO HELP SMALL BUSINESS, CHANGE THE DEFINITION OF INDEPENDENT CONTRACTOR

By Carol Roth

There has been a fundamental shift in the foundation of business in the U.S. Services have replaced manufacturing as the primary growth driver. On one hand, this has created a skills gap for those in the workforce. However, it has also created an opportunity for individuals to become self-employed through freelancing. Freelancing gives individuals an opportunity to take more control of their own destiny and is often a first step in establishing a small business that grows and employs others.

Small business growth is the most obvious catalyst for growth in the U.S. economy. There are more than 28 million of them, including solo business owners. In cities like Chicago, small businesses employ half of the workforce. This means that we need to be highly focused on creating a favorable business environment where small businesses can grow and thrive. However, the U.S. tax code hasn't kept up with the changes in the business environment and the needs of small business owners.

One simple definitional change in the tax code – revising the definition of an independent contractor, aka a 1099 worker – would provide substantial support to help foster a pro-small business environment.

If you are confused by the difference between a 1099 worker/independent contractor and an employee, you are not alone. Per the IRS, “Generally, you must withhold income taxes, withhold and pay Social Security and Medicare taxes, and pay unemployment tax on wages paid to an employee. You do not generally have to withhold or pay any taxes on payments to independent contractors.”

This may seem like a small distinction, but to small business owners who are already consumed with burdensome administrative tasks, not to mention a cost structure that may not be yet scalable, it is a significant one.

Many businesses, especially small businesses, use independent contractors and freelancers as a way to fill in gaps in their business. However, the IRS says that if you perform work that would be done in the normal course of business by an employee (including, amongst other things, not setting your own hours or methodology for completing the work), you are considered an employee, not an independent contractor, for tax purposes. This stands even if you own your own firm, have additional clients and/or just plain want to be one.

It is very clear that this outdated definition creates a barrier to hiring, especially for small business owners. It means that a freelancer may be considered an employee by IRS standards, meaning additional paperwork and compliance for a small business owner. It affects small business owners on both sides – impeding the hiring company from growth and the freelancer from getting more work. If a small business only needs a person for projects, shortened hours or even for part of the year, having an expanded 1099 definition would allow an independent contractor to be able to be employed by multiple businesses without creating redundancy in administrative work and other paperwork.

What is the stress and burden for going from no employees to one employee like for a small business? It is significant. It affects a business through the cost and time of payroll and reporting.

Plus, there is other compliance that is necessary when you have employees (such as legalities regarding hiring, firing and more). It may also affect the structure of one-person business’s retirement plan.

Independent contractors who are paid more than \$600 a year by a business and have a non-corporate entity (LLC, Sole Proprietorships) issue hiring firms a form called a W-9. The hiring firm then files a form 1099-MISC with the IRS each year to report those payments. If the government and the IRS are concerned about income reporting, this 1099 reporting should take care of that concern.

If both parties are in agreement that an independent contractor arrangement makes sense, why would the government stop that? Income and other taxes are still getting paid. While businesses pay and collect Social Security and Medicare taxes (aka FICA taxes) for each employee, an independent contractor is subject to self-employment taxes, which cover both Social Security and Medicare contributions in an amount roughly equivalent to the FICA tax. So, why should the government and the IRS care which entity is responsible for those taxes? Shouldn’t that be up to the parties in the work arrangement? Allowing more individuals to work as independent contractors as they are hired by other businesses should actually increase tax revenues by making it easier to put people to work and for companies to grow.

With an estimated 22 million of the approximately 28 million small businesses in this country being one-person entities, recognizing the need to change legislation to support freelancers is an important step towards giving small business owners a real voice in Washington.

About the Author

Carol Roth is a contributor for CNBC, bestselling author of **The Entrepreneur Equation**, recovering investment banker and a small business advocate. She also has an action figure made in her likeness. Check out her website at www.CarolRoth.com and follow her on Twitter: [@CarolJSRoth](https://twitter.com/CarolJSRoth).