

# W2 versus 1099

## 9 Things you need to know before you choose

Dear Catherine,

*"I just said yes to a 12-month contract position through a staffing firm. The recruiter asked me "W2 or 1099?" When I asked her "What's the difference?" she said "Not much at all. It's really just a choice of whether or not you want us to withhold taxes for you." I told her I want to go do some research and get back to her tomorrow. **What's the difference, and what do I need to be worried about?**" – Brenda*

Dear Brenda,

*Congratulations on getting the contract position, and for being such a smart job seeker (asking for a day to do research was very smart). As for W2 versus 1099 ... I have some bad news for you: **what the recruiter said to you is a BIG FAT LIE.** I wish it were as simple as "How do you want to get paid?" It isn't. **There are some BIG differences for you. Taxes are just one of them.** Quite frankly, there are some big differences for her company, too (and I cannot believe her company did not train her on them). My best advice for you is this: talk to an experienced small business accountant (and maybe even a good, reputable financial planner) before you decide. Also, think about whether or not you are willing to run a small business (which is really what you'll be doing as a 1099).*

### Most first-time freelancers choose W2 because it is easier than 1099

Most people who are new to contract work choose W2 simply because it is easier. However, working as a 1099 offers some nice advantages to consider. I've been running my own business (working as a 1099 with clients) for over 14 years now, and I absolutely love it. But that's me. Everyone is different, and only you can decide which scenario is best for you. I would love to help you understand the difference, and some of the pros and cons of both sides.

### What do "W2" and "1099" mean?

Both W2 and 1099 are the names of IRS tax forms. As a full-time salaried employee, or as an hourly employee, your employer will send you a W2 tax form at the beginning of each year (for the year prior). When you work as an independent "1099," they will send you a "1099" form, which is quite different. If you have any income aside from a job (investments, for instance), then you have received 1099 forms in the past which state your income (dividends from mutual funds, etc.) 1099s report income from sources other than an employer.

*“I’m leaving for the weekend, so I hid \$100 in your room for food.  
Clean your room and you will find it.” – Unknown mom*

## **You should get a higher pay rate if you choose to work as a 1099**

If you choose to work as a 1099, you should absolutely expect to be paid more money per hour because the employer will have lower costs, and you will have higher costs. I hired and placed consultants for well over ten years, and used a rate calculator every time I negotiated rates with contractors and clients. If I paid someone \$30.00 per hour as a W2, the extra cost for my company was \$2.93 per hour (versus paying a 1099). So, I would pay a 1099 at least \$3.00 more per hour (more likely, I would pay an extra \$5-\$9 per hour). \$3.00 per hour is an extra \$6,000 over 12 months. \$9.00 per hour is an extra \$18,000 over 12 months. If I paid someone \$100.00 per hour as a W2, the extra cost to the business was \$6.36 per hour. I would pay 1099s at that level at least an extra \$6.50 per hour (but more likely \$10-\$20 more per hour). \$6.50 per hour is an extra \$13,000 over 12 months. \$20 per hour is an extra \$40,000 over 12 months. You can see what a few extra bucks per hour can do for you! It’s worth negotiating! Every dollar counts. To be perfectly honest, if you’re working as a 1099, it is standard practice to increase your rate 30% or more over a W2 employee rate. You’ve got to cover your additional costs.

If they give you a higher rate, you still need to run your numbers before you decide if you want to take it. Read on to understand what your additional taxes and business costs will be. You might walk away with more money in your pocket, but you could also walk away with less. Every family’s situation is different, and healthcare costs can vary dramatically from person to person, too. If your spouse carries the health insurance for your family, that will help a lot.

## **Is your contract position even eligible to be a 1099?**

As you read through the difference between a W2 and a 1099 below, it may become clear which one you should choose. The way you work, and how you are managed at work (if at all) really dictates what the working relationship and payment scheme should be. The feds have been cracking down hard (read: levying hefty fines and forcing back wages) on businesses that misclassify employees. That’s more of a concern for the staffing firm than it is for you, but it might give you an easy answer as to which one you should choose.

## 9 SIGNS that position should be W2, not 1099

1. You will submit hours to them, and the staffing firm will pay for those hours on a weekly or bi-weekly basis client (versus you creating an invoice with your hours on it and a charge to them)
2. There will be other people there doing the exact same job, but they are working as W2 employees (not 1099s)
3. You will work for someone who considers himself your boss / direct supervisor
4. You will use a company computer (and/or other tools)
5. They will give you a company email address
6. You will have a specific schedule (8am – 5pm), and need to ask for time off (including vacation)
7. You will have a company uniform (they tell you what to wear)
8. You will drive a company vehicle.
9. They will give you company business cards

### How to tell the difference between a “W2 employee” and a “1099”

If you will be directed as to how, when and where you do the job then you are most likely an employee and need to be treated as such. Here are two examples:

- **JANE IS A W2 HOURLY EMPLOYEE:** Jane took a 6-month contract as a financial analyst. She was paid as a W2 employee. Jane was told to work onsite from 8am - 5pm, Monday through Friday. She was expected to use their computer systems and work just like all of their full-time employees. Jane had a direct supervisor who gave her projects and told her how he wanted her to do the projects. The company paid her every two weeks, and they withhold her taxes for her. She will receive a W-2 Form from the employer at the end of the year stating her income and withholdings for the year.
- **BARRY IS A “1099” INDEPENDENT CONTRACTOR:** Barry is an electrician who runs a small business by himself (he is a solopreneur). He hires other electricians when he wins big projects. Barry did a free consult, then sent the client a bid and a contract. The contract clearly outlining the work he would do for them, anticipated costs and language about the potential for additional costs if he ran into any surprises during the project. The contract included deadlines, deliverables (what he would accomplish) and payment terms. Barry will bill the client monthly and the client will pay him net 30 (within 30 days). Barry is responsible for withholding and paying all of his taxes. He is also responsible for carrying his own business insurance ... and it is VERY important for him to maintain that insurance in case he gets sued. Barry is clearly a 1099 independent contractor.

## 9 Things to Consider before choosing 1099

There are a lot of things for you to consider before making this choice. Some are really enticing (business expense deductions!) and some are alarming (higher taxes!). Only you can make the right choice for yourself.

**1. You will need to pay your taxes differently.** The IRS is very clear about the difference in tax liability for W2 employee versus independent self-employed contractor. [Read here](#) to learn more. **Your taxes will be more complicated, and you will have greater tax liability.**

- **The biggest difference will be your responsibility around FICA taxes** (Federal Insurance Contributions Act, which governs the amount of money that goes toward funding key programs like Social Security and Medicare).
- **You will need to do your own tax withholdings & pay quarterly taxes.** Most people who are self-employed need to make quarterly estimated tax payments throughout the year. In addition, they need to keep track of their expenses and do itemized expense reports in order to deduct any business expenses. I hired an accountant the first day I opened my own business, and his fees have been worth every single penny.

**It's not all bad news! There are some great tax advantages to consider.**

- **You may be able to reduce your taxable income** for the self-employment tax you have to pay. Health insurance premiums and self-employed retirement plan deductions (SEP IRA, Simple or Keogh Plan) are often tax deductible as well. And listen to this: self-employed folks can put up to 25% of annual compensation into a SEP-IRA. That can be a significant advantage for retirement planning.
- **Work related business expenses can be deducted from your taxes as well.** Expenses such as a computer, internet access, travel, postage and office costs might qualify. Before you get too excited and carried away (dreaming about buying an Aston Martin for your company car?), know that any suspicious or extravagant expenses (like box seats at USBank stadium) will increase scrutiny and might trigger an IRS audit. Furthermore, if all of your work is happening onsite at a client, you'll have a tough time justifying a tax write off for any office space at home. Tax deductions vary by state and by business situation. Best advice I can give is to get the advice of a professional small business accountant, and pay close attention yourself to what's allowable and what is not.

- 2. You will need to formally start a business (even if it's only you).** If you choose to become a 1099, you are choosing to start your own business. Becoming a 1099 doesn't mean you need to start a complex business. You can simply work as a sole proprietor in many places. However, regulations vary from one jurisdiction to the next, so contact your local small business administration to find out more. Your accountant may advise you to start a professional LLC or perhaps even an S-Corp (depending on your long-term goals for your business). You may need a business license depending on your trade and where you live. A great place to start with all of this is the [U.S. Small Business Administration](#) website. Next, head to your state small business administration website or local office.
- 3. You will need to sign a different kind of work agreement.** If you choose 1099, make sure that you have a contract that is signed by both your company and the hiring company. The contract needs to be clear about what work you will perform, what you will deliver when and how you will get paid (as well as when fees kick in for late payments). As a 1099, you will be responsible for getting your own payment. Early on with my business, I had a client who simply never paid a \$10,000 invoice. I did the work, but he kept telling me he would pay me "Soon. I'm waiting on a payment from one of my biggest clients." When I finally went to a collections firm for help, it was too late. Ouch! It was an excruciating lesson, and I have been much smarter about picking my clients since then, and making sure my contract has some teeth in it for late payments. Thank goodness I have never had another rotten client like that.
- 4. You will need to send invoices, and you will get paid less often.** That takes financial fortitude! In other words, you better be really good at managing your money ... or hire someone else who is (a bookkeeper or business partner). Companies usually pay W2 employees every 2 weeks. They usually pay 1099s once a month. Some large companies pay 1099s only once every 3 months! If you don't have cash in the bank, and/or you aren't good at managing your cash flow and budget, this could be very risky for you. Just because you're smart doesn't mean it will be easy to manage your financials.
- 5. You will need to carry your own personal insurance (health, disability and life).** *You might have to do this as W2 employee, too!* Did the recruiter talk to you about insurance benefits? Some staffing firms provide benefits for their hourly employees. Some don't. Many W2 employees get access to discounted group health insurance and other benefits (like life insurance and disability insurance). If you choose 1099, you will have to take care of your own insurance. There may be some tax advantages for you as a self-employed individual (health insurance premiums can be deductible when you are self-employed). I'll be honest with you: this used to be a big deal (employer health plans used to be much cheaper than you could buy on the private market as a small business owner). However, employers everywhere have been cutting down on healthcare benefits and passing increased costs on to their employees, so this is no longer the huge differential it used to be. There are other forms of insurance to consider as well:

- 6. You'll need to get liability and business insurance:** I have one question for you: are you willing to risk losing all your savings? I'm not. I think it's simply not worth the risk. As an employee, if you make a major mistake and the company gets sued, the employer's liability insurance covers it. As a 1099 if you make a major mistake at work, you and your company will get sued. Trust me, if your mistake costs your client a bunch of money, or causes them to get sued, they will want to get their money back. As a 1099, you will sign a different kind of contract that is "corporation to corporation." Read the fine print to make sure you understand your liability for things like sharing trade secrets (confidential data) and other mistakes. Some clients will require you to carry business insurance. All of my big clients do, and most of them require \$1M in coverage. Before you freak out about this, know that liability insurance for your business is not really that expensive (depending on the type of business you do). Insureon estimates that 22.1% of small businesses pay between \$200-\$400 per year. 57.9% pay \$400-\$600 per year. 7.7% pay \$600-\$800 per year. The highest cost on their chart was \$2,200 per year, but that's for small businesses with enormous liability.
- 7. You may incur additional work expenses:** As an employee, you are provided with the essential tools (desk, phone, computer etc.) If you are self-employed, you will have to buy and provide your own tools (think about Barry the electrician). You will very likely be able to deduct most of all of these as business expenses on your taxes, but you can still expect to have some out of pocket expenses that will not be reimbursed.
- 8. You will need to find a new retirement plan** (if you have relied on employer plans): Many employers help their employees save for retirement by providing 401(k) or similar plans. Some still offer matching funds on those. 1099s (freelancers, contractors) do not get any of those, so they need to save for retirement on their own. Before you freak out, that's not necessarily a bad thing. I have much more freedom in my portfolio now, and there are some great tax-advantaged accounts available to self-employed individuals. Best advice here is to talk to your financial planner for recommendations.
- 9. You will lose out on some employee protections:** W2 employee status carries a host of laws to protect you: nondiscrimination laws, pension and benefits laws and wage and hour protections. None of those are available to 1099s. The Coronavirus Pandemic prompted Congress to offer unemployment insurance to independent workers for the first time ever, but it is very unlikely that they will offer that again. This just means that you need to make sure you have a strong financial cushion if you lose a client and go without a paycheck for awhile.

## Working as a 1099 is not as scary or difficult as you think

Millions of people (over 30%) work as 1099s every day (from truck drivers and massage therapists to senior IT consultants). As long as you enter this situation with your eyes wide open, I can tell you that working as a 1099 can be a great way to make a living. Consider your long term plans, as well as the financial, legal and insurance ramifications to you and your family before you make your decision. Know this as well: if you try it out and hate it, you can always do things differently on your next project.