1099 Independent Contractors Can't Ignore These 11 Issues

Q. I think it would be great if there was a new article on becoming a new locum tenens physician, paying taxes through 1099 forms, options with SEP-IRA, and quarterly taxes. I just started my job in September, and I am working on finding an accountant currently. I think that all this information would be very useful.

A. It can always be intimidating to do something new and sometimes after you've been doing something for a while you forget how intimidating it was at first. This is the way I feel about being self-employed. I haven't had any employee (W-2) income since I made partner in 2012, and I've had self-employment income since about 2008. So the information in today's post seems incredibly basic to me, but I recognize it is not to many of you. Let's go step by step through the eleven issues faced by the newly self-employed.

1 Learn the Terminology

Just like with medicine, finance has its own language. Each term has a precise meaning and if you don't know what it is, you not only look ignorant but are likely to make critical mistakes.

An employee receives a copy of the W-2 tax form her employer filed with the IRS at the end of each year. That information flows directly on to the 1040 tax form. An independent contractor is self-employed and receives 1099 forms from each client she did work for during the year. For a sole proprietor, these 1099 forms (along with all the business expenses) flow onto Schedule C and then on to the 1040. For a partner, these 1099 forms flow onto Schedule K of a partnership return (1065). The partnership issues the partner a Schedule K-1 which then flows onto the 1040. Similarly, income paid to a corporation goes on to the corporate return (1120 for a C Corp or a 1120S), which issues W-2s to its employees and K-1s (for an S Corp) or 1099-Divs (for a C Corp) to its owners. LLCs are taxed either as a sole proprietor, as a partnership, or as a corporation (C or S).

An employee fills out a W-4 for her employer. An independent contractor fills out a W-9 for her client.

You don't "pay taxes" through a 1099 form. Most of the time, you are issued 1099 forms and you pay taxes via the 1040. There is also no such thing as a "1099 employee." If you're getting a 1099, you're in business.

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2 Decide on a Business Structure

Speaking of business structures, every self-employed doctor has a decision to make. If you fail to make the decision, you automatically become a sole proprietor. The good news is that is usually fine for an independent contractor doctor. Even if your spouse is also an independent contractor doctor, there's no point in forming a partnership. Just have two separate sole proprietorships. The main reasons any doctor ever considers doing anything else is to reduce liability and to reduce their taxes. However, the main liability most doctors face is malpractice, and malpractice is always personal.

Forming a partnership, a limited liability company, or a corporation, doesn't reduce your malpractice risk. It can potentially reduce some business-related risks, but for a typical independent contractor doc without employees, that risk is negligible and can be safely ignored.

Forming a partnership or an LLC doesn't reduce your taxes at all. However, if an LLC or a corporation is formed AND chooses to make an "S election" it will then be considered an S Corporation by the IRS. This allows the owners to split the income from the business into salary and distributions. Salary is taxed just like it is for any W-2 employee and since the owner must pay both the employer half and the employee half of the payroll taxes, you will end up paying an equivalent amount of tax on W-2 salary issued by your S Corp as on sole proprietor income. However, the savings comes in on the distributions. Distributions are not subject to payroll taxes such as Social Security tax, unemployment tax, and Medicare tax. Most doctors are going to max out their Social Security and unemployment taxes anyway if they are paying themselves a salary [the IRS will consider reasonable](), but there is potential tax savings available due to the Medicare tax.

For example, if a doctor forms an S corp and pays herself a salary of $200,000 and distributions of $100,000, she will save 2.9% in Medicare tax on that last $100,000, or $2,900. In reality, it is less than that, since $1,450 of that tax is deductible to the business. Of course, there is also additional time, hassle, and expense associated with corporation formation, maintenance, and tax returns that should be taken into consideration with this decision. I think a good general rule is that if your distributions won't be at least $100,000 per year for at least a decade, I would not bother forming an S Corporation, I would just function as a sole proprietorship.

Topping out on Steort's Ridge, Big Cottonwood Canyon

A C corporation has a few advantages, but these are almost always outweighed by the disadvantages for a typical physician independent contractor.

3 Quarterly Estimated Taxes

Another big change for a lot of newly self-employed doctors is making quarterly estimated tax payments. This involves sending in [IRS Form 1040ES](), along with a check, once per quarter (oddly enough, the due dates are the first business day after April 14th, June 14th, September 14th, and January 14th.) That's pretty easy, just put a reminder in your phone. The only complicated part is figuring out what amount to put on the form and check. There are three goals with this process. The first is to avoid having to pay any [penalties for underwithholding](). The second is to avoid giving the IRS an interest-free loan. The third is to avoid being surprised come April with a big tax bill and not have the money to pay it.

The easiest method to avoid penalties is to simply take what you owed last year on your taxes (see line 18 on the new 2018 1040 or line 63 on the old 2017 1040), multiply it by 27.5%, and pay that amount each quarter. This will ensure that you are in the "safe harbor" to avoid penalties, but it may or may not be anywhere near what you actually owe in taxes. You could still be over or underpaying. If you wish to be more accurate, you will actually need to estimate about what your tax burden will be, divide it by four, and pay that. It gets even more complicated if your income varies dramatically between quarters, but even with some variation, I would still just try to make even quarterly payments to minimize your tax preparation hassle.

The best way I have found to make sure I have enough money set aside to pay any amount due in April above and beyond the quarterly payments is to find my effective tax rate for the prior year and multiply that each month by what I made that month and set it aside for taxes. Quarterly payments are made out of this account and there should be about enough extra in there to make up the difference in April. If that effective tax rate changes for the next year, I adjust.

Some states may also require you to make quarterly estimated taxes. I was pleased to see that Utah does not; I am allowed to pay the whole lump sum in April without penalty. That does, of course, require a little bit of discipline to make sure I don't spend it.

If you incorporate (or declare your LLC a corporation for tax purposes) there will be other tax forms that must be filed.

4 Health Insurance

If you've never been self-employed before, you may have never purchased your own health insurance and likely will dramatically underestimate what it costs. Health insurance is expensive, ranging from a few hundred dollars a month for a bare-bones plan for a single healthy person to $3000 a month for a better plan for a family. You may qualify for some kind of a group plan through a professional association, or perhaps your spouse's plan if your spouse is an employee, but most docs will end up simply buying it on the open market. That doesn't necessarily mean going through the ACA exchange. Most of the time there is no point in doing that since you will earn too much to receive a subsidy. You might as well go through a local health insurance broker to help you decide. The policy won't cost you any more than buying it directly from the insurer and you'll be offered several different options and get some advice on what is best. You might also consider a Christian health sharing ministry to save money, but realize that this is not exactly insurance, so READ THE FINE PRINT. If you end up buying a High Deductible Health Plan, be sure to invest in a Health Savings Account at one of these fine providers.

5 Disability and Life Insurance

Sometimes employers provide other benefits beyond health insurance. Two common ones are life and disability insurance. These life insurance policies are usually way too small to be anything other than a minor supplement to your main policy. Group disability policies also have significant limitations. At any rate, if you're in business for yourself, you'll need to take care of all of your life and disability insurance needs on your own. Not a big deal, just buy them from an independent agent.

6 Retirement Accounts

Another common and important benefit often provided by employers is a retirement account. If you are self-employed, you're on your own for this. There is both good news and bad there though. The good news is you get to choose the plan. The bad news is that you have to pay for the plan. There won't be any employer match. This, along with having to pay both halves of the payroll taxes and all the other benefits, is an important reason why you should be paid more, perhaps 10% more, as an independent contractor than as an employee.
However, many doctors PREFER being able to choose their own retirement plan. Costs are quite low for single person plans like a SEP-IRA, an individual 401(k), and a personal defined benefit/cash balance plan. No more ticky-tacky fees. No more "advisors to the plan" ripping you off with another layer of fees. No more crummy loaded, high expense ratio funds in the plan.

One word of caution here though. While a SEP-IRA is a little easier to open and run than an individual 401(k), the 401(k) is ALMOST ALWAYS the right plan for the independent contractor physician. You max it out on less income because $19K of the $56K is an “employee contribution”, so you only need approximately $190K to max it out rather than approximately $285K to max out a SEP-IRA. In addition, using a [401(k) instead of a SEP-IRA] preserves your ability to do a [Backdoor Roth IRA] because it avoids the pro-rata rule.

7 Business Deductions

Another nice aspect of being an independent contractor is that it is far easier to take business-related deductions. Anything you spend on your business including scrubs, white coats, shoes, computers, phones, CME materials, licensing fees, subscriptions, mileage and more can be placed directly on Schedule C (assuming sole proprietorship, but the process is similar for partnerships and corporations) as a business expense and is deducted from the business income before any taxes, including payroll taxes, are paid on that income. It is super easy. An employee, on the other hand, is hosed here. They were pretty hosed before 2018 because the employee had to attempt to deduct these sorts of expenses as an unreimbursed business expense on Schedule A, where it was subject to a 2% of income floor. 2% of a physician income represented the loss of a big deduction, and maybe the entire deduction. Starting in 2018, this deduction is gone completely for employees. So a 1099 doc pays for CME with pre-tax dollars and a W-2 doc pays for CME with after-tax dollars. As I tell my kids, “Life isn’t fair.” If you’re in this situation, you might want to lobby your employer to provide a “CME Fund” as one of your benefits for these types of expenses.

8 EIN and a Business Bank Account

You're in business now, so you need to act like it. You should keep the finances of your business separate from those of your personal life. That means getting an Employer Identification Number (EIN) from the IRS and providing it to your clients on the W-9 form instead of your Social Security Number. You don't have to, but it is good practice to do so and perhaps even provides a bit of identity protection. It is also free and super easy by going to the link above. You should also open a business bank account and run all business income and expenses through it. Then you pay yourself periodically by transferring money from the business bank account to your personal bank account. This practice will make tax preparation much easier and look a lot better in an audit. Trust me, just do it. You'll be happy you did.

9 Corporations Don't Need W-9s and 1099s

If you do decide to go the S Corp route, your tax life mostly becomes a lot more complicated. But there is one aspect in which it becomes less complicated. Your clients no longer need to issue you a 1099 for any payments of $600 or more. That means you shouldn't have to provide them a W-9 either. Of course, lots of people don't understand this and continue to request them, even if you insist they don't need to send you a 1099. It's not a hill worth dying on, just send them the W-9 and let them send you a 1099. The important thing is you report the income on your tax return even if they didn't have to send you a 1099.

10 PSLF Implications

Public Service Loan Forgiveness (PSLF) is a program where someone with qualifying direct federal loans in a qualifying payment program (IBR, PAYE, REPAYE, Standard 10 year repayment plan) who makes 120 monthly, on-time payments while directly employed by a non-profit company (501(c)3) has whatever is left after those 120 payments forgiven tax-free. This program is NOT AVAILABLE to the self-employed, even if they contract with a 501(c)3 hospital. So independent contractor docs ought to just refinance their student loans and pay them off rapidly by living like a resident. Unsurprisingly given all the issues with PSLF, there is some controversy here, but I wouldn't risk this one if I were you. I think the law is pretty clear in this regard. But there are some smart people who disagree with me and I've been wrong before. If you're in this situation, best to read up on it, make a decision, and for heaven's sake be sure to keep a PSLF Side Fund, just in case the program and your life don't work out as planned.

11 The Pass-Thru Business (199A) Deduction

Starting in 2018, some self-employed doctors will be eligible to receive a rather large deduction, up to 20% of the income from their business. This subject is ridiculously complicated but worth knowing about. Doctor income is only eligible for this deduction if your total taxable income (including your spouse's income if filing MFJ) is less than $207,500 ($415,000 married.) Don't be surprised if you don't qualify for the whole deduction, most won't due to some of the complicated rules. Still, it makes being self-employed a little more attractive than it used to be and certainly complicated the decision about whether to elect S Corp status or not.

Being in business for yourself is exciting and empowering, but does come with taking care of a few things on your own that your employer used to take care of for you. But if you work through this list, you'll be up to speed with those of us who have been self-employed for a long time.

What do you think? Did I miss anything new 1099 docs need to know? Are you 1099 or W-2 or a combination? Comment below!