

Self-Employment Income

by Sophia



WHAT'S COVERED

In this lesson, you will compare the financial pros and cons of self-employment and ways to structure a business. You will also explore how strong productivity, problem solving, and technology skills can help you be successful working under this arrangement. Specifically, this lesson will cover:

1. Overview of Self-Employment

1a. Characteristics of Self-Employment

1b. Characteristics of Self-Employed Individuals

1c. Independent Contractors

2. The Pros and Cons of Self-Employment

2a. The Advantages of Self-Employment

2b. The Risks of Self-Employment

3. Business Structures

3a. Sole Proprietorships

3b. Partnerships

3c. Limited Liability Companies

3d. Corporations

1. Overview of Self-Employment

Do you, like millions of others, dream of being your own boss? The ever-changing economy will always have space for motivated and thoughtful **self-employed** individuals. Being self-employed or working for someone else is often a choice for those working in almost any industry or profession.

1a. Characteristics of Self-Employment

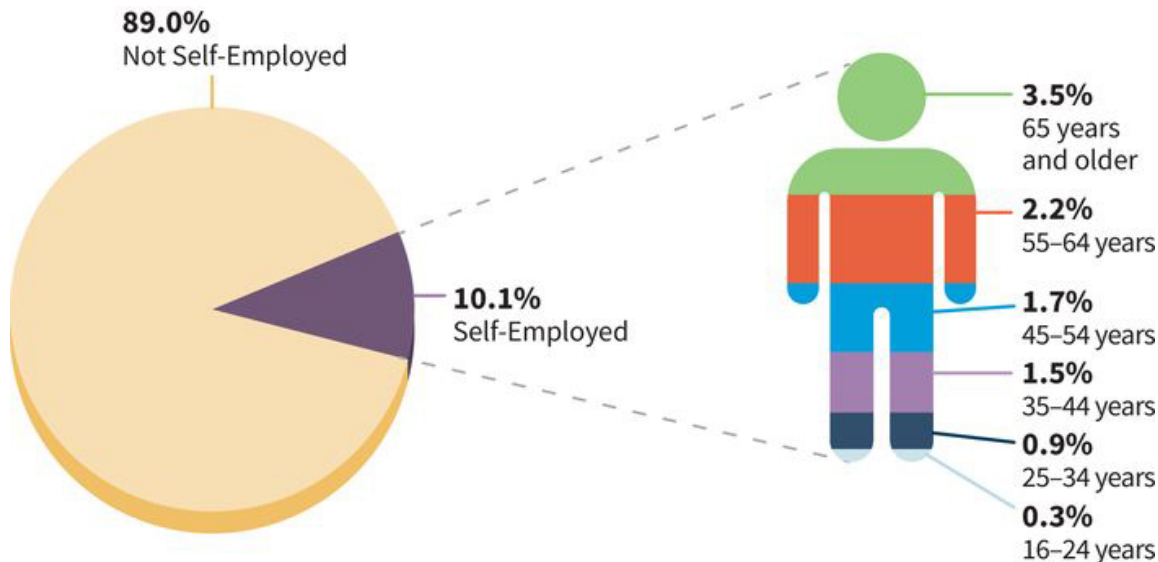
If you are self-employed, then you earn income from a business that you operate. As a result, being self-employed means that you:

- Set your own hours of work

- Charge for your products or services
- Pay your own taxes

About 25% of self-employed individuals have one or more employees working for them. The term *small business* also applies to self-employed individuals, whether they have employees or not.

As shown in the following illustration, approximately 10% of all workers in the United States are self-employed.



Source: <http://www.bls.gov/spotlight/2016/self-employment-in-the-unitedstates/home.htm>.



TERM TO KNOW

Self-Employed

Earnings come from a business that you operate.

1b. Characteristics of Self-Employed Individuals

Self-employed individuals share some common personality traits. These general personality traits apply regardless of whether the self-employed person owns a landscape maintenance company or an investment firm.

- Wanting to be their own boss; self-directed
- Possessing a high level of motivation and individual responsibility
- Placing a high emphasis on individual effort
- Solve problems proactively

1c. Independent Contractors

Self-employed individuals can also work as **independent contractors**. Independent contractors enter into agreements with other businesses and individuals to perform specific tasks or functions. This may sound like being an employee, but it is different.



KEY CONCEPT

If you are in college or just starting your career, it is important to understand how you are being paid. Sometimes employers hire people as “employees” but pay them as independent contractors. These employers do this because it saves them money as they do not have to provide benefits to independent contractors.

Recall that independent contractors are responsible for their own taxes, which saves these employers more money. Some employers are not effective in communicating this to their independent contractors (who think they are employees). This can result in a big surprise when the workers file their tax return.



Technology: Skill in Action

It is April 1st and Ken, an independent contractor, has \$15,000.00 set aside for taxes. He used a spreadsheet and online tax calculator to make sure he saved enough money throughout the year to cover his tax burden. His strong technology skill means he can rest easy knowing he can pay his bill on time and without any penalties.



TERM TO KNOW

Independent Contractor

An individual who enters into an agreement with other businesses and individuals to perform specific tasks or functions but is not considered an employee.

2. The Pros and Cons of Self-Employment

Although starting and managing a business often requires a lot of work, the benefits can be equally large.

2a. The Advantages of Self-Employment

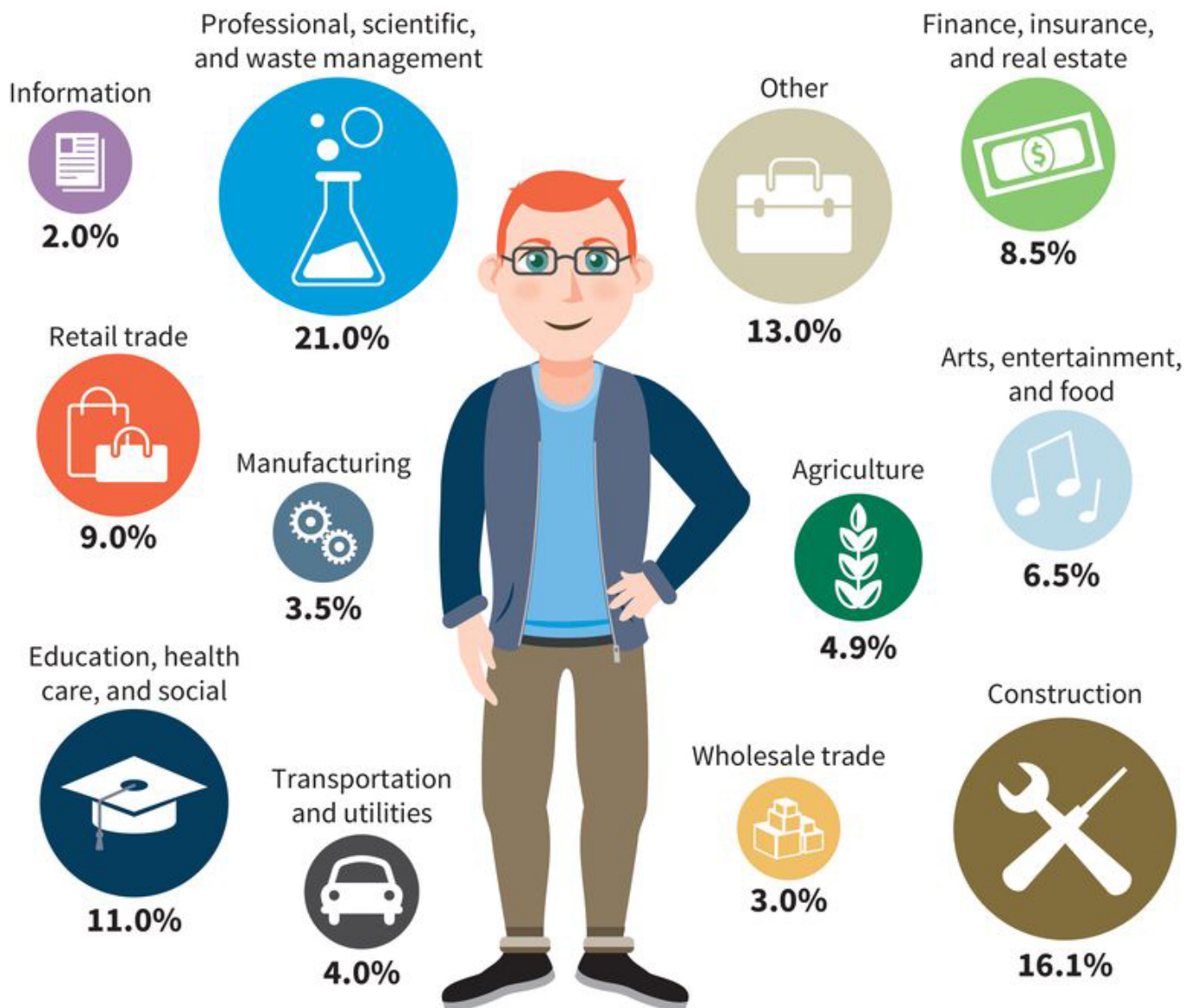
- Being self-employed allows you the freedom to be in charge of your own destiny, including setting your own work hours. However, many self-employed individuals work much more than 40 hours per week and some work irregular hours depending on client needs.
- Small business owners tend to do well financially.
- Some tax advantages associated with being self-employed include being able to deduct a variety of expenses from your annual income tax return.
- In many situations, small business owners also have the option to later sell their businesses, often quite profitably.



Productivity: Skill Reflect

The most successful entrepreneurs are productive individuals. They work long hours, but they use that time wisely. That time is focused on the business and making the most of each day. Do you know any small business owners? What steps do they take to be productive each day? Do they use technology? Manage their time wisely? Do you think they would be successful if they were not productive?

The following illustration shows the diversity of industries and professions that include self-employed individuals.



Source: "Self-Employment in the United States," Bureau of Labor Statistics (2016), <https://www.bls.gov/spotlight/2016/self-employment-in-the-united-states/pdf/self-employment-in-the-united-states.pdf>.

Distribution of Self-Employed Individuals Across Industries



DID YOU KNOW

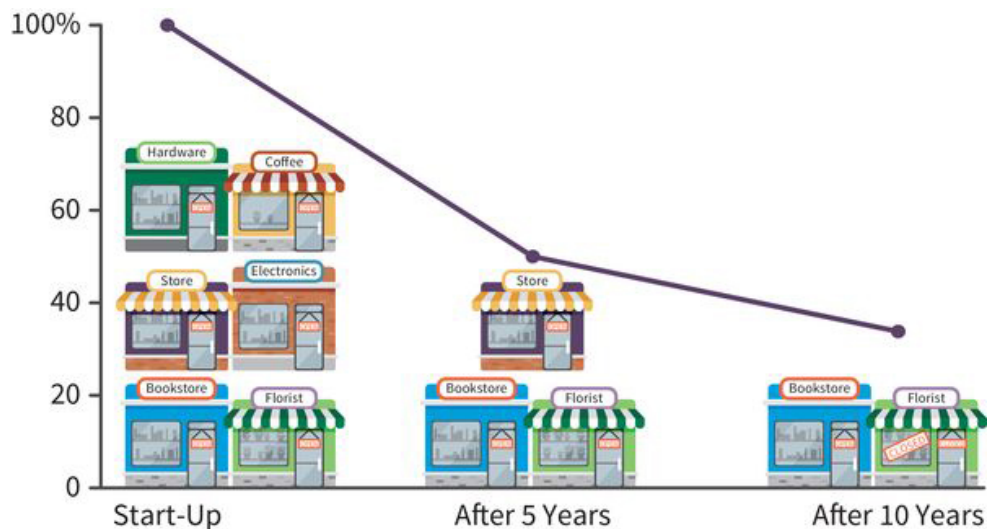
A recent study found that although self-employed individuals make up about 10% of the working population, they account for nearly two-thirds of the working millionaire population. These are individuals who had a good idea, were willing to take a chance, and are strong in the 10 skills.

2b. The Risks of Self-Employment

With so many of the wealthy households in the United States being self-employed, what could be the downside? Consider these statistics from the Small Business Administration (SBA).

- Only about half (50%) of small business start-ups are still around after 5 years.

- Only one-third (33%) are still in business after 10 years.
- The following line chart shows how the small business survival rate declines over time.



Source: "Frequently Asked Questions," Small Business Administration, <https://www.sba.gov/sites/default/files/sbfaq.pdf>.

Additionally, many self-employed individuals are not able to enjoy common employee benefits, such as paid vacation, sick days, and employer-provided health insurance. This requires using problem solving skills, and most likely some technology, to find other ways to obtain these benefits.

3. Business Structures

If you are thinking about starting your own business, one of the most important questions that you have to answer first is, "What is the legal structure of my business?"

3a. Sole Proprietorships

The default legal structure for a self-employed individual is a **sole proprietorship**. The advantages of a sole proprietorship are as follows:

- This form of business organization is easy to start up and requires no legal registration or paperwork.
- Because you are the owner, you are in charge of the decisions.
- All income and expenses from the business activity flow through to your personal tax return, including paying income tax and self-employment tax on the earnings. Losses from your business can lower your tax liability.

Legally, a sole proprietorship is not separate from the individual. As a result, there are also some associated disadvantages.

- You have **unlimited liability**, that is, you are totally responsible for paying any business debt and expenses. All of the liabilities that the business incurs (e.g., debts, lawsuits, and taxes) are yours.
- These liability amounts are not limited to the amount you invest in the company. This means that if your small business runs into financial difficulties and you are unable to pay its obligations, your personal assets

can be seized by creditors to pay the debts and obligations of the business.

If the latter occurs, many small business owners file for **bankruptcy** to protect their remaining personal assets. Bankruptcy is a legal process through which an individual's assets or income are divided among creditors and any remaining unpaid debts are forgiven.



TERMS TO KNOW

Sole Proprietorship

The default legal business structure of a self-employed individual; requires no legal registration or paperwork, and all income and expenses from business activities flow through to the individual's personal tax return.

Unlimited Liability

Having total responsibility for the losses associated with a negative event; most often associated with owning a business as a sole proprietor.

Bankruptcy

A legal process through which an individual's assets or income are divided among creditors and any remaining unpaid debts are forgiven.

3b. Partnerships

In contrast to a sole proprietorship, you may choose to form a partnership with one or more other individuals. There are many different types of partnerships, with the most basic being a **general partnership**. In a general partnership:

- Decision making is typically by majority.
- **Capital** – the money used to start or expand the business – can be raised through the collective assets of the partners and through the borrowing capacity of the partners.
- Taxation for each partner's share of income is included on each partner's respective tax return. The partnership does not pay taxes on business profits. Instead, taxable income flows through to the owners.

A major drawback of a general partnership is that each partner has unlimited liability for the entire partnership. This means that each partner is totally responsible for the mistakes of other partners. As a result, other partnership structures have been developed.



TERMS TO KNOW

General Partnership

Form of legal business structure operated by two or more individuals where decision making is typically made by the majority.

Capital

The money used to start or expand a business.

3c. Limited Liability Companies

One of the most popular business structures is a **limited liability company**. A limited liability company (LLC) shields the personal assets of the owner(s) from the liabilities of the business even though all losses (and earnings) from an LLC flow directly to the owner(s).

- If the business is not able to pay its debts, creditors can claim the assets of the business, but they cannot claim the nonbusiness assets of the owner.
- LLCs are similar to partnerships in structure but limit liability much better than general partnerships.
- Although there are higher legal costs associated with setting up an LLC as opposed to a general partnership, the added liability protection generally outweighs the additional costs.



TERM TO KNOW

Limited Liability Company (LLC)

A legal business structure that shields the personal assets of the owner(s) from the liabilities of the business.

3d. Corporations

Another way to avoid being personally responsible for the liabilities of your business is to form a **corporation**. A corporation is a legal structure that is separate from the owner(s) of the business. Corporations are very effective at limiting liability, but they are also expensive to form and maintain. Because of this, few self-employed individuals and small businesses are structured as corporations.



BIG IDEA

If you are self-employed, how you choose to structure your business can have a big impact on your ability to make decisions about the business, including issues related to:

- Raising and borrowing money
- Limiting your liability
- Paying taxes

These issues, in turn, can affect how much income you will be able to earn from your business. It is, therefore, important to talk with an attorney when making business structure decisions.



TERM TO KNOW

Corporation

A legal business structure that is separate from the owners of the business.



SUMMARY

In this lesson, you learned about the **characteristics of self-employment**. You also studied several **characteristics of self-employed individuals** which include motivation and individual responsibility. You examined how the 10 skills play a big role for anyone who is self-employed. You also weighed the **advantages and risks of self-employment** to see if being your own boss fits with your financial goals. Finally, you compared the pros and cons of four different **business structures**:

- **Sole proprietorship**
- **Partnership**
- **Limited Liability Company**
- **Corporation**

Each legal structure is different when it comes to making decisions, raising money, paying taxes, and incurring liability.

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TERMS TO KNOW

Bankruptcy

A legal process through which an individual's assets or income are divided among creditors and any remaining unpaid debts are forgiven.

Capital

The money used to start or expand a business.

Corporation

A legal business structure that is separate from the owners of the business.

General Partnership

Form of legal business structure operated by two or more individuals where decision making is typically made by the majority.

Independent Contractor

An individual who enters into an agreement with other businesses and individuals to perform specific tasks or functions but is not considered an employee.

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