Financial Planning
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5 Planning Rules for Self-Employed Clients

They've been dubbed the 1099ers for the tax forms used to report their income: freelancers, sole proprietors, contract workers. The population of workers who are not employees of a company is a growing part of the American workforce. The business services company MBO Partners found in a survey last year that there are 17.7 million independent workers in the U.S., up 10% from 2011.

The needs of those workers are likely to be very different from those of the average client, and planners need to know more about the variables that can affect independent workers in order to best advise them.

The biggest difference is a greater volatility in their finances. "Short-term disruptions can derail long-term goals," says Jake Akoury, director of business development and training at the Bulfinch Group in Needham, Mass. Freelancers don't benefit from "the safety net in the corporate world," he points out.

Self-employed clients need a much bigger cash cushion to ride out income volatility. Although the conventional wisdom is for people to keep three to six months' worth of expenses in an emergency fund, advisors tend to agree that the threshold should be much higher for the self-employed.
cash reserve

"When you have a highly variable in-come, one of the things you want to do first is to build up a cash reserve," says Benjamin Sullivan, client service manager at Palisades Hudson Financial Group in Scarsdale, N.Y. "Six to 12 months isn't sufficient. ... It might not be earning much in the short term, but you want to have liquid assets."

Depending on the nature of the client's business, "I like to see people have 18 to 24 months in terms of a backstop cash flow," says Andy Smith, senior vice president at the Mutual Fund Store in Indianapolis.
And it's often best to keep these funds in a safe, accessible vehicle. "Usually, I'm going to keep reserves in a money market account," says Micah Porter, president and CEO of the Minerva Planning Group in Decatur, Ga.

"The worst thing you can do with reserves is to chase returns."

INVESTING FOR RETIREMENT

Independent contractors don't have the built-in benefit of a corporate 401(k) or pension plan, but there are other ways to build tax-advantaged retirement savings. "There's a dizzying array of options for people who are self-employed, but sort of a first stop is the basic IRA," says Christine Benz, director of personal finance at Morningstar. "The administrative barriers are next to none."

Other options for 1099ers are a SEP IRA or a solo 401(k) plan. "They can basically look at what their net income is and put 20% of their net income into an SEP," says Bob Glovsky, vice chairman and a principal at the Colony Group in Boston. The current annual limit for people younger than 50 is $52,000.

There are also annual caps on contributions to a solo 401(k) — but this isn't as much of a hindrance as it seems, Glovsky says. "In a 401(k), you have the 401(k) piece and then you have an employer part, which is considered profit sharing," he explains. Since a sole proprietor is wearing both hats, he starts with the individual contributions and then can add 20% of net adjusted profits, up to $52,000 for workers younger than 50.

ROLLOVER OPTIONS

Many independent workers used to work for companies until, by either design or default, they went into business for themselves. This means they may have 401(k) assets in a former employer's account.
Benz suggests a cost-benefit analysis to determine if a rollover is worth it. "If it's a very large employer with a gold-plated plan, it might make sense to leave those assets behind," she says, "but often the rollover is better."

One detail that should be examined is the plan's administrative fees. A client might be better off rolling over the funds to avoid these. "If you're being charged more than 50 basis points in administrative expenses in addition to fund costs, that's a red flag you've got an expensive plan," Benz says.

There is another option for older independent workers with relatively high incomes. "If they've over 50 and making a sizable amount, they may want to explore a defined-benefit plan," Glovsky says. For people making at least six figures annually who don't have much saved for retirement, this lets them catch up by saving more than they can with defined-contribution plans.

The big caveat is that the client has to commit to financing the plan at a certain rate, so professionals whose income can be volatile — say, high-end real estate agents — might not be the best candidates. An additional drawback is that these plans require administration by an actuary, which can cost up to a few thousand dollars a year.

INSURANCE ISSUES

Most employees get their health insurance through their employers, and may get disability coverage or life insurance, as well. But independent workers have to provide all this for themselves.
In general, because of the Affordable Care Act, self-employed individuals should find it easier to buy private health insurance, especially if they have a pre-existing condition that barred them from coverage.

"Consider whether a high deductible plan and health savings account combo is a good idea," Benz suggests.

"The HSA allows you to put in pretax dollars, it compounds on a tax-deferred basis and it's not taxed upon withdrawal." Unlike a flexible spending account, HSA funds can roll over from year to year, and there aren't income limits. That's good, Benz says, for "when you're retired, and you have a lot more out-of-pocket health care costs."

Planners say disability insurance is more important for self-employed people than for company employees. If they can't work, their income stream vanishes. But getting a policy can be tricky for some independent workers, Porter says. If clients don't have firm contracts to show their earning capability, insurers often can't put a dollar value on how much their ability to work is worth. "If you're a freelancer working from home, it's tough to get disability insurance," he says.

Life insurance is also critical. How much is enough? "Usually when we approach life insurance, we look at it as a way to cover income replacement and potentially debt repayment," Porter says. Rather than focusing on income, calculate the value based on a client's expenses, he suggests. "The expenses are much more constant."

TALKING TAXES

The self-employed have to cover not only their own share of Social Security and Medicare taxes, but the portion normally picked up by employers, too. "The biggest implication is going to be their tax situation," says Greg Sarian, managing director of the Sarian Group at HighTower Advisors in Wayne, Pa.

These clients pay taxes quarterly, so "for someone who's a brand-new self-employed individual, make sure you're setting aside enough money," Benz adds.

There is an upside to this additional bite: "They have a lot of unreimbursed business expenses," Sarian says. Many of these — mileage, computer expenses, office space rental or home office expenses — may be deductible, lowering a client's taxable income base. "We want to get to know his or her accountant."

Martha C. White, a New York writer, has contributed to The New York Times, Fast Company and Time.com.

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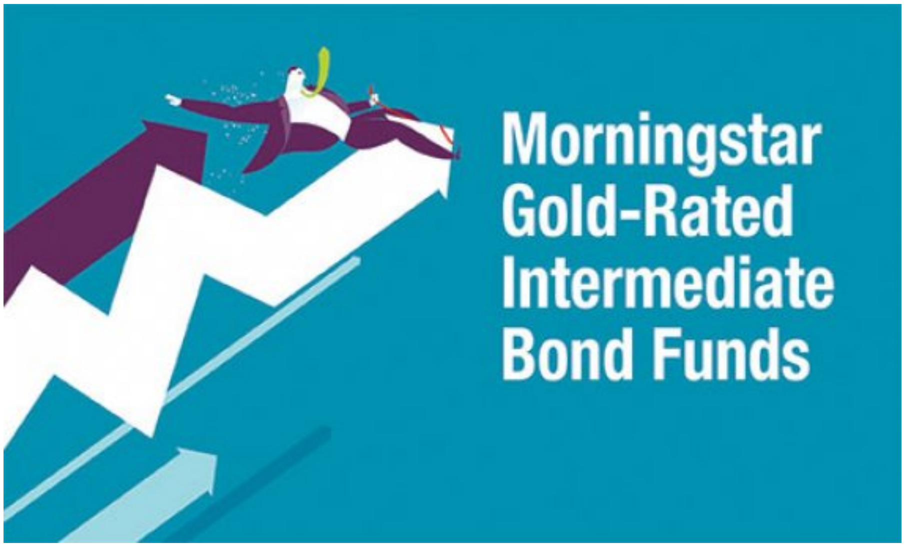

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