

WHO WORKS FOR WHOM? AND WHO REPORTS IT?

We'd like to remind you again of a situation we frequently encounter that poses a financial risk to freelancers and multi-person shops alike. It is the practice of not recognizing the legal distinction between when an individual is an independent contractor (freelance), and when he or she may actually be working as an employee.

A COMMON SITUATION

To illustrate, let's say a creative firm just got in a large chunk of business, one that strains its current resources. Since they're not sure how long it will last, they decide to take on a "in-house freelance" to help out rather than hiring a new employee.

By doing so they may end up paying up to twice as much an hour in wages, but they will also avoid a long-term commitment to the individual, and they won't have to provide employee benefits.

Then, too, and this is an even bigger consideration, they won't have any employer's payroll headaches and expenses to worry about: withholding and escrowing payroll taxes, and paying employer FICA, worker's compensation, unemployment, or state taxes.

In short, it is simpler and cheaper for them.

Note to CB readers outside the United States: while the specifics here apply only to US companies and residents, other countries have similar laws. The risks of running afoul of taxing authorities on this issue are universal, and growing.

The freelancer hired may also like this arrangement. There's no permanent commitment, he or she will get paid more than regular employees do (albeit probably less than an "outside" freelance). More important, as an independent contractor he or she is entitled to deduct all business-related expenses when computing taxes, such as traveling to and from a place of work. (Employees can deduct expenses only when they exceed 2 percent of adjusted gross income.)

He or she can also more easily qualify for business deductions for computers, autos, and home offices. There's more latitude in tax-favored retirement plans such as Keoghs, too.

In short, this arrangement supposedly preserves the individual's independent status and the tax breaks that accompany it.

A COMMON MISUNDERSTANDING

As prevalent as these assumptions are about who is and isn't an independent contractor, they're wrong.

If either the firm or individual in the situation above was audited by the IRS or state authorities, chances are they would not only be assessed for back taxes, but also slapped with penalties and interest for avoiding them. The reason has to do with the authorities' interpretation—not yours—of who is self-employed and who is an employee.

WHO IS AN "EMPLOYEE?"

While you may believe that any individual with a temporary—i.e., non-permanent—work assignment qualifies as a freelance, the IRS and state tax collectors take a different view.

They also view misclassified workers as the source of a major

drain of taxable revenue. Small businesses like yours are not only potential offenders, but are also much easier to audit than larger firms. (By the IRS' own estimates, approximately 40% of unreported taxes are attributable to self-employed taxpayers.)

But don't feel you're being discriminated against. One of the IRS's recent investigations involved the practices used by Microsoft in classifying its temporary workers.

Employment according to the IRS. The IRS utilizes a nineteen-question test to determine whether a worker is an employee (subject to more taxation), or an independent contractor (allowed more tax deductions). Basically, the test attempts to determine the extent to which a business directs and controls how, when, and where a worker performs his or her duties. If there is much direction and control, the worker is considered an employee; if little or none, he or she is considered self-employed.

These questions can be reviewed by downloading IRS Form SS-8 "Determination of Employee Work Status" from their web site: www.irs.gov. In addition, if you would like the IRS to make a determination in your case, you can also answer the questions and then submit the form to them. (Not recommended unless you don't mind having their determination on file.)

Employment according to many states. In addition to the IRS' criteria, many states now utilize a somewhat tougher standard—what has come to be called the "ABC test"—to determine when state unemployment taxes (and sometimes workers' compensation insurance) must be contributed by the employer. Any employer who cannot

answer “yes” to these three questions is probably liable:

A) Is the worker free from direction and control over his or her work performance?

B) Is some or all of the service performed outside the regular course or place of the employer’s business?

C) Is the worker customarily engaged in an independent business?

HOW EMPLOYERS CAN AVOID THE TAX PROBLEM

The simplest way is to treat any individual working on a temporary assignment on your premises as a temporary employee. Use the same payroll procedures and withhold the same taxes as with other employees. (Employee benefits may or may not be provided at your discretion.) Otherwise, heed the following:

Hire freelance pros, not amateurs. Insist that freelancers act and operate like independent business people. If they don’t, don’t take a chance, don’t hire them. Granted, this eliminates from consideration much inexpensive talent, but it will help keep you from paying a much higher price in audits and possible penalties later on.

The freelance should conduct his or her affairs under a business name (e.g., Jane Smith & Associates) and have all the normal attributes of a separate business—a business address, letterheads, and a business telephone. In addition, the more clients he or she has, the better. If your payments become a major percentage of any one individual’s yearly income, chances are high they’ll be considered an employee.

Before hiring, ask for a written cost estimate, then issue a purchase order against it. State on the purchase order what is expected and give an assignment termination date.

Treat freelancers as outsiders. Always make sure that the freelance submits an invoice,

on his or her business letterhead, for work done. Weekly invoicing is best. If you issue checks without an invoice, the individual will almost certainly be considered an employee.

Working hours should be defined as “flexible,” there should be a minimum of direction, and if possible they should work in different locations, including occasionally working on your assignment in their own office. (Interrupting your assign-

Misclassifying is a common and potentially expensive mistake.

ment to occasionally take another is even better.)

Consider a temp agency. Obtaining a freelance through a temp agency eliminates the tax worries. (The freelance is actually an employee of the agency, which is responsible for covering all tax obligations.) Going this route also relieves you from having to keep up with the available talent pool, evaluating relevant experiences, and considering applicant work habits.

The major tradeoff, of course, is cost, typically 25% to 50% more than for a freelance you would hire directly. This is not only because the agency’s costs are included, but also because it is unlikely that you will discover, and be able to exploit, grossly underpriced talent this way. And there is also the time factor: contacting the temp firm, reviewing applicants, making all the arrangements.

Two sources that have both a large talent base and numerous offices are Acquent Partners (www.acquentpartners.com) and Paladin Staffing (www.paladin-staff.com.)

HOW FREELANCES CAN AVOID THE TAX PROBLEM

It is crucial to maintain the appearance and operating style of an independent business. Make sure you at least follow the procedures outlined in “Hire freelance pros, not amateurs” above. It also helps to have a separate business checking account, and the normal expenses associated with an independent office and promotional and marketing activities.

You should encourage anyone hiring you to follow the advice in “Treat freelancers as outsiders” also laid out above. Although this may be awkward (“They’re hiring me, I’m not hiring them!”), remember that doing so also protects them. If they are worth working for, they should be impressed with your knowledge, and appreciative of your concern.

Even better than any of this is avoiding the problem by not getting into the situation in the first place—not accepting long-term, in-house assignments. They may be necessary occasionally. But they should always be thought of as employment of last resort, accepted only when there are no alternatives.

Aside from the risk of jeopardizing your important tax benefits, in-house freelance assignments are nearly always bad for your business in the long-term. It is difficult to build a stable business without developing a very broad base of clients. The only way to get it is to have the time to solicit new clients, and to be available for new assignments when they come along.

Don’t make the all-too-common mistake of trading short-term cash flow for long-term business prosperity.

ON ASKING ABOUT SLOWDOWNS... BILLING FOR PLANS... ETHICS... BAD TEAMING... VALUE PRICING... AND ART THAT'S TOO GOOD?

Advice

We are a small firm with three main clients who have been with us a long time. The work from one has slowed to a trickle. Should we ask them if they are trying someone else? Or should we assume that this is just a slow period and that the work will pick up in the future?

My partner feels that it would look bad to ask. But I'm getting nervous and want to know what the problem is. What is your advice?

L. D., Denver, CO

We don't think you should ask clients directly if they are using other suppliers. We do think it is appropriate to ask occasionally if all is well

All *Creative Business* subscriptions include free over-the-telephone business advice. Anytime you want another opinion, give us a call: (617) 424-1368, weekdays 10 to 5 Eastern Time. If these times aren't convenient, or we are unavailable, leave a message and we'll return your call. (For overseas subscribers [only] e-mail to: edit@creativebusiness.com.)

in your relationship with them, and whether there is anything you can do better. This may provide the information you seek. You may also wish to ask them whether they have any assignments coming along, so you can make sure to accommodate their needs when the time comes. Indicate that you are busy, so being forewarned will help ensure that they get the priority treatment their work deserves when it comes in. In other words, inquire by being helpful, but not overtly.

The underlying problem here is that you are too dependent on three clients. The problem would be reduced or go away if your workload was spread among more.

Our biggest client asked us to prepare a marketing plan for one of their products, something we had never done before. They liked what we suggested, but their new Marketing Director has a problem paying our bill (\$2,500). He says they shouldn't have to pay for a "proposal." We put a lot of time into this, including providing several ideas. Weren't we right to bill

for it? How do you suggest we handle this and future situations.

M. C., Sweetwater, TX

You were right. A proposal involves only providing pricing and scheduling information. A plan, which you provided, also involves strategizing, proposing original ideas, and defining projects. The former is normally your overhead expense; the latter billable to the client.

The problem may be that the Marketing Director was unclear on the difference. So we suggest that you go over it with him, stressing the effort you put into developing it and its potential value to the firm. Perhaps in doing so he will agree to pay.

If you still sense a reluctance, we'd cancel the billing due to the misunderstanding. In doing so, however, make it clear that future planning activities will be billable. If possible, we'd also try to recoup some of the loss by finding a way to hide some of the costs in future projects for them.

After reviewing the September/October issue of CB, I was troubled by the advice

recommended on page 10, where you said, "The easiest way to handle this situation is to tell a white lie." I about fell off my chair. The majority of what is in CB is refreshing and candid. But, you should never tell a client a lie, white or not. For your publication to endorse that philosophy is disgraceful.

It is important to maintain high ethics in our industry. This will only be passed on to new designers if publications like CB recommends ethical decisions, rather than taking the easy way out.

B. J. Madison, WI

Sorry our advice offended you. But we'll stick by it.

We certainly agree that trust between client and supplier is crucial and it is important to maintain high ethical standards in our industry. But there are times in business, as in life, when "diplomatic untruths" (the definition of a white lie in our dictionary) are called for. Such instances don't deceive in a malicious way and they don't change the outcome—they just make it easier

for one party to explain, and the other party to accept. We don't know of a person who hasn't done this—in life and in business—at one time or another. It may be the easy way out, but what is the advantage of making a situation more difficult than it need to be just to maintain an ideal?

You may disagree. And we probably could have phrased the advice a little more carefully. But rest assured that it doesn't reflect a lowering of our feelings about the importance of business ethics.

One of our clients brought in a new Advertising Manager who wants us to work with one of her consultant buddies. Apparently the idea is for the consultant to decide direction and write copy, and for us to handle art direction and ad production. We are not only concerned about this approach, but we have heard that the consultant is abrasive, opinionated, and hard to work with. How should we handle this?

M. Z., Fairbanks, AK

Good advertising is developed by a team whose members are mutually comfortable exploring, suggesting, trying, criticizing, and refining. The ability to work together, however fractiously, is not an extra, it is essential.

Meet with the consultant to come to your own conclusion as to whether you can work productively together. You may find the reported difficulties exaggerated.

If not, tell the Ad Manager that the arrangement won't work. Indicate that it is not a question of pride or who knows more or less. Rather, it is that you see basic personality and strategic differences that would make working together productively impossible. The advertising would suffer, and you can't in good conscience by party to that.

A strong stand—the quality of our work is more important than this assignment—may convince her to reconsider. More likely is that you will lose the account. Even so, it is preferable to trying to tough it through. If you did, you would likely lose the account eventually anyway, but only after much unhappiness by everyone involved.

We did a theme and logo for a client to use at a big industry trade show. They loved it so much that they've now decided to use it everywhere—in ads, on brochures, even on company vehicles. We put it together in a hurry so we didn't charge very much. Is there any way we can now charge for its true value?

C. E., White Plains, NY

Not directly. It sounds like the client had the good sense to take advantage of a bargain you handed to them.

There may be ways you can leverage it to get more money, though. We'd first explain to them the advantages of letting you refine the logo, "To make it more adaptable

to the many additional uses it is now being put to."

In addition, we'd try to get them to commit to letting you develop guidelines for its use—at minimum style sheets for different applications, ideally a usage manual. Inform them that continued uncoordinated and inconsistent use will not only threaten the logo's market impact, but may also jeopardize the copyright they hold in it.

If you haven't already, done so, we would also pitch hard to do the materials the logo will be used on in the future. After all, who better?

One or more of these opportunities—refinement, usage, and follow-on work—could more than make up for the low initial pricing.

Finally, in the future resist the temptation to do assignments fast and cheap. If you charge adequately for your efforts, how much value you create should be a non-issue. After all, creating value is exactly what clients pay you to do. Don't provide your talent

and experience at bargain-basement prices, then wonder why clients have the good sense to take advantage of it

We, copywriter and art director team, are having a disagreement. Copy side says that if art in a direct mail package is too tasteful it won't work; art side says nonsense, good taste is always effective. What do you think?

F. B., Pittsburgh, PA

Sticking our nose in this classic argument will probably get it broken. But here goes.

While we believe it ultimately depends on one's definition of taste and the audience being addressed, tests do show that white space and elegant art often discourage involvement in direct mail. Clutter apparently agitates readers, and agitated readers are more likely to respond. Too much sophistication can remove the emotional component that's necessary for direct mail success.

CB

CREATIVE BUSINESS MANAGEMENT BENCHMARK

MORE EXPOSURE TO FEWER PROSPECTS INCREASES PROMOTIONAL RESPONSE.

Because your business is providing services that are often needed only occasionally, frequency—keeping your name and capabilities in front of prospective clients—is the key to promotional success. Yet given communications clutter and the pace of business, client awareness erodes quickly after each contact. Thus, it is far more cost effective to spend a given amount of promotional money on a many-exposure campaign to fewer prospects, than on a campaign that targets more prospects but fewer times. Likewise, doing more promotions that are less elaborate usually outperforms doing fewer promotions that involve elaborately-produced items or ads.