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How to Establish a Profitable Hourly Rate

by

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Self-employed people need to carefully think through how they establish their hourly rates and take into account a number of considerations. If you are self-employed, you will have a number of costs to recover that you probably never thought about when you worked for someone else.

Those who are new to self-employment run the risk of charging an hourly rate that is far too low for them to make any serious money. Usually it's a matter of not understanding how to build an hourly rate that recovers all your costs. I suspect it's also because many lack self-confidence or are scared the fees will be too high and drive business away. (Think Chutzpah.)

If you don't recover all your costs, most likely you will never earn a profit as these costs remain even if you deal with them infrequently. Costs you must load into your hourly rate include: benefits and taxes, retirement contributions, the costs of promotion and publicity and unbillable time.

Costs Your Fees Must Cover

Benefits and Taxes

You must pay for your health, disability, errors and omission insurance and life insurance. Additionally, as a self-employed person, you pay the equivalent of both the employer and employee share of social security and Medicare taxes.

When thinking about the cost of your benefits, consider this: *Companies generally figure that the cost of benefits is about 30% of payroll.* Your percentage will be higher as you don't have the purchasing power of a company and you will pay more for the same, or less, insurance coverage. Your hourly rate must enable you to pay for all your benefits, formerly paid for by your employer, plus social security and Medicare taxes.

Self-employment has major tax implications as you must pay the Self-Employment tax. According to the IRS, "Self-employment tax is a tax consisting of Social Security and Medicare taxes primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners."

These taxes can add up as according to the IRS,

- **Tax rates.** For tax years beginning in 2011, the social security part of the self-employment tax decreases from 12.4% to 10.4%. The Medicare part of the tax

remains at 2.9%. As a result, the self-employment tax is reduced from 15.3% to 13.3%.

- **Maximum net earnings.** The maximum net self-employment earnings subject to the social security part of the self-employment tax remains \$106,800 for 2011. There is no maximum limit on earnings subject to the Medicare part.

Note: Tax rates can change annually so check your tax preparer or with the IRS for the latest tax rates. <http://www.irs.gov/>

Therefore, keep meticulous documentation of your income and expenses. The IRS requires filing a Schedule C, which is the form you file if you have self-employment income (or loss).

Learn about the tax aspects of self-employment. Understand how self-employment income is taxed, particularly the IRS requirement for quarterly payment of taxes on estimated income. Many newcomers to self-employment fail to file quarterly returns and when they file in April they are shocked with a large tax bill along with penalties for underpaying taxes. *As with any tax matter, always consult with a qualified tax advisor.*

Retirement Contributions

This is a company benefit and you must contribute what your employer formerly contributed. I write about this separately as it is important that you think about this cost now and not wait until the time when you plan to retire. When you are self-employed you won't have a company-sponsored 401k or a defined benefit plan (aka company-sponsored pension). True, you will have social security income in retirement, but you will want more income than just social security. I suggest that you earmark 10 to 15 % of each dollar earned as retirement saving.

That means you must establish your own self-directed IRA or purchase an annuity, so that when the time comes you will have a sizable nest egg from which to draw income. As with any tax matter, I urge you to check with your tax preparer for advice on the various tax-deferred retirement vehicles available to the self-employed that comply with IRS regulations and your state tax regulations.

Costs of Promotion and Publicity

Maybe you can do all your promotion on your own, but I doubt it. You will need a website, probably a brochure, business card, postage and a copywriter. You may think that all you need in order to promote your business is social media, which is free except for the cost of your time. However, you will also need a website to serve as an information/promotion hub plus outstanding promotional material such as a business card and a brochure. These items cost money.

Your Unbillable Time

You will have lots of unbillable time in keeping your books, preparing taxes shopping for insurance, collections, promoting, talking with prospects, doing social media, running errands, etc. This is time you must spend, yet no income is earned. You need to

absorb these overhead costs into your hourly rate. My own ball park figure is that at least each 15 % of your time are unbillable hours and you need to figure at least 15% of each dollar earned will go to these many tasks.

Questions to Ask When Setting Your Rate

What is the market rate for your services?

Because there is a wide variance geographically in the cost of living, what you charge will depend on where you live. For example, in my area (Milwaukee, WI) I pay \$125 an hour to my CPA and \$195 per hour to my attorney. These rates are reasonable for the location. However, these rates could be low for New York or San Francisco or could be high for Keokuk, IA.

What do your competitors charge?

Unless you are a highly skilled orthopedic surgeon or established actor like Meryl Streep or Jack Nicholson, you will have lots of competition. Find out what your competitors charge. Many times that information is available at a website. You can also talk to their clients. You don't want to be dramatically higher or lower than your competition. Once you are established and have a proven reputation, and are busy, you can gradually raise your rates.

When you are starting out and hungry for business (i.e., desperate) you might be tempted to charge significantly lower rates than the market rates. I suggest not doing this as you will attract marginal customers who may not pay their bills. Cut-rate fees also suggest that your services are subpar and that you are a beginner.

One exception: for a large dollar, steady job you may want to offer a discount of perhaps 5% to 10% . Here's why that makes sense. First, large accounts save the administrative cost of managing a large number of smaller accounts. Second, once you have that major client, you save the cost of acquiring new business. Look at it this way: it is more profitable for you to have one \$10,000 account rather than twenty \$500 accounts.

What is the value of your service to the client?

Granted, judging value is subjective and translating it into your rate is subjective. But ask yourself: "What does the client perceive as the value of my service?" "What value will my service create for the client?" Low-end prospects shop on price alone; high-end prospects are interested in results in addition to the cost of your services.

Example: When my wife and I did our estate planning we selected an attorney on the basis of one interview and did not question his fee for all our estate planning. Granted, our needs were a bit more modest than Mr. & Mrs. William Gates yet we still wanted the assurance of competence and comprehensiveness in our estate planning. Once we felt that was the case with this attorney, we decided to proceed without any further shopping around.

Will you deal with individuals or businesses?

For the most part, if your clients are individuals spending their own money, and not a corporation's, price will always be an issue. Many individuals may not understand the value of your services, will probably shop extensively, and try to bid you down. Many individuals cannot afford to pay you a rate that will cover your costs and earn you a respectable profit.

Tip: Establish a Reserve for Quarterly Taxes

Many self-employed people fail to take seriously IRS and state requirements *that you must file quarterly estimated taxes (ES) and send a check for any taxes due. Some make the mistake of thinking those amounts of taxes due are really positive cash-flow and as such additional working capital or income.* They are not. Your quarterly taxes are a cost of doing business and you must budget for them.

By setting aside cash regularly, and using it to pay your quarterly withholding taxes, you will be spared the "April surprise" the next year when you must write a large check for taxes due and penalties for underestimated quarterly taxes due. Obviously, many variables will affect the amount you need to set aside such as gross income, deductions, your marginal tax rate, etc. My own ballpark figure is 15 % As with all tax matters, always consult with a fully qualified tax professional.

Tip: Establish a "Rainy Day" Reserve Fund

When you are self-employed you will have times when no income is earned. You will also have periods when your income drops. However, your daily living costs continue as will other costs of your business such as taxes and benefits.

For this reason, I suggest you set aside a percentage of each dollar earned as a reserve fund that will provide money to pay your bills. When business slows, it's always tempting to cut promotion but that is the time to invest in promotion. Your reserve fund will allow you to promote your business during a downtime.

Your reserve fund can also serve as a capital improvement fund. By that I mean you will have money for new hardware and software as technology becomes obsolete, and up-to-date technology is important for your own productivity.

Where you invest this money will vary depending on what is going on in the financial markets. The first rule is that these monies must be in highly liquid accounts, which means you can immediately convert them into cash without any penalty or loss of capital. Money market funds and conservative mutual bond funds have been popular, but avoid stocks and real estate as these investments are highly illiquid.

How much for your rainy day fund? As with all these amount to set-aside, a one size fits all estimate is difficult. But I recommend to strive for somewhere between 5 to 10 % for your rainy day fund.

Rule of Thumb for Your Hourly Rate

I learned that the following rule of thumb works well in setting an hourly rate: Figure that at least 50% of your hourly rate will cover the many costs you must absorb being self-employed. The other 50% will be profit. So if you charge \$100 an hour, figure you will net around 50% of that amount, or \$50, as you will spend the other \$50 for a variety of costs mentioned previously and/or reinvest in the growth of your business.

Flat Fee or Hourly Rate?

What is best for you, a flat fee or hourly rate? Both arrangements can work. I generally use a flat fee and not reveal an hourly rate, given the nature of my assignments. I have found that most clients prefer the certitude of a flat fee. However, when I estimate my fee, which is fixed, I have a range of target hourly rates that I want to earn.

Hourly rate fees are common in law and accounting. Also, in my business (publishing) copyeditors and designers charge an hourly rate. And most tradesmen charge hourly fees.

In management consulting, hourly rates can be a turn-off to the prospect. If they see an hourly rate of \$150, they may resent someone making that kind of money. Of course, the prospect may not understand that you may have spent nine unpaid hours preparing a proposal and learning about the prospect's needs before making a cent.

Few prospects understand that your hourly rate must also absorb the myriad other costs, as previously discussed, involved in self-employment. So if you charge \$150 an hour, you might net out \$75 an hour, which would be fine if you worked consistently 35 or more hours a week. But you won't, as many hours each week will be unpaid hours for soliciting business and attending to the many administrative aspects of self-employment, such as shopping for insurance and bookkeeping. Your hourly rate must cover these unbillable overhead costs.

Tip: If you quote an hourly rate, suggest minimum and maximum hours to complete the job. You should also be prepared to cap the hours at the maximum as this gives assurance to the client of the total cost of your work.

However, if you quote a fixed fee, you might find that your ultimate hourly rate approaches what workers make in Bangladesh if you underestimate the number of hours it will take to complete the job.

For example, I had an assignment that I ultimately learned was a hopeless situation that even a miracle worker couldn't fix. I took this job on a flat fee basis. I charged X figuring a range of Y to Z hours to do the job. By the time I finished, I had invested three times as many hours as I estimated to complete. My hourly rate was one-third of what I budgeted. Lesson: Spend some time estimating the maximum number of hours that a flat fee job will take. See my tip.

Tip: If you are working on a flat fee basis, always keep a log of hours worked on every job. That way you have a database that will be useful in estimating how many hours various jobs should take. For example, in my data, I can find information that will help to estimate the number of hours needed for five or six of my major specialties. I also know

about how much unpaid time I should spend before I receive client commitment and get paid. For me, on major assignments, that should not exceed three hours.

Final Tip on Rates

You may be timid about charging an aggressive hourly rate for a variety of reasons. As I look back, I am shocked at how little I charged when I started to work for myself.

The one absolute truth about your fees: *No client will ever tell you that your fees are too low.*

Reviewer Acknowledgment

I wish to thank Gary Porter for his critical review of this manuscript. Gary Porter is a retired professor of accounting and author of numerous college textbooks. He is currently on the National Advisory Council and Distinguished Lecturer in the College of Business and Public Administration at Drake University. His passion for creative writing has resulted in the publication of various newspaper articles and essays, including a first-place award in the River Falls Reads (Wisconsin) contest. Gary's first fiction book, *Duffy: The Tale of a Terrier* (Beaver's Pond Press, 2011) tells the story of a rescue dog arriving in heaven with a longing for his adoring folks back home. Then he meets Rex, a literary easterner of the Boston Terrier persuasion, who encourages him to write his life story. Gary lives with his wife Melissa in Hudson, Wisconsin, where they actively support animal rescue and welfare organizations.

Services for Self-Employed Individuals

If you are interested in self-employment, consider McHugh's ***Self-Employment Evaluation Interview***, which consists of 24 questions and a self-assessment of the eight key attributes in order to judge your potential for self-employment success. For a modest fee, McHugh will evaluate your self-employment plan or, if you are self-employed, offer an evaluation of your current efforts. A written report is part of this service. Included also in your fee are complementary copies of the four papers listed below, which are for sale (\$26.00). See contact information at the end.

McHugh Papers on Self-Employment

SE-30, *Self-Employment Tactics and Tips*, 2012, 2 pages, Free

SE-31, *Ten Tips for an Effective Website*, 2012, 1 page Free

SE-32, *Self-Employment 101: Questions & Answers, Starting Out*, 2012, 9 pages, \$6

SE-33, *Eight Attributes Needed for Successful Self-Employment*, 2012, 6 pages, \$4

SE-34, *How to Establish a Profitable Hourly Rate*, 2012, 6 pages, \$6

SE-35, *Self-Employment 102, Questions & Answers, Suggestions for Success*, 2012, 14 pages, \$10

Self-Employment Forum

John B. McHugh's Self-Employment Forum provides regular tips and serves as a venue to exchange ideas with others on self-employment. Join now to participate in this informative exchange and to grow your self-employment expertise. The [-Self-Employment Forum.](#)

About John B. "Jack" McHugh

Jack McHugh is a self-employed publishing advisor and publisher. Over the last 30 years, he has created and refined his own self-employment business model. During this period of trial, error, mistakes, and successes, he kept a journal on his self-employment efforts and now has distilled them into succinct "how to's" for those who aspire to be self-employed.

McHugh contends that "there is precious little information on the 'how to's' of self-employment." Much of what is available amounts to either get-rich-quick scams or pyramid deals. He also states "the needs of those aspiring to become self-employed are not met. I have much practical wisdom to share with folks. I am the living proof of the cliché, 'You ought to write a book.'"

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