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“Taxing the Gig Economy”

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SCHEDULE FOR 2017 NYU TAX POLICY COLLOQUIUM

(All sessions meet from 4:10-6:00 pm in Vanderbilt 208, NYU Law School)

1. Monday, January 23 – Lily Batchelder, NYU Law School. “Accounting for Behavioral Biases in Business Tax Reform: The Case of Expensing.”
2. Monday, January 30 – Mark Gergen, Berkeley Law School. “How to Tax Global Capital.”
3. Monday, February 6 – Alan Auerbach, Berkeley Economics Department. “U.S. Inequality, Fiscal Progressivity, and Work Disincentives: An Intragenerational Accounting.”
4. Monday, February 13 – Allison Christians, McGill Law School. “Human Rights at the Borders of Tax Sovereignty”
5. Tuesday, February 21 – Jason Oh, UCLA Law School. "Are the Rich Responsible for Progressive Marginal Rates?"
6. Monday, February 27 – Stephen Shay, Harvard Law School. “‘A Better Way’ Tax Reform: Theory and Practice.”
7. Monday, March 6 – Scott Dyreng, Duke Business School. “Trade-offs in the Repatriation of Foreign Earnings.”
8. Monday, March 20 – Daniel Hemel, University of Chicago Law School. "Federalism Safeguards of Progressive Taxation."
9. Monday, March 27 – Leonard Burman, Urban Institute. “Is U.S. Corporate Income Double-Taxed?”
10. **Monday, April 3 – Kathleen Delaney Thomas, University of North Carolina Law School. “Taxing the Gig Economy.”**
11. Monday, April 10 – Julie Cullen, UC San Diego Department of Economics. “Political Alignment and Tax Evasion.”
12. Monday, April 17 – Miranda Perry Fleischer, University of San Diego Law School. “The Libertarian Case for a Universal Basic Income.”
13. Monday, April 24 – Joel Slemrod, University of Michigan Business School. “Taxing Hidden Wealth: The Consequences of U.S. Enforcement Initiatives on Evasive Foreign Accounts.”
14. Monday, May 1 – Richard Vann, University of Sydney Law School. "International tax post-BEPS: Is the corporate tax really all that bad?"

Taxing the Gig Economy

KATHLEEN DELANEY THOMAS*

Due to advances in technology like mobile applications and online platforms, millions of American workers now earn income through “gig” work, which allows them the flexibility to set their own hours and choose which jobs to take. To the surprise of many gig workers, the tax law considers them to be “business owners,” which subjects them to onerous recordkeeping and filing requirements, along with the obligation to pay quarterly estimated taxes. This Article proposes two reforms that would drastically reduce tax compliance burdens for this new generation of small business owners, while simultaneously enhancing the government’s ability to collect tax revenue.

First, Congress should create a “non-employee withholding” regime that would allow online platform companies such as Uber to withhold taxes for their workers without being classified as employers. Second, the Article proposes a “standard business deduction” for gig workers, which would eliminate the need to track and report business expenses. Although this Article focuses on the gig economy as an illustration of how the workplace has evolved in recent years, the proposals apply more broadly to taxation of small, individually run businesses. In an era when the use of cash is on the decline and information can be shared rapidly and at little cost, it is time for policymakers to institute a more modern tax enforcement regime for small businesses.

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INTRODUCTION

Technology is revolutionizing the way we do business. Online platforms like Uber and TaskRabbit now efficiently connect service providers and other workers with willing consumers. This new mode of transacting has transformed the landscape for twenty-first century workers. No longer must they choose between working solely as an employee (subject to the restrictions and control of their employer) and starting their own business (requiring an investment of time and money to do things like advertise and find a customer base). Using mobile applications, workers can now tap into the existing infrastructure and customer network of an online platform company, while maintaining the freedom of setting their own hours and choosing which jobs to take.¹ As a result, millions of Americans have joined the so-called “gig economy”² in recent years, and that number is on the rise.³

The profile of the twenty-first century gig worker is somewhat different than that of a traditional small business owner. The former tend to be younger, less financially sophisticated, work fewer hours (often supplementing traditional employment with gig work), and make less money. Whereas a traditional sole proprietor who owns a catering business, for example, might earn \$100,000 per year working 40-hour weeks, a typical Uber driver earns less than \$10,000 per year and works fewer than 15 hours per week.⁴ Because the majority of gig workers use online platforms to supplement wages or otherwise earn part-time income, they are commonly thought of as independent contractors rather than small business owners.

But from a tax perspective, there is little distinction between the full time caterer and the 10 hours per-week Uber driver. For purposes of the tax law, if an individual earns income from services outside of the traditional employee-employer relationship, that individual is a “business owner” for tax purposes. What this means is that the Uber driver earning \$5,000 per year must file the same complex tax forms and make the same quarterly tax

¹ See Sarah A. Donovan, David H. Bradley & Jon O. Shimabukuro, *What Does the Gig Economy Mean for Workers?* CONG. RES. SERV. R44365, available at <https://www.fas.org/sgp/crs/misc/R44365.pdf>.

² *Id.* at 1 (The gig economy is “the collection of markets that match providers to consumers on a *gig* (or job) basis in support of on-demand commerce.”).

³ An estimated 2.5 million people earn income in the on-demand economy every year, with over 10 million reporting having done so in the past 3 years. See Diana Farrell & Fiona Greig, *Paychecks, Paydays, and the On-demand Platform Economy: Big Data on Income Volatility*, JP MORGAN CHASE INSTITUTE, 1-43 (Feb. 2016), available at <https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf>. These numbers are expected to increase over the next decade. See Caroline Bruckner, *Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy*, REPORT FROM THE KOGOD TAX POLICY CENTER, 3 (May 23, 2016), available at <http://www.american.edu/kogod/news/Shortchanged.cfm>.

⁴ See Farrell & Greig, *supra* note 3, at 6; Bruckner, *supra* note 3, at 5.

filings as a seasoned and wealthy business owner. And the tax implications of being a business owner can be severe. Because there is no employer to withhold taxes, business owners must budget for self-employment and income taxes on their own and pay quarterly estimated taxes to avoid imposition of a penalty. The taxpayer must also keep receipts and other detailed records of expenses to calculate their taxable income on IRS Schedule C, which can be a burdensome and time-consuming process. Because many gig workers do not consider themselves to be business owners and have never filed business-related tax returns, they are at best confused by and at worst completely unaware of their tax obligations.

For a more established business owner – one who earns significant income, has an established book and recordkeeping system, and likely employs an accountant – the current business tax regime may be appropriate. But that regime is a mismatch for lower income and potentially unsophisticated gig workers. Subjecting them to tax compliance rules aimed at traditional sole proprietors is not only burdensome, but likely leads to lower tax compliance (leading, in turn, to less revenue for the government). It is also inefficient, as individuals spend hours of time navigating complex tax rules to report relatively low amounts of income.

This Article argues for a new tax regime to apply to workers in the growing gig economy. In doing so, it proposes two novel and fundamental changes to the current tax law. First, it calls for “non-employee withholding” on earnings paid out by online platform companies like Uber and TaskRabbit. Like traditional employers, platform companies would withhold a fixed percentage of a gig worker’s gross receipts to cover the worker’s self-employment and income tax obligations, obviating the need for the worker to file quarterly estimated taxes. Second, the Article proposes a “standard business deduction” (“SBD”) for gig workers equal to 60 percent of the worker’s gross receipts.⁵ Like the regular standard deduction, the SBD would be optional and the taxpayer could forego it if actual business deductions exceeded the SBD. However, if the taxpayer chose the SBD, she would simply report her net business income by subtracting 60 percent of her gross receipts, eliminating the need for her to track and report business expenses. This highly simplified tax regime should improve compliance and taxpayer morale among gig workers, reduce the time, financial cost and anxiety associated with tax compliance, and is likely superior from an efficiency standpoint.

While this Article focuses specifically on gig workers to illustrate how the business landscape has changed in recent years, the proposals apply more broadly to individual small business owners. Alternative work arrangements are on the rise, money is changing hands electronically, and sharing information is easier and cheaper than ever before. On the plus side, this means that tracking income and withholding taxes are often viable now

⁵ The sixty percent SBD proposed here is based on historic average profit ratios for small sole proprietorships of around 40 percent, and may be subject to changed based on newer and/or better data. *See infra* Part II.D.

when they previously were not. The downside is that more and more taxpayers are being subjected to complicated tax reporting rules for relatively small amounts of income. Thus, this Article's ultimate goal is to advocate for an updated tax regime that reflects the modern realities of small business ownership.

The Article proceeds in four parts. Part I provides general background on the gig economy and the current tax rules applicable to all small business owners, including gig workers. Part II details the two proposals: non-employee withholding and the standard business deduction. Part III explores potential issues, objections, and alternatives to the proposed regime. Part IV concludes.

I. TAX ISSUES FOR WORKERS IN THE GIG ECONOMY

This Part summarizes the evolution of the gig economy and discusses particular tax challenges faced by gig workers. Many of these challenges apply more broadly to all types of individual small business owners.⁶ However, it is useful to focus on the gig economy because it highlights two trends that are highly relevant to the design of tax compliance policies. First, digitization has made commercial transactions traceable when they were not previously, which can greatly improve tax enforcement. Second, the role of platform companies as online intermediaries has made self-employment significantly more attractive than it was in the past.

A. *Background on the Gig Economy*

Advances in technology and the proliferation of smartphones have made it vastly easier for consumers to connect with providers of goods and services via the Internet or mobile applications.⁷ This new virtual marketplace has been created by a number of online platform companies like Uber, Lyft, TaskRabbit, and Airbnb,⁸ whose websites and apps allow consumers to search for and purchase goods or services. At the same time,

⁶ For purposes of this Article, I use "small business" to refer to individually operated sole proprietorships, not businesses operated through corporations or pass-through entities, which implicate additional tax rules. Given that most gig workers operate on a small scale and frequently are not financially sophisticated, presumably the vast majority do not operate through a separate entity.

⁷ Donovan et al., *supra* note 1, at 1.

⁸ While driving services (e.g., Uber and Lyft) and personal services (e.g., TaskRabbit) are perhaps the most well-known gig economy sectors, there are many others, such as medical care, delivery, and business services. See Donovan et al., *supra* note 1, at 2. For a description of twenty-six "prominent online intermediary companies," see Seth Harris & Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First Century Work: The "Independent Worker"*, THE HAMILTON PROJECT, Disc. Paper 2015-10, Appendix (Dec. 2015), available at http://www.hamiltonproject.org/assets/files/modernizing_labor_laws_for_twenty_first_century_work_krueger_harris.pdf.

the platforms allow workers to advertise and sell goods or services in exchange for a fee (typically a percentage of the worker's receipts from use of the platform).⁹

The so called “gig workers” who are providing goods and services through online platforms represent a departure from the typical twentieth century worker. Prior to the advent of the on-demand economy, most workers were employees, usually sacrificing some measure of control and flexibility in return for steady wages and other benefits like health insurance. A smaller subset of workers were self-employed, i.e., individuals who operate their own businesses or work as freelancers. Self-employment offers the control and flexibility missing from traditional employment, but may come at the expense of high start-up costs and income insecurity. But in recent years, online platforms have broadened the opportunity for individuals to become self-employed by vastly reducing these start-up costs.¹⁰

Nowadays, no longer must an individual establish a customer base, incur marketing and advertising costs, or build a brick and mortar storefront to earn income outside of the employment context.¹¹ In exchange for a fee to the platform company, the customer base and other necessary infrastructure to earn income are in place on day one, and the worker maintains much of the flexibility and control associated with self-employment.

As a result of these relatively recent technological innovations, there has been a dramatic rise in non-employee work arrangements in the past decade that is expected to continue.¹² Each month, more than 3 million workers earn money through online platforms by doing things like driving, running errands, renting rooms or apartments, or selling goods.¹³ Platform work is currently the fastest growing segment of the labor market, with the size of the on-demand economy expected to at least double by 2020.¹⁴

⁹ For a more in-depth discussion of the gig economy, see Shu-Yi Oei & Diane Ring, *Can Sharing Be Taxed?* 93 WASH. U. L. REV. 989 (2016).

¹⁰ Donovan et al., *supra* note 1, at 2.

¹¹ *Id.*

¹² From 2014 to 2015, the number of alternative work arrangements in the U.S. rose from 14.2 million to 23.6 million, an increase of 66 percent. Bruckner, *supra* 3, at 2, citing Lawrence F. Katz & Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015* (Mar. 29, 2016), available at http://scholar.harvard.edu/files/lkatz/files/katz_krueger_cws_v3.pdf. The number of participants in the gig economy has increased nearly forty-seven times between 2012 and 2015, with gig earnings increasing ten fold. Farrell & Greig, *supra* note 3, at 21.

¹³ Bruckner, *supra* note 3, at 2, 4 (“[M]ore than 3.2 million Americans [are] currently working in the on-demand platform economy....”).

¹⁴ Testimony of Professor Caroline Bruckner, *The Sharing Economy: A Taxing Experience for New Entrepreneurs Part I*, U.S. of Representatives Committee on Small Business, 3 (May 24, 2016), available at http://smallbusiness.house.gov/uploadedfiles/5-24-16_bruckner_testimony_.pdf

For most gig workers, platform earnings are a secondary source of income, often supplementing wages.¹⁵ For workers providing services (e.g., driving, running errands), a recent study showed average monthly earnings of \$533 (\$6396 annually), which represented about a third of workers' total monthly income.¹⁶ For those earning money from property (e.g., renting a house¹⁷ or selling jewelry), average earnings were just \$314 per month (\$3768 annually), representing 20 percent of total income.¹⁸ These lower income amounts, generally less than \$10,000 per year for most gig workers, reflect less-than-fulltime hours invested in gig work. One survey of gig workers revealed that 72 percent work less than 10 hours per week on average, while 92 percent reported working less than 20 hours per week.¹⁹

B. Tax Issues Related to Gig Work

Currently, most online platform companies treat their gig workers as independent contractors, rather than employees for tax (and other) purposes.²⁰ The employee/contractor distinction is a hotly contested issue in this context, and many gig workers have argued that they deserve the various legal protections that come with employee status, such as overtime pay, the right to organize, and health benefits.²¹ The employment status of gig workers is subject to ongoing litigation,²² and this Article does not attempt to resolve that debate in the tax context²³ or in a broader legal context.²⁴ Instead, I assume the status quo will remain in place for the

¹⁵ Farrell & Greig, *supra* note 3, at 24.

¹⁶ *Id.*

¹⁷ The average Airbnb host earns \$7530 annually. Bruckner, *supra* note 3, at 7.

¹⁸ Farrell & Greig, *supra* note 3, at 24.

¹⁹ Bruckner, *supra* note 3, at 5. Eighty-eight percent of gig workers surveyed earned less than \$15,000 from online platforms in 2015, with 74 percent earning less than \$5000.

²⁰ Oei & Ring, *supra* note 9, at 1020.

²¹ Gig workers have alleged, for example, that their arrangements violate the Fair Labor Standards Act, which requires minimum wage and overtime. Donovan et al., *supra* note 1, at 8.

²² For a discussion of federal and state related claims, see Donovan et al., *supra* note 1, at 8 – 9.

²³ Oei and Ring also point out that independent contractor/employee classification would have to be decided separately for each business in the gig economy. See Oei & Ring, *supra* note 9, at 1044. Determining whether a worker is an employee or an independent contractor for tax purposes depends upon the application of numerous factors, the most important of which are the purported employer's behavioral and financial control over the worker, along with intended duration of the arrangement. See Rev. Rul. 87-41, 1987-1 C.B. 296 (twenty factor test); IRS Chief Counsel Advice Memorandum, 1999 IRS CCA LEXIS 239; IRS CCA 199948001 (1999).

²⁴ Some commentators have argued that gig workers do not fit neatly into either classification and that a new third category of worker is needed. See Harris & Krueger, *supra* note 8, at 5 (proposing "independent worker" classification for gig workers). Harris and Krueger note that gig workers are not as independent as true independent contractors because they generally cannot negotiate their compensation, yet they don't have the extensive and ongoing relationships with platform companies that are typical of an employer-employee relationship. *Id.* at 7. The proposed "independent worker" classification would carry some benefits associated with employment status like tax

foreseeable future (i.e., that gig workers are independent contractors rather than employees). Thus, in Part III, I argue for tax reforms that don't depend on gig workers being classified as employees. But first, this subpart provides a brief overview of the tax implications of non-employee status.

1. Tax Implications of Non-Employee Status

The characterization of gig workers as independent contractors rather than employees affects their tax obligations in several important ways.

Withholding

First, employers are required to withhold income taxes on employees' wages.²⁵ This means that most employees do not have to think about their income tax obligations during the course of the year. Though income tax payments are generally due on a quarterly basis,²⁶ employers fulfill these quarterly obligations on their employees' behalf. When an employee files his tax return at the end of the year, he reconciles his annual tax liability with the tax previously withheld by his employer and, in the majority cases, claims a refund.²⁷

For a worker who does not enjoy employee status, there is no employer to withhold income taxes during the course of the year. This means the worker generally must budget for taxes and make estimated tax payments four times per year,²⁸ in addition to filing a year-end return and paying any additional balance due. Failure to make estimated tax payments can result in the imposition of a tax penalty when the taxpayer files her year-end return.²⁹

Self-Employment Taxes

Independent contractors must also pay self-employment taxes on their net earnings. Employees pay employment taxes on their wages as well, but the tax burden is split among employees and employers, with employees bearing responsibility for a 7.65 percent tax on their wages³⁰ and employers

withholding and the ability to obtain health insurance, but generally would not provide labor law protections like overtime and minimum wage. *Id.* at 15-21.

²⁵ I.R.C. § 3402.

²⁶ I.R.C. § 6654(a).

²⁷ See Joel Slemrod, *Does It Matter Who Writes the Check to the Government? The Economics of Tax Remittance*, 61 NAT'L TAX J. 251, 265 (2008) (at least three-quarters of taxpayers claim refunds).

²⁸ I.R.C. § 6654(c)(2).

²⁹ I.R.C. § 6654(d)(1) (To avoid a penalty, total estimated tax payments generally must be at least 90 percent of the current year's tax liability or 100 percent of the previous year's liability.).

³⁰ See I.R.C. § 3101(a) and (b) (6.2 percent for Social Security (on up to \$118,500 of wages) plus 1.45 percent for Medicare).

bearing responsibility for another 7.65 percent on those wages.³¹ In addition to paying half of the employment tax, the employer withholds the employee's share of employment taxes and pays them to the IRS,³² so the employee can effectively ignore these obligations. The self-employed, on the other hand, are responsible for both portions shared by employers and employees, or 15.3 percent self-employment tax on net earnings.³³ Self-employed workers must include payments for self-employment tax in their quarterly estimated tax payments.

Business Deductions

Despite more onerous filing and employment tax obligations, there is a major tax advantage to non-employee status if one has incurred significant business expenses. The tax law makes a crucial distinction between business expenses incurred by employees and those incurred by non-employees. Non-employee business expenses are deductible in computing adjusted gross income, i.e., they are considered “above the line” expenses.³⁴ This means taxpayers can generally take those deductions in full (assuming they are otherwise allowable under the Code and not subject to any specific limitations), which will reduce the amount of self-employment earnings that are subject to income and self-employment taxes.

In contrast, employee business deductions are itemized deductions taken “below the line” – after computing adjusted gross income and before arriving at taxable income.³⁵ This means that taxpayers will only take those deductions if, combined with other itemized deductions, the total amount

³¹ See I.R.C. § 3111(a) and (b) (6.2 percent for social security plus 1.45 percent for Medicare). Additional Medicare taxes (0.9 percent) apply for employees paid more than \$200,000/year, and social security taxes are not required after the first \$118,500 of wages for 2016. See IRS Publication 15 (Circular E), *Employer's Tax Guide*, 3, 23 (2016) available at <https://www.irs.gov/pub/irs-pdf/p15.pdf>. The employer may also have to pay federal unemployment taxes on the first \$7000 of wages at a rate that varies based on the amount of state unemployment contributions made. See *id.* at 34-35.

³² I.R.C. § 3102.

³³ Self-employment taxes apply if an individual earns at least \$400 from self-employment, at a rate of 12.4 percent for social security (subject to the same \$118,500 cap as for employee wages) and 2.9 percent for Medicare (subject to the same additional 0.9 percent for earnings over \$200,000). See IRS, Topic 554, *Self-Employment Tax*, <https://www.irs.gov/taxtopics/tc554.html> (last visited Sept. 27, 2016). Individuals may deduct half of their potential self-employment tax liability from their net business income before applying the 15.3 percent rate. *Id.* Thus, if an individual earned \$1000 of net business income, he could first deduct \$76.50. The result is that 92.35 percent of net earnings are subject to self-employment tax. *Id.* For example, self-employment taxes on \$1000 of net self-employment income would be 15.3 percent x \$923.50 = \$141.30.

³⁴ See I.R.C. § 62(a)(1). Additionally, half of self-employment tax is deductible in computing the taxpayer's adjusted gross income. *Id.*

³⁵ The exception is employee business expenses that are reimbursed, which may be deducted in full (above the line) against that reimbursement. See I.R.C. § 62(a)(2)(A).

exceeds the standard deduction.³⁶ Additionally, employee business expenses are considered miscellaneous itemized deductions, meaning they are only deductible if and to the extent they exceed (when combined with other miscellaneous itemized deductions) 2 percent of the taxpayer's adjusted gross income.³⁷ The practical effect of these limitations is that most minor employee business expenses are not deductible.

The deductibility of non-employee business expenses – though economically beneficial – comes with an administrative drawback. These expenses must be documented on a separate form when filing taxes (Schedule C³⁸), which adds significant time and complexity to tax return preparation.³⁹ Deductibility of these expenses also requires taxpayers to keep detailed records during the year, which employees can generally avoid since any minor expenses they incur are likely not deductible anyway.

2. Information Reporting for Gig Workers

Because they generally treat gig workers as independent contractors,⁴⁰ platform companies are not required to withhold income taxes or pay employment taxes with respect to these workers.⁴¹ However, the tax code does impose certain information reporting requirements for independent contractors that are relevant in this context. Information reporting generally describes the process by which third parties issue year-end information statements, often on Form 1099, to certain private parties they have transacted with, while simultaneously transmitting that information to the

³⁶ See I.R.C. § 63(a) and (b). For 2016, the standard deduction for a single taxpayer is \$6300. See IRS, *2016 Federal Tax Rates, Personal Exemptions, and Standard Deductions*, <https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions> (last visited Sept. 28, 2016).

³⁷ I.R.C. § 67.

³⁸ IRS Schedule C, *Profit or Loss From Business*, available at <https://www.irs.gov/pub/irs-pdf/f1040sc.pdf>.

³⁹ Self-employed taxpayers generally must also fill out Schedule SE related to their self-employment taxes. See IRS Schedule SE, *Self-Employment Tax*, available at <https://www.irs.gov/pub/irs-pdf/f1040sse.pdf>. Some taxpayers participating in gig economy may not be subject to Schedule C filing or self-employment tax if their only activity is renting real estate and if they are not actively involved in providing services related to that real estate (e.g., a person who rents a home on Airbnb but hires others to do things like clean the home). In that case, the individual must instead file Schedule E. See IRS Schedule E, *Supplemental Income and Loss*, available at <https://www.irs.gov/pub/irs-pdf/f1040se.pdf>.

⁴⁰ This Article uses “independent contractor” and “small business owner” interchangeably – both refer to non-employee workers and the tax law essentially treats an individual independent contractor as a “business owner” by requiring a Schedule C to be filed.

⁴¹ These companies would still have employment tax and withholding obligations with respect to other workers who are properly classified as employees. For example, Uber does not treat its drivers as employees, but it likely has many fulltime employees to operate its business, like financial analysts, lawyers, office managers, etc.

IRS.⁴² For example, a bank at which a taxpayer has an account will send a Form 1099-INT at the end of the tax year to inform the taxpayer of how much taxable interest his account earned that year and will also provide that information to the IRS.⁴³ The IRS, in turn, will automatically “match” the information with the taxpayer’s tax return to ensure that the interest income is reported.⁴⁴

There are two information-reporting provisions that are relevant to gig workers. First, the Code requires that payments made to an independent contractor for services aggregating over \$600 in the tax year must be reported on Form 1099-MISC.⁴⁵ In theory, this means that, if an Uber driver receives \$4000 in payments from Uber in 2016, Uber would issue a Form 1099 to the driver to reflect that amount.

However, a second information reporting provision has created some confusion in this area. That provision requires that banks, credit card companies, and “third party settlement organizations” report payments to certain payees on Form 1099-K.⁴⁶ Importantly for this purpose, payers that are considered to be third party settlement organizations -- i.e., non-bank entities that make payments for goods or services on behalf of others through a central account (PayPal, for example) – are subject to a de minimis rule.

The de minimis rule states that third party settlement organizations need only report payments to a single payee that exceed \$20,000 and represent over 200 payment transactions in the aggregate.⁴⁷ Thus, for platform companies like Uber, who appear to qualify as third party settlement organizations,⁴⁸ the 1099-K reporting requirements only apply with respect to a worker to whom the platform company pays at least \$20,000 in a given year and who accumulates payments from at least 200 different transactions.⁴⁹

⁴² See, e.g., Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?* 78 *FORD. L. REV.* 1733, 1736-39 (2010).

⁴³ See Treas. Reg. § 1.6049-1.

⁴⁴ See, e.g., Lederman, *supra* note 42, at 1738 n.20.

⁴⁵ See I.R.C. § 6041(a). There are certain limitations to the scope of this requirement: the payment must be made in the course of the payer’s trade or business and the rule does not apply to payments for goods nor for payments made to a corporation. See 2016 Instructions for Form 1099-MISC, available at <https://www.irs.gov/pub/irs-pdf/i1099misc.pdf>.

⁴⁶ I.R.C. § 6050W; Treas. Reg. 1.6050W-1.

⁴⁷ I.R.C. § 6050W(a), (e).

⁴⁸ Oei and Ring note that this position is “at least debatable,” since platform companies could potentially be viewed as “aggregated payees” under section 6050W. Oei & Ring, *supra* note 9, at 1036. An aggregated payee collects payments from a bank or credit card company on behalf of other payees, and is effectively treated as bank for purposes of the 1099-K reporting rules – meaning no \$20,000/200 transaction reporting threshold. See I.R.C. § 6050W(b)(4)(A).

⁴⁹ I.R.C. § 6050W(b)-(d). Payments that the platform company collects from others (riders in the case of Uber) are subject to this rule. However, direct payments to workers from the platform company – such as a cash bonus – are not, and should instead be subject to the 1099-MISC reporting rules under section 6041.

The confusion stems from the interaction of the 1099-MISC reporting requirements (section 6041(a)) and the 1099-K reporting requirements (section 6050W). Regulations under section 6041(a) state that, when both requirements apply, the 1099-K reporting requirements trump.⁵⁰ But that creates a surprising result: the section 6050W rules, which were intended to expand information reporting,⁵¹ effectively eliminate information reporting for transactions under \$20,000 as long as a credit card or third party settlement organization is involved.

This strange loophole⁵² has created uncertainty amongst taxpayers and tax professionals.⁵³ For now, it appears at least some platform companies have taken the position that the 1099-K rules, including the de minimis threshold, govern their information reporting requirements.⁵⁴ This means those companies are only reporting income for their workers when the \$20,000/200 transactions threshold is exceeded, rather than the much smaller \$600 threshold for 1099-MISC reporting. Others have taken a more conservative approach, interpreting the regulations as requiring issuance of a 1099-K in lieu of a 1099-MISC when both requirements would apply, but *without* regard to the de minimis threshold.⁵⁵

⁵⁰ Treas. Reg. § 1.6041-1(a)(1)(iv). *See also* IRS, *2016 Instructions for Form 1099-K*, available at <https://www.irs.gov/pub/irs-pdf/i1099k.pdf> (“Payments made by payment card or through a third party payment network after December 31, 2010, that otherwise would be reportable under [both] sections 6041 (payments of \$600 or more)...and 6050W are reported under section 6050W and not section[] 6041....”).

⁵¹ *See* H.R. 3221, Housing Assistance Tax Act of 2008, at 4 (July 23, 2008) (explaining that section 6050W was intended improve compliance among merchants who do not accurately report gross income by requiring information reporting for credit card payments made to those merchants).

⁵² The language in the regulations is somewhat ambiguous, however, as the final sentence states: “Solely for purposes of this paragraph, the de minimis threshold for third party network transactions in § 1.6050W-1(c)(4) is disregarded in determining whether the transaction is subject to reporting under section 6050W.” Treas. Reg. § 1.6041-1(a)(1)(iv). Commentators have noted that one interpretation is that payments to payees under the \$20,000/200 threshold are now exempted from information reporting even if section 6041 would have otherwise applied. Another interpretation is that section 1099-K reporting applies in lieu of 1099-MISC reporting where there is overlap, but the de minimis threshold does *not* apply, meaning all transactions must be reported on Form 1099-K when section 6041 would have applied. *See* Erik J. Christenson & Amanda T. Kottke, *Guidance Needed to Clarify Reporting Obligations for Online Marketplaces and Peer-to-Peer Platforms*, 55 TAX MGMT. MEM. 243 (2014); *see also* Oei & Ring, *supra* note 9, at 1037; Kelly Phillips Erb, *Credit Cards, the IRS, Form 1099-K and the \$19,399 Reporting Hole*, FORBES (Aug. 29, 2014), <http://www.forbes.com/sites/kellyphillipserb/2014/08/29/credit-cards-the-irs-form-1099-k-and-the-19399-reporting-hole/#3c532d86c37b>.

⁵³ *See* Oei & Ring, *supra* note 9, at 1034-38; Erb, *supra* note 52.

⁵⁴ Oei and Ring report that, for 2014, Lyft and Sidecar issued 1099-Ks only if their drivers received more than \$20,000 from rides or had over 200 rides, but issued 1099-MISCs if driver received direct bonus payments over \$600. Oei & Ring, *supra* note 9, at 1034-35. Airbnb has taken a similar position that it will only issue a 1099-K to hosts that exceed the \$20,000/200 threshold. *Id.* at 1037.

⁵⁵ *See supra* note 52. Uber appears to take this position and issues a Form 1099-K to all drivers without regard to the de minimis threshold. *See* Shu-Yi Oei & Diane Ring, *The*

The result of some companies using the \$20,000/200 reporting threshold is that substantially fewer gig workers are receiving information statements compared to what would be the case if platform companies were issuing a Form 1099 to every worker receiving more than \$600.⁵⁶ Recall that the majority of gig workers earn under \$10,000 per year from platform companies, which would not trigger the \$20,000 threshold for 1099-K reporting.⁵⁷ As a result, not only does the IRS not receive information about earnings for those workers to aid in its enforcement efforts, but the workers themselves don't receive that information either. From the worker's perspective, this lack of information reporting imposes a higher compliance burden, because it forces them to keep records of gross receipts that may be avoidable if the platform company were sharing that information with them.

3. Gig Workers Are Business Owners, But Many Don't Know It

To summarize the previous sections, the tax implications of independent contractor status for gig workers are crucial. On the plus side, these workers can deduct their business related costs without the limitations imposed on itemized deductions. For an Uber driver, for example, this might mean deducting gas, car repairs, and depreciation on her car.⁵⁸ However, despite these economic advantages, gig workers also bear the administrative burden of being treated as a "business owner" for tax purposes. It should be restated that these workers are generally treated as such without regard to how many hours they work,⁵⁹ how much they earn in the gig economy,⁶⁰ and whether

Tax Lives of Uber Drivers: Evidence from Internet Discussion Forums, 8 COLUM. J. TAX. L. (forthcoming 2017) at ____; see also Oei & Ring, *supra* note 9, at 1037.

⁵⁶ In one study, 61 percent of gig workers surveyed said they did not receive a Form 1099. Bruckner, *supra* note 3, at 15.

⁵⁷ See *supra* notes 15-19 and accompanying text.

⁵⁸ However, drivers can also claim the standard mileage deduction in lieu of deducting car-related actual expenses (like gas and depreciation), which is calculated at a fixed rate (currently \$0.54 for 2016) per mile driven in a business capacity. See Treas. Reg. § 1.274-5(j)(2); IRS, *2016 Standard Mileage Rate for Business, Medical, and Moving Announced*, <https://www.irs.gov/uac/newsroom/2016-standard-mileage-rates-for-business-medical-and-moving-announced> (last visited Oct. 10, 2016). For a more in-depth discussion of deductible driver expenses and related issues, see Oei & Ring, *supra* note 9, at 1009-13.

⁵⁹ A couple of caveats are in order. If a business does not generate profits after several years, the IRS may recharacterize it as a "hobby," which implicates different tax rules regarding deductions. See I.R.C. § 183. Further, for-profit activities (like trading stocks) may not be considered a "business" if not engaged in continuously, but that standard is generally not applied when goods or services are sold to the public. See James Edward Maule, 505-4th T.M., *Trade or Business Expenses and For-Profit Activity Deductions*.

⁶⁰ Another caveat is that self-employed taxpayers are not required to file an income tax return or report self-employment tax unless they have at least \$400 of net self-employment income. See IRS, *Form 1040 Instructions 10* (2015), available at <https://www.irs.gov/pub/irs-pdf/i1040gi.pdf>; IRS, *2015 Instructions for Schedule SE (Form 1040) SE-1*, available at <https://www.irs.gov/pub/irs-pdf/i1040sse.pdf>.

they also have wage income. This means that gig workers are responsible for detailed recordkeeping of expenses, budgeting for taxes, making quarterly estimated tax payments, paying self-employment taxes, and completing complex tax forms at the end of the year. And while some of these workers may receive information statements that help them track gross receipts, many others do not.

Dealing with the complexity of the business tax regime is no small feat for gig workers, many of whom are young, financially inexperienced,⁶¹ and work only part-time for platform companies.⁶² Because they are often unaware that the tax law considers them to be business owners,⁶³ many gig workers don't realize that they must pay estimated taxes or that they are subject to self-employment taxes.⁶⁴ This ignorance is understandable, since individuals who previously have earned only wage income would have no experience with these features of the tax system.

Even taxpayers who realize that they must make quarterly payments might have trouble budgeting for taxes or even estimating how much to set aside during the year.⁶⁵ To make matters worse, taxpayers who do not properly budget may find themselves subject to penalties and interest when they file their tax return if they cannot come up with the funds to pay the income and self-employment taxes that they owe.⁶⁶ Others may face additional difficulty at the end of the year if they did not keep detailed records of receipts and expenses. Even workers who receive 1099s may be confused about how to use gross receipts information to calculate their tax liability.⁶⁷

Business expenses are also particularly challenging for gig workers. Nearly half of gig workers in one survey didn't know about "*any* tax deductions, expenses or credits that could be claimed related to their on-demand platform income" (emphasis added).⁶⁸ Even those who are aware of the rules surrounding deductible expenses often struggle to apply them

⁶¹ Bruckner, *supra* note 3, at 10.

⁶² See *supra* note 19 and accompanying text.

⁶³ See Testimony of Professor Caroline Bruckner, *supra* note 14, at 3-4 ("Many of these taxpayers don't necessarily realize they are small business owners or what their tax filing obligations are until they receive an IRS notice.").

⁶⁴ In one survey of platform workers, roughly a third did not know that they needed to file quarterly estimated taxes or what kinds of records they needed to keep, and over forty percent were unable to estimate how much tax they would owe on their platform income. See Testimony of Professor Caroline Bruckner, *supra* note 14, at 4. These estimates are likely conservative, because the survey covered only people who identified as members of the "National Association of the Self-Employed," and presumably many, less sophisticated gig workers do not.

⁶⁵ Bruckner, *supra* note 3, at 11 ("43% of survey respondents were unaware as to how much they would owe in taxes and did not set aside money for taxes on that income.").

⁶⁶ See, e.g., I.R.C. § 6651(a)(2) (penalty for failure to pay tax reported on a return); § 6654(a) (penalty for failure to pay estimated tax); § 6601 (interest on underpayments).

⁶⁷ For example, Uber reports gross amounts on Form 1099-K, and drivers must deduct the fees they pay to Uber in calculating their taxable income. This appears to be a source of confusion for some drivers. See Oei & Ring, *supra* note 55, at .

⁶⁸ Bruckner, *supra* note 3, at 12.

to their own situations.⁶⁹ This uncertainty causes workers headaches throughout the course of the year in determining which records to keep and again at the end of the year when taxpayers must deal with their tax return and accompanying schedules. Most platform workers report that they do not receive tax assistance from the platform company,⁷⁰ and many gig workers report spending between ten and thirty-five hours preparing their tax returns.⁷¹

4. The Need for A New Regime

As discussed above, the current rules applicable to small business owners entail significant compliance burdens. As a result, new and inexperienced gig workers will bear disproportionately high compliance costs⁷² relative to their business income, including recordkeeping, seeking information about their taxes, and preparing tax returns.⁷³ And this compliance burden imposes additional costs that go beyond the time and expense imposed on the workers themselves, which itself is inefficient. High compliance burdens also likely lead to lower tax compliance on the part of gig workers, resulting in less revenue collected by the government.⁷⁴ The complexity of the business tax regime also imposes significant administrative and enforcement costs on the IRS. The government must expend resources to educate and advise confused taxpayers, to audit returns, and potentially prosecute or otherwise penalize offenders.

In a broad sense, these compliance issues are not new or unique. Small business owners have always exhibited low compliance rates compared to

⁶⁹ For a fascinating study of this issue in the context of Uber drivers, see Oei & Ring, *supra* note 55. Oei and Ring researched Internet discussion forums to learn about the particular tax challenges facing Uber drivers, and found that the highest volume of discussions centered around business deductions. Specifically, they found that the drivers “displayed uncertainty regarding: (a) line drawing between business and personal outlays, and (b) the timing of deductions and whether expenditures had to be capitalized instead.” *Id.* at _____. Others clearly did not understand the difference between current deductibility and capitalization and/or depreciation over time. *Id.* at _____. Further, many drivers had never dealt with reporting expenses on Schedule C. *Id.* at _____.

⁷⁰ Bruckner, *supra* note 3, at 13 (Sixty-nine percent surveyed did not receive tax assistance from the platform company.).

⁷¹ *Id.* at 13-14.

⁷² See, e.g., Martin Sullivan, *Economic Analysis: 10 Challenges for the Sharing Economy*, TAX NOTES (Jul. 23, 2015), <http://www.taxnotes.com/tax-notes/excise-taxes/economicanalysis-10-tax-challenges-sharing-economy/2015/07/13/14910186>.

⁷³ Of course, some gig workers will turn to a tax return preparer for assistance with their return, which entails its own costs, and does not eliminate the need for the worker to keep records throughout the year.

⁷⁴ See Mark Phillips & Alan Plumley, *Effort and Compliance as Endogenous Taxpayer Decisions* 35 (Nov. 6, 2014), available at <https://www.ntanet.org/wp-content/uploads/proceedings/2014/141-phillips-plumley-effort-compliance-endogenous-taxpayer-decisions.pdf> (“[T]axpayers are more likely to choose inaccuracy over exerting the effort to be accurate when the ‘easy-to-report’ amount is relatively lower than the expected true amount.”); Kathleen DeLaney Thomas, *User-Friendly Taxpaying*, Ind. L. J. (forthcoming 2017).

wage earners,⁷⁵ in part due to opportunity and in part due to the complexity associated with the business tax regime.⁷⁶ A number of commentators have identified the efficiency costs and inequity associated with this noncompliance.⁷⁷ However, there are two important reasons to revisit these issues in the context of gig workers, as detailed in the next part. First, the scale and scope of the businesses operated by most gig workers do not justify the compliance and enforcement costs of the current business tax regime. Second, advances in technology and the evolution of the platform economy have made it possible to simplify compliance obligations for gig workers in a way that was not previously possible for traditional small businesses.

II. A NEW TAX REGIME FOR THE GIG ECONOMY

The gig economy represents a departure from traditional “small business” in a number of ways. By dramatically lowering the cost of entry, platform companies have enabled millions of individuals to become business owners with little to no start-up cost. This has enabled more individuals to undertake non-employee work than ever before, often on a part-time basis. Additionally, advances in technology have also changed the way that business owners receive and make payments and track income and expenses. In the wake of these developments, the “old” small business tax regime is no longer a sensible model. This part develops that argument – that the current regime is antiquated in the context of the gig economy – and proposes an alternative tax regime for individual small business owners.

A. *The “New” Small Business Owners: What’s Changed*

1. Tax Enforcement in the Old Economy

Historically, the complexity of the small business tax regime made sense because of the nature of tax enforcement in the United States. The IRS relies heavily on third party information reporting and tax withholding to make sure it collects taxes in a timely matter, and those mechanisms are

⁷⁵ See, e.g., Kyle D. Logue & Gustavo G. Vettori, *Narrowing the Tax Gap Through Presumptive Taxation*, 2 COLUM. J. TAX. L. 100, 106-110 (2011); Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX LAW REV. 111, 112-113 (2013).

⁷⁶ See Logue & Vettori, *supra* note 75, at 109 (opportunity); Thomas, *supra* note 75, at 112 (opportunity); Cf. Phillips & Plumley, *supra* note 74 (complexity); Thomas, *supra* note 74 (complexity).

⁷⁷ See, e.g., Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506 (Oct. 29, 2007); Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Business and Tax Evasion*, 20 STAN. L. & POL’Y REV. 37 (2009); Thomas, *supra* note 75, at 113-114.

highly effective.⁷⁸ But for individual business owners, there traditionally has been no third party in place to act as a withholding agent or a reporter of information.

Consider, for example, a restaurant owner whose revenue is derived from paying customers. Those customers cannot be expected to withhold taxes when they pay for their meal, nor can they be expected to issue 1099s to the restaurant owner reporting the amount they pay for a meal. So in the case of business owners, the IRS has had to rely on a true voluntary compliance regime supplemented by deterrence mechanisms like audits and penalties. The restaurant owner is expected to keep careful records of his receipts and expenses, to make a detailed and honest return (facing a risk of audit and penalties if he does not comply), and to pay any tax due. The complexity associated with the business owner having to calculate and self-report his tax liability might be seen as a necessary evil to accurately taxing his net income.

From the perspective of the restaurant owner, tax compliance obligations are an inevitable cost of doing business. In the same way that the owner incurs costs to rent and insure the restaurant space, to maintain a proper business license, and to hire staff, he will expend resources to keep records and make the appropriate tax filings himself, or to retain the services of another person to do so. It's likely that the restaurant owner already has a bookkeeping system in place for his business, so keeping track of expenses and receipts for tax purposes may not entail much if any additional work that is not already being done for business purposes. He also is likely to have a segregated bank account for business earnings and a budget for regularly incurring expenses, which include but are not limited to tax obligations.

From the IRS's perspective, the primary enforcement challenge for sole proprietors like our restaurant owner has historically been the use of cash.⁷⁹ Without information reporting and withholding, the restaurant owner is essentially self-reporting his income on an honor system. This makes tax evasion comparatively easy for small business owners since they have ample opportunity to conceal or conveniently forget about receipts, particularly cash receipts.⁸⁰ Even in the unlikely⁸¹ event that the taxpayer is audited, the IRS has a much harder time detecting income when there is no

⁷⁸See IRS, *Tax Gap Estimates for the Years 2008-2010* Attachment 3, available at <https://www.irs.gov/PUP/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf> (99 percent compliance rate when withholding is present and 93 percent compliance rate when "substantial information reporting" is present).

⁷⁹ See Thomas, *supra* note 75, at 113.

⁸⁰ The compliance rate among cash businesses has been estimated to be as low as 19 percent. A Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation & IRS Oversight, S. Comm. on Fin., 109th Cong. 14 (2006) (statement of J. Russell George, Treas. Inspector Gen. for Tax Admin.), available at http://www.treasury.gov/tigta/congress/congress_07262006.pdf.

⁸¹ In 2015, the IRS audited less than 3 percent of individual returns with business income under \$1,000,000. See Internal Revenue Service, *2015 Data Book*, Table 9a, available at <https://www.irs.gov/pub/irs-soi/15databk.pdf>.

paper trail. An unscrupulous restaurant owner could simply omit all or a portion of cash receipts from his books and records and, in most cases, will not get caught. The IRS's compliance data from the past several decades reflects this reality. While the compliance rate among wage earners (who are subject to withholding and information reporting) is ninety-nine percent, compliance among sole proprietors is below fifty percent.⁸² The data also indicates that the majority of evasion among business owners has traditionally involved understating cash receipts.⁸³

2. Tax Enforcement in the New Economy

Fast forward to the present. With the rise of the gig economy, the landscape has changed from both the taxpayer's and the government's perspective. Consider first the gig workers themselves. As discussed above, most of these workers earn relatively small amounts of income (often under \$10,000) and use gig work to supplement other earnings.⁸⁴ The ease of access to part-time gig work through online platforms, along with relatively low start-up costs, suggests that these arrangements will only continue to proliferate.

But for the most part, these new small businesses do not operate on the scale that many traditional "small"⁸⁵ businesses do. A typical Uber driver, for example, has no employees, has little or no business experience, might not have a formal recordkeeping system, and likely does not have a segregated bank account for her business earnings.⁸⁶ This means that tax compliance – which requires budgeting, making quarterly tax payments, and keeping detailed records – isn't just a relatively minor cost of doing business as it may be for the restaurant owner. For the Uber driver, it likely requires significant additional time and effort that would not otherwise be expended but for the tax laws. As a result, gig workers spend disproportionately large resources dealing with tax compliance obligations compared to relatively small amounts of income, a nonsensical result that may deter future participation in the gig economy or foster tax evasion.

The tax enforcement landscape is also changing in the small business sector in two notable ways. First, the use of cash is declining⁸⁷ and, along

⁸² See Thomas, *supra* note 75, at 112. These percentages are based on the ratio of income actually reported to income that should have been reported. See, e.g., IRS, *Tax Gap Estimates for the Years 2008-2010*, *supra* note 78, Attachment 3 n.2.

⁸³ See Thomas, *supra* note 75, at 113, 128 n.109.

⁸⁴ See *supra* notes 15-19 and accompanying text.

⁸⁵ The IRS's definition of "small business" is one with receipts under \$10 million. See IRS Self-Employed Tax Center, <https://www.irs.gov/businesses/small-businesses-self-employed> (last visited Oct. 13, 2016).

⁸⁶ See *supra* Part I.B.3.

⁸⁷ See James Alm & Jay A. Soled, *Whither the Tax Gap?* [WASH. L. REV.](forthcoming 2017) ("[O]ver the course of the last several decades, the use of electronic currency in commerce has experienced a meteoric rise, supplanting physical currency use....The emergency of electronic currency as a means of payment strongly supports the proposition that the widespread use of cash to finance transactions may be coming to an

with it, taxpayers' ability to hide their receipts from the government.⁸⁸ Second, and relatedly, the use of technology to facilitate payments for goods and services interjects third parties into transactions between buyers and sellers.⁸⁹ An example of such a third party is the website Etsy, which offers an online marketplace for individuals to promote and sell, and for consumers to browse for and purchase, a variety of handmade goods. This is important from the government's perspective because those third parties can provide information to the government about transactions in contexts where third information reporting was previously not possible. Now, under the 1099-K reporting requirements, credit card companies -- and more recently platform companies -- are an important source of information for the IRS to track business receipts.⁹⁰

Underreporting business receipts, which used to be the primary source of tax evasion among small business owners, is thus becoming virtually impossible as third party information reporting expands and the use of cash declines. But unfortunately this doesn't mean that tax evasion among business owners is obsolete. Rather, it appears that many determined taxpayers have simply adapted their methods to the new enforcement landscape. A recent study of the effect of 1099-K reporting demonstrates that many small business owners offset increases to their reported receipts by simply increasing their reported business deductions, resulting in little change to net income.⁹¹ The overstatement of deductions -- previously a much smaller problem than understated receipts⁹² -- has essentially become the new tax enforcement challenge for the IRS in the wake of recent technological advancements.

3. Examples

Consider two hypothetical examples that illustrate the evolution of small business tax evasion. First, consider a restaurant owner who typically earns \$400,000 in gross receipts in a year, half (\$200,000) of which is in cash. Assume the restaurant owner also has \$150,000 of legitimate business expenses. A dishonest restaurant owner might intentionally omit much or all of the cash receipts from both his books and records and his tax return. Thus when he reports his net income for tax purposes, he might report just \$200,000 of gross receipts (omitting \$200,000), all \$150,000 of his business

end."); see also Jeffrey Kahn & Gregg D. Polsky, *The End of Cash, The Income Tax, and the Next 100 Years*, 41 FL. ST. U. L. REV. 159 (2014).

⁸⁸ See Kahn & Polsky, *supra* note 87, at 165 ("E-payments automatically leave an electronic trail for every transaction, which decrease the risk of non-reporting of income.").

⁸⁹ See *id.*

⁹⁰ See *supra* Part I.B.2.

⁹¹ Joel Slemrod et al., *Does Credit-Card Information Reporting Improve Small-Business Tax Compliance?* NBER WORKING PAPER 21412 (July 2015), available at <http://www.nber.org/papers/w21412>.

⁹² See *supra* note 83 and accompanying text.

expenses, resulting in net business income of \$50,000, which would be subject to income and self-employment taxes.⁹³ Although his true net business income from the restaurant was \$250,000,⁹⁴ the business owner's underreporting of the cash income is unlikely to be detected by the IRS.

Now consider an Uber driver who earned \$12,500 in gross receipts from driving in the past year. In addition to having paid 20 percent of that amount in fees to Uber (\$2,500),⁹⁵ assume the driver incurred \$5,000 of additional deductible business expenses during the year from gas and other car-related expenses. Because Uber will issue the driver a Form 1099-K reflecting the \$12,500 of receipts, and will also send that information to the IRS, the driver does not have the option of reporting something less than \$12,500 of gross receipts on Schedule C of her tax return.

But if she is determined to cheat, she can instead fudge her expenses. She might report, for example, that she had \$8,000 of car-related expenses, for net business income of just \$2,000⁹⁶ instead of \$5,000.⁹⁷ If the driver is audited, the IRS might have an easier time detecting her dishonesty (particularly if her claimed expenses don't match contemporaneous records) than in the case of the restaurant owner failing to report cash income. However, the odds of the dishonest Uber driver being audited are very low, and she will likely succeed in paying less tax than she owes.

These developments in technology and tax enforcement suggest a new way forward for taxing the gig economy, which is detailed in the next three sections. First, Congress and/or Treasury should clarify the application of Section 6050W to platform companies and require information reporting on Form 1099-K for transactions that exceed \$600, not the much higher \$20,000/200 transaction threshold. Second, Congress should enact legislation that would allow for withholding on payments to certain independent contractors like gig workers who qualify for information reporting. Third, additional legislation should provide for a "standard business deduction" (SBD) that would take the place of tracking actual business expenses for small businesses below a certain receipts threshold. In combination, these modifications should improve tax compliance while drastically reducing the time and resources small business owners spend dealing with their tax obligations.

⁹³ For income tax purposes, the \$50,000 of net business income (along with other adjusted gross income) would be further reduced in arriving at taxable income by deductions like the personal exemption, the standard deduction, or itemized deductions. *See* I.R.C. § 63.

⁹⁴ \$400,000 (gross receipts) - \$150,000 (business expenses) = \$250,000 net income.

⁹⁵ The typical Uber commission is 20 percent, though it varies, and Uber also deducts certain other amounts such as a "Safe Ride Fee." *See* Oei & Ring, *supra* note 55, at . All of these fees paid to Uber are deductible by the driver from the gross amount on Form 1099-K.

⁹⁶ \$12,000 (gross receipts) - \$2,000 (deductible fee to Uber) - \$8,000 (claimed car-related expenses) = \$2,000 net business income.

⁹⁷ \$12,000 (gross receipts) - \$2,000 (deductible fee to Uber) - \$5,000 (actual car-related expenses) = \$5,000 net business income.

B. *Expanded Information Reporting*

The primary contributions of this Article are the proposals for non-employee withholding and the SBD for gig workers. However, these proposals are incomplete without a call for expanded information reporting in this context, an issue that has been raised by several other commentators.⁹⁸ To briefly reiterate those arguments: information reporting is crucial to tax compliance; section 6050W's application to platform companies is somewhat unclear;⁹⁹ and Treasury or Congress could easily clarify that the obligations of platform companies to report income to independent contractors continue to be governed by the \$600 threshold, rather than the much higher \$20,000/200 transactions threshold.¹⁰⁰

Clarification of Section 6050W would ensure that any gig worker who earns more than \$600 from a platform company would receive a 1099 at the end of the year reporting her gross receipts. Not only does such third-party reporting aid in the government's enforcement efforts, it would also greatly assist the gig workers themselves by serving as a form of recordkeeping.

For now, it appears that at least some platform companies are already taking the position that 1099 reporting is required below the \$20,000/200 transaction threshold,¹⁰¹ and others may soon follow suit. Additionally, given the attention that the 1099-K reporting "loophole" has received¹⁰² and the ease with which it could be rectified, the odds of clarification in this area are probably high. The remainder of this Article thus assumes that information reporting for all payments to gig workers over the \$600 threshold will be in place, and offers two additional proposals that should significantly improve tax compliance in this area.

C. *Non-Employee Withholding*

The compliance benefits of third-party information reporting are well documented.¹⁰³ Because the IRS receives information reported by third parties, taxpayers have a strong incentive to report it and are highly likely to be caught if they do not.¹⁰⁴ But withholding provides additional

⁹⁸ See, e.g., Oei & Ring, *supra* note 9 (With respect to 1099-K reporting, "[l]egislators and regulators must act quickly to close loopholes...."); Oei & Ring, *supra* note 55 ("It would also be easy to issue guidance on how the Form 1099-K rules apply to the ride sharing (and other sharing economy) platforms...."); Kahn & Polsky, *supra* note 87, at 165 ("Section 6050W could easily be expanded to cover the information-reporting regime; the \$20,000/200 transaction floor could be lowered to cover nearly all e-payment transactions.").

⁹⁹ See *supra* Part I.B.2.

¹⁰⁰ The \$20,000 threshold was likely intended for third party payment processors like PayPal. See Erb, *supra* note 52.

¹⁰¹ See *supra* note 55.

¹⁰² See *supra* note 52.

¹⁰³ See, e.g., IRS, *Tax Gap Estimates for the Years 2008-2010* Attachment 3, *supra* note 78 (93 percent compliance rate when "substantial information reporting" is present).

¹⁰⁴ See *supra* Part I.B.2.

compliance benefits, along with efficiency advantages, that information reporting alone cannot provide.

1. Why Withholding Matters

While 1099 reporting may help independent contractors keep track of annual gross receipts, it does not ease the bulk of their tax compliance burden, which comes from: (1) budgeting for and paying quarterly estimated taxes (addressed here) and (2) tracking expenses (addressed by the SBD in the next section). Paying quarterly income and self-employment taxes on independent contractor income requires an awareness of the obligation, an understanding of how to calculate those payments, and sufficient liquid funds to make the payments.

Yet, as discussed above,¹⁰⁵ gig workers may have a particularly difficult time dealing with their tax obligations because they tend to be inexperienced, potentially illiquid, and often do not understand the tax rules that apply to them. Those who miss quarterly tax payments may owe estimated tax penalties, and those who cannot pay their balance due at the end of the year will owe additional penalties and interest.¹⁰⁶ Even workers who are able to come up funds to pay their year-end tax burden may be forced to shift their consumption patterns or asset allocations to meet their obligations.¹⁰⁷ To address these concerns, Congress should enact legislation requiring platform companies to withhold income and self-employment taxes from gig workers' gross earnings.

Reduction in Compliance Burden for Taxpayers

Withholding would eliminate a large segment of gig workers' tax compliance obligations. Because a portion of their tax liability would be collected each time they were paid,¹⁰⁸ there would be no obligation for workers to pay quarterly estimated taxes in the majority of cases.¹⁰⁹ This would also mean those workers would not have to budget for taxes during the year and worry about coming up with sufficient funds to make quarterly payments or large year-end payments.¹¹⁰ This is the treatment currently

¹⁰⁵ See *supra* Part I.B.3.

¹⁰⁶ See *supra* note 66.

¹⁰⁷ See Harris & Krueger, *supra* note 8, at 18.

¹⁰⁸ Gig workers, like any independent contractor, are generally paid periodically. For example, Uber generally pays its drivers once per week, but also offers an "Instant Pay" feature, which allows some drivers to receive their share of passenger payments immediately. Don Reisinger, *Uber Will Instantly Pay Drivers In Need*, FORTUNE (Mar. 17, 2016), <http://fortune.com/2016/03/17/uber-instant-pay/>.

¹⁰⁹ Those who earned significant amounts of income not subject to withholding from other sources may still owe estimated taxes.

¹¹⁰ Oei and Ring found that some Uber-driver forum posters – who were also wage-earning employees – dealt with this issue by adjusting their withholding levels to cover additional taxes from gig work. Oei & Ring, *supra* note 55, at .

afforded to wage earners, most of whom do not have to worry about their tax compliance obligations during the year.

Tax Refunds Provide Additional Benefits

In addition to reducing tax compliance burdens, withholding would enable workers to claim refunds when they file their tax returns. This is important because studies have demonstrated that taxpayers generally prefer receiving a refund as opposed to owing a balance, notwithstanding the fact that there is generally no interest paid on tax refunds.¹¹¹ Surveyed taxpayers indicate that they feel dread about owing a balance with their tax return, they feel anxiety about underestimating what they will owe, and that they experience enjoyment from getting a refund.¹¹² Refunds may also serve as a form of forced savings for lower income taxpayers, helping them purchase durable goods like appliances, for example.¹¹³ Notably, taxpayers' awareness about the economics of a tax refund (i.e., that the refund is essentially an interest-free loan to the government) does not appear to affect their preferences.¹¹⁴ Rather than constituting an irrational preference, it seems that the psychological benefits of receiving a refund outweigh its financial cost for many taxpayers.¹¹⁵

There are also compliance benefits to tax refunds from the government's perspective. Collecting taxes in advance will inevitably result in more taxes collected overall, as it will help some taxpayers overcome budgeting and liquidity issues. But beyond that benefit, numerous studies reveal that tax refunds actually result in more honest tax reporting, all other things being equal.¹¹⁶ This phenomenon is consistent with prospect theory, which

¹¹¹ See, e.g., Donna D. Bobek, Richard C. Hatfield & Kristin Wentzel, *An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach*, 29 J. AM. TAX. ASSOC. 93 (2007); Benjamin C. Ayres, Steven J. Kachelmeier and John R. Robinson, *Why Do People Give Interest-Free Loans to the Government? An Experimental Study of Interim Tax Payments*, 21 J. AM. TAX. ASSOC. 55 (1999).

¹¹² See Bobek et al., *supra* note 111, at 95, 99, 109; Ayres et al., *supra* note 111, at 56, 70.

¹¹³ See Michael S. Barr & Jane K. Dokko, *Paying to Save: Tax Withholding and Asset Allocation Among Low- and Moderate-Income Taxpayers*, FEDS Working Paper No. 2008-11, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327119.

¹¹⁴ See Bobek et al., *supra* note 111, at 93, 109.

¹¹⁵ See *id.* at 109.

¹¹⁶ See, e.g., Paul Corcoro & Peter Adelsheim, *A Balance Due Before Remittance: The Effect on Reporting Compliance*, in Recent Research on Tax Administration and Compliance: Selected Papers Given at the 2010 IRS Research Conference (June 29-30, 2010), available at <http://www.irs.gov/pub/irs-soi/10rescon.pdf>; Henk Elffers & Dick J. Hessing, *Influencing the Prospects of Tax Evasion*, 18 J. ECON. PSYCHOL. 289 (1997); A. Schepanski & T. Shearer, *A Prospect Theory Account of the Income Tax Withholding Phenomenon*, 63 ORG. BEHAV. & HUM. DECISION PROCESSES 174 (1995); Per Engstrom et al., *Tax Compliance and Loss Aversion*, AM. ECON. J. (forthcoming), available at http://economics.handels.gu.se/digitalAssets/1501/1501292_loss_aej_3revision.pdf; Henry S.J. Robben, et al., *Decision Frame and Opportunity as Determinants of Tax Cheating*, 11 J. ECON. PSYCHOL. 341 (1990); Otto H. Chang, Donald R. Nichols & Joseph J. Schultz, *Taxpayer Attitudes Toward Tax Audit Risk*, 8 J. ECON. PSYCHOL. 299,

generally predicts that individuals tend to be risk-seeking when facing a loss and they tend to be risk-averse when facing a gain.¹¹⁷ In the context of taxes, this means individuals who face a balance due (a loss) are more likely to engage in risky behavior like tax evasion, while individuals claiming a refund (a gain) are more likely to play it safe and report honestly.¹¹⁸ Consistent with this theory, researchers have found that, across varying income levels and sources of income, taxpayers file more accurate returns if they are owed money and less accurate returns when they owe money to the government.¹¹⁹ Thus, putting gig workers in a refund position when they file their tax return should result in more honest tax reporting by those workers.

Increased Efficiency

In addition to compliance benefits, withholding by platform companies is likely more efficient than a system under which each worker pays taxes on a quarterly basis. This is in part because the companies can take advantage of economies of scale that should make tax payments for multiple workers less costly in the aggregate.¹²⁰ Additionally, the platform companies already have the systems in place (either internally or through an external payroll company) to withhold taxes for their fulltime employees, and already have some tax information for their independent contractors for purposes of issuing 1099s.

While implementing withholding on top of information reporting may add some minor,¹²¹ additional costs for the platform companies, the overall cost is surely lower than the collective cost incurred by gig workers under the current system. The availability of online payroll systems and other advances in technology in recent years also mean that withholding can be accomplished at a lower cost than ever before.¹²² These cost savings would inure to the benefit of the government, as well, who would now have a

304 (1987); Richard Dusenbury, *The Effect of Prepayment Position on Individual Taxpayers' Preferences for Risky Tax-Filing Options*, 16 J. AM. TAX. ASS'N 1, 2 (1994).

¹¹⁷ See generally Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1972).

¹¹⁸ See Thomas, *supra* note 75, at 131-135.

¹¹⁹ See, e.g., Corcoro & Adelsheim, *supra* note 116, at 23; Thomas, *supra* note 75, at 138-139.

¹²⁰ See Joel Slemrod, *supra* note 27, at 263 (“[C]ost savings are more likely to be realized when the withholders are fewer in number than the taxpayers on whose behalf they are remitting the tax.”); see also Harris & Krueger, *supra* note 8, at 18.

¹²¹ See, e.g., Testimony of Joseph V. Kennedy, Information Technology and Innovation Foundation, before the House Committee on Small Business, *The Sharing Economy: A Taxing Experience for New Entrepreneurs Part I* (May 24, 2016), at 5, available at http://smallbusiness.house.gov/uploadedfiles/5-24-16_kennedy_testimony_.pdf (“I suspect that in many cases, it will be fairly simple for the platform to alter its payroll system to withhold taxes from workers who do more than a threshold amount of business with them.”).

¹²² See, e.g., Kahn & Polsky, *supra* note 87, at 159.

smaller group of players to monitor, and those players (i.e., the platform companies) would be much more likely to have sophisticated recordkeeping and accounting systems in place.¹²³

Further, it is likely beneficial for the platform companies to take steps to ease the tax compliance burdens of their workers, even if it entails some additional costs.¹²⁴ If workers feel uncertain or intimidated about the tax compliance costs associated with gig work, they may reduce their hours in response or be deterred from participating in gig work altogether.¹²⁵ Indeed, one study of the effect of tax complexity on labor supply found that people reduce their work effort when it is harder for them to understand what their net wage will be.¹²⁶

In the study, subjects were given a choice between earning wages for performing a task or taking part in a leisure activity.¹²⁷ Some subjects saw the wage presented as a *gross wage* minus a tax or plus a bonus (“partitioned price”); in other words, they were required to figure out the net after-tax wage themselves. Others were presented with *net wage* information (“inclusive price”) along with the partitioned price. The authors found that subjects were more willing to work in the inclusive price condition, when their net wages were more transparent, and concluded that “[a]ny additional complexity in the wage description . . . decreases work participation.”¹²⁸

The study’s findings are relevant to gig workers and other independent contractors: tax withholding essentially provides workers with an inclusive wage presentation. Every time they receive their paychecks, they can view

¹²³ Slemrod, *supra* note 27, at 266.

¹²⁴ Some platform companies have indicated a willingness to do more to help workers with tax compliance obligations, but they also indicate that they are reluctant to do so. *See* Bruckner, *supra* note 3, at 16. This reluctance is understandable because tax withholding by platform companies may appear to be an admission of “employer” status, which could carry with it a whole host of unintended non-tax implications (the right to overtime and minimum wage, for example).

¹²⁵ *See* Testimony of Joseph V. Kennedy, Information Technology and Innovation Foundation, before the House Committee on Small Business, *supra* note 121.

¹²⁶ Andrew T. Hayashi, Brent K. Nakamura & David Gamage, *Experimental Evidence of Tax Salience and the Labor-Leisure Decision: Anchoring, Tax Aversion, or Complexity?* 41 PUB. FIN. REV. 203 (2013).

¹²⁷ The subjects faced varying presentations of their wages that all resulted in the same net amount: some were offered a lower wage with no tax, others with offered a higher wage subject to a flat or progressive tax, and some were offered a lower wage with a bonus. *Id.* at 5-6. A second experiment varied the net wage. *Id.* at 7.

¹²⁸ *Id.* at 12. The authors of the study also concluded that the result was most likely due to cognitive limitations, rather than preferences for price descriptions (like a preference for a bonus over a tax), because making the wage description complex lowered work effort regardless of whether it was presented as a lower wage plus a bonus or a higher wage minus a tax. *Id.* at 15.

Another study similarly found that subjects have a harder time optimizing their compensation when they are subject to a complicated tax system as compared to when they are subject to a simpler system. Johannes Abeler & Simon Jager, *Complex Tax Incentives – An Experimental Investigation*, AM. ECON. J. (forthcoming), available at <http://ftp.iza.org/dp7373.pdf> (draft April 2013).

which portion went to taxes and what their net compensation is.¹²⁹ In contrast, when workers receive gross payments not subject to withholding, they must estimate the tax liability themselves. This is even more complicated than the partitioned price condition in the study (which lowered work effort),¹³⁰ because many workers don't even know what the appropriate tax rate will be. Thus, it's possible the uncertainty and complexity associated with receiving gross compensation payments actually reduces labor supply and that tax withholding can mitigate this effect.

Precedent For Independent Contractor Withholding

Lastly, requiring tax withholding by platform companies would not be without precedent. A number of other countries require withholding on some payments to independent contractors.¹³¹ And on an analogous front, Airbnb has begun collecting local hotel and occupancy taxes for property owners in some cities, a move that apparently has helped them curry favor with state and local governments.¹³²

2. Details of the Proposal

The current tax rules require that employers withhold income taxes and payroll taxes on wages paid to employees,¹³³ but there is no such requirement for payments to independent contractors. Thus, under the

¹²⁹ However, withholding is just a form of paying estimated taxes upfront; taxpayers are required to reconcile their year-end tax liability with what they have paid through withholding at the end of the year. In that sense, withholding doesn't necessarily reflect a true net wage. One study found that high withholding rates (20 or 50 percent) had a negative effect on work effort, possibly because people confuse high withholding rates with high marginal tax rates. See Johannes Becker, Jonas Fooker & Melanie Steinhoff, *Behavioral Effects of Withholding Taxes on Labor Supply* 6-7, 21, DRAFT available at <http://www.wiwi.uni-muenster.de/iff1/en/workshop/Fooker.pdf>.

But to the extent that withholding puts taxpayers in a refund position (which it does for most people), it seems that any discrepancies between prepaid taxes and actual tax liability won't impose the same kinds of psychological costs on taxpayers that estimating their taxes from gross wages does. See *supra* note 115 and accompanying text. Notably on this point, the study by Becker et al. found that work effort, while decreasing after imposition of high withholding taxes, *increased* in the period after receipt of a refund. *Id.* at 16.

¹³⁰ In the study, the partitioned wage condition description did not calculate the net wage for the subject, but the pertinent tax or bonus information was provided. Hayashi et al., *supra* note 126, at Appendix 2.

¹³¹ Slemrod, *supra* note 27, at 263.

¹³² See *Airbnb: Generating \$2 Billion in Potential Tax Revenue for America's Cities*, <https://www.airbnbaction.com/airbnb-generating-2-billion-in-potential-tax-revenue-for-americas-cities/> (last visited Sept. 6, 2016); see also Alison Griswold, *Why Airbnb Desperately Wants to Pay Hotel Taxes*, SLATE (Feb. 13, 2015), available at http://www.slate.com/articles/business/moneybox/2015/02/airbnb_hotel_taxes_why_does_the_sharing_economy_startup_want_to_pay_them.html.

¹³³ See I.R.C. §§ 3102, 3402.

current regime, whether or not platform companies must withhold taxes on payments to gig workers depends entirely on the resolution of whether the workers constitute independent contractors or employees. There may be many valid reasons to classify gig workers as employees,¹³⁴ or to create a new, third category of worker that is a hybrid of the two.¹³⁵ Resolving that issue is beyond the scope of this Article and, from a practical perspective, it may take many years before the legal disputes are resolved.

But the stakes of tax withholding do not have to be so high. Congress should enact legislation that provides specifically for *non-employee* withholding on certain payments to independent contractors. This would require withholding regardless of the status of gig workers as employees or independent contractors, and could be enacted in the short-term without having to take into account the multitude of non-tax considerations wrapped up in employee status.

Scope of Withholding

What should be the scope of the new legislation? First, there should be a de minimis threshold under which withholding is not required. One sensible possibility is to use the same \$600 threshold that exists for information reporting,¹³⁶ i.e., withholding would only be required once gross payments to an independent contractor exceed \$600 for the year. This would exempt very small one-off payments to independent contractors. Payers that anticipated an ongoing relationship with a service provider or seller of goods could begin withholding with the first payment even if it was under the threshold, though there would be no penalty for failing to do so.

The withholding rule should also apply only to payments made in the course of the payer's business, meaning it would not apply to individuals who are purchasing goods or services for personal purposes.¹³⁷ Finally, while large platform companies like Uber or Etsy are good candidates for acting as withholding agents, non-employee withholding would not have to be limited to platform companies alone. Instead, those independent contractors who don't technically qualify as "gig workers" should also be able to partake in the benefits if they receive qualifying payments.¹³⁸

¹³⁴ For example, some commentators have pointed out that gig workers receive no protection from workplace discrimination. *See, e.g.,* Harris & Krueger, *supra* note 8, at 7.

¹³⁵ *See supra* note 24.

¹³⁶ *See* I.R.C. § 6041.

¹³⁷ The withholding legislation could be similar in scope as the rule for information reporting to independent contractors under section 6041, which applies only to business payments and contains certain other exemptions. However, there does not appear to be a good justification to exempt payments for goods, as the section 6041 rules do. For example, a company like Etsy that makes payments to artists who sell goods should still be required to withhold.

¹³⁸ For example, a business that hires a handyman to make occasional repairs would withhold taxes in addition to issuing a 1099-MISC. On the other hand, withholding should not apply to credit card companies or payment processors like PayPal or Google Checkout. Although those entities may be subject to 1099-K reporting requirements, they

Self-Employment Taxes

Independent contractor withholding should also cover workers' self-employment tax obligations, but should not impose separate payroll tax obligations on the payers. Economically, it probably doesn't matter who is nominally responsible for payroll taxes; if the platform company (or other payer) were responsible for half of those taxes, they would likely reduce gross payments to workers to compensate.¹³⁹ However, there is good reason not to impose nominal payroll tax burdens on businesses that pay independent contractors. Such a requirement would require additional legislation and would further blur the employee/independent contractor distinction. A requirement to pay employment taxes would also likely result in much more resistance to withholding in general from platform companies and other affected parties.

Setting an Appropriate Rate

The most significant consideration in designing a non-employee withholding rule is the proper withholding rate. Too much withholding would leave workers strapped for cash, which in turn may deter work effort. Not enough withholding could leave workers in the position of owing estimated taxes and hefty year-end balances, largely obviating the benefit of withholding.

The proper withholding rate depends on several factors: the worker's expected annual income, their expected deductions, and their marginal tax rate. In the context of wage withholding, the IRS uses proxies to help estimate these three factors. First, expected income is projected by annualizing the employee's periodic payments. For example, an employee who receives a monthly gross paycheck of \$1000 will be treated as if she earns \$12,000 in gross wages annually. Second, expected deductions are taken into account by having employees fill out a Form W-4 and claim allowances for certain things like dependents, spouses, and child care expenses, which approximate personal exemptions and other deductions.¹⁴⁰ Finally, using the employee's projected income and the number of allowances, IRS withholding tables apply marginal tax brackets to determine the amount that employers should withhold from each paycheck.¹⁴¹

have a much more tenuous relationship with workers (e.g., less control over the worker) as compared to platform companies. See Oei & Ring, *supra* note 9, at 1036 (discussing distinction between platform companies and payment processors).

¹³⁹ In the employment context, the economic burden of the employer's share of payroll taxes is generally considered to be borne by the employees. See Harris & Krueger, *supra* note 8, at 25.

¹⁴⁰ IRS Form W-4 (2016), available at <https://www.irs.gov/pub/irs-pdf/fw4.pdf>.

¹⁴¹ IRS Circular E, *Employer's Tax Guide* (2016) 42-44, available at <https://www.irs.gov/pub/irs-pdf/p15.pdf>.

There are, of course, instances where wage withholding is not accurate for some taxpayers. For example, the Form W-4 does a poor job accounting for marriage penalties for two working spouses making similar incomes. Employees who leave a job and stop earning income mid-year will pay withholding taxes as if they earned a year's worth of salary, and they cannot get their overpayment refunded until they file their tax return the following year. But for the most part, the government's wage withholding proxies are successful in achieving their desired goal: approximating tax liability and slightly over-withholding.¹⁴²

In theory, these same general principles should apply in calculating withholding for gig workers and other independent contractors. But approximating annual earnings, expected deductions, and applicable marginal tax rates can be significantly more challenging for independent contractors as compared to wage earners. This is partly because the former may have multiple sources of income from multiple jobs, and withholding from each payer won't necessarily take into account payments from other sources. Additionally, wage earners frequently receive level, periodic payments, which makes calculating an annualized salary fairly simple. In contrast, even aside from receiving payments from multiple payers, the potential lumpiness of independent contractor income makes estimating annual earnings more challenging.

Another difficulty stems from the fact that independent contractors may incur significantly more deductible expenses than wage earners because their business-related expenses are deductible in arriving at adjusted gross income (i.e., above the line). These deductions aren't accounted for in the allowances listed on Form W-4, even though they may significantly reduce taxable income. As a result, if the current W-4 were used, many independent contractors would be significantly over-withheld. In light of these issues, a different form should be used for independent contractor withholding.

Additionally, because it is so much more difficult to estimate taxable income from independent contractor payments, withholding should be set at a fixed rate of gross receipts, rather than relying on the existing withholding tables. One option would be to pick a single rate that would apply to all independent contractors. Another option would be to have taxpayers fill out a form comparable to a W-4, on which they estimate their expected earnings (including any wage income). On the basis of their estimated net earnings, one of several flat rates would then be applied to all gross receipts from all payers. The goal would be to have withholding cover all of taxpayers' income and self-employment tax obligations and provide a modest refund.

The remainder of this subpart discusses a proposal for a schedule of withholding rates, where one rate in the schedule would apply to all of an independent contractor's gross receipts (above a de minimis threshold). As detailed below, the gross receipts withholding rates are derived by: 1)

¹⁴² See Thomas, *supra* note 75, at 142 n.180 (wage withholding tables designed to intentionally over-withhold).

having taxpayers project their net business income for the year; 2) choosing a marginal tax rate that is based on the taxpayer's projected net income; and 3) estimating a net, taxable portion of each gross payment by assuming a fixed profit ratio (which would apply in all cases).

Calculating Self-Employment and Income Taxes based on Net Income

Withholding on a gross payment to an independent contractor would ideally collect the portion of the payment that is taxable. But because our tax system doesn't tax gross receipts, a proper withholding scheme must be able to derive net, taxable income from each gross payment. In other words, to collect the appropriate amount of tax, we must be able to figure out: (1) how much of each gross payment represents net income and (2) how much tax is owed on that net income.

Estimating Net Income

A relatively simple approach to estimate net business income is to look at historic net profit ratios for Schedule C filers and apply an average profit ratio¹⁴³ to all taxpayers' gross receipts. The IRS's Statistics of Income Division publishes relevant information for sole proprietors grouped by sector (e.g., food and beverage sales, legal services, laundry services). Across all sectors of non-farm sole proprietorships, the average ratio of net business income to gross receipts is approximately 22.7 percent for the most recent year available (2014).¹⁴⁴ However, the overall average takes into account various industries (e.g., retail stores, warehouses) that may not be relevant for this purpose, and many of those industries might have lower profit ratios than would be expected for gig workers and other small sole proprietorships. Additionally, many larger Schedule C filers are included in the overall average, and those businesses incur expenses like employee payroll expenses that would not be typical of gig workers and other small sole proprietors. When considering just those sectors most likely to encompass gig work (e.g., driving services, laundry services, etc.), and eliminating payroll expenses, the weighted average net profit ratio is approximately 40 percent.¹⁴⁵ For this purpose, then, assuming an average profit ratio of 40 percent appears to be a reasonable approach.

¹⁴³ As used here, profit ratio means the ratio of net income (gross receipts minus business expenses) to gross receipts. For example, a business with \$10,000 of receipts and \$6000 of expenses would have a profit ratio of 40 percent.

¹⁴⁴ SOI Tax Stats, Non-Farm Sole Proprietor Statistics: Business Receipts, Selected Deductions, Payroll, and Net Income (2014), <https://www.irs.gov/uac/soi-tax-stats-nonfarm-sole-proprietorship-statistics> (last visited Feb. 8, 2017).

¹⁴⁵ Calculations showing weighted net profit ratios after exclusion for payroll expenses are on file with the author and are based on 2014 data available at <https://www.irs.gov/uac/soi-tax-stats-nonfarm-sole-proprietorship-statistics>. Sectors considered were: non-store retailers; lessors of real estate; couriers and messengers; transit and ground transportation; specialized design services; computer systems design

A presumed profit ratio of 40 percent allows any gross receipts payment to be easily converted into net profit for purposes of calculating withholding. For example, if a gig worker received a \$1000 payment from a platform company, \$400 would be presumed to be net income. The next step is to calculate the amount of tax that should be withheld from the presumed profit.

Calculating Tax Liability on Presumed Net Income

The proper withholding amount can be calculated based on a combination of self-employment tax and income tax rates. Taxpayers must report and pay self-employment taxes at a rate of 15.3 percent on net business income, although the net income subject to self-employment tax is reduced slightly because taxpayers can deduct half of their potential self-employment tax liability from net business income before calculating their self-employment tax.¹⁴⁶ The Appendix provides a detailed calculation of self-employment tax liability taking this deduction into account, while this discussion assumes a 15 percent self-employment tax rate (rounded for simplicity).

In addition to self-employment tax, taxpayers must pay income tax at the applicable marginal rates provided under the Code. The appropriate rate for purposes of withholding can be determined by asking taxpayers to project their net earnings at the beginning of the year and using the highest applicable marginal rate. For example, if the taxpayer projects that he will earn \$40,000, the appropriate tax rate is 25 percent.¹⁴⁷

We can then combine income and self-employment tax rates to determine a total tax rate on gross receipts. For example, for a taxpayer who projects she will earn \$40,000 (putting in her in the 25 percent income tax bracket), her total tax rate for purposes of withholding will be 40 percent (15 percent for self-employment plus 25 percent for income tax).

Finally, by combining the presumed profit ratio and the total tax rate, we can derive a single, flat rate to withhold on gross receipts for each

services; other professional, scientific and technical services; consulting services; other miscellaneous services; personal and laundry; miscellaneous repairs; and unclassified establishments.

Grouping workers by industrial sector classification is probably not a well-targeted way to summarize aggregate data for gig workers, but for now, it's the only sector-based data publicly available from the IRS. Each of the sectors listed here likely encompasses many businesses that are not related to gig employment, particularly for vague categories like "unclassified" and "miscellaneous" businesses. Additionally, taxpayers self-select sector classification and, thus, some gig workers may misclassify themselves or otherwise choose sectors not listed here.

¹⁴⁶ The result of the deduction for half of potential self-employment tax liability is that the 15.3 percent self-employment tax rate is applied to 92.35 percent of net business income. *See supra* note 33; *see also* IRS Schedule SE, *supra* note 39.

¹⁴⁷ *See* Rev. Proc. 2015-53 (Nov. 15, 2015), https://www.irs.gov/irb/2015-44_IRB/ar10.html (marginal tax rate for income between \$37,651 and \$91,650 for a single filer). Of course, applying a marginal tax rate to each dollar of income will overstate tax liability, but this might not be problematic if the goal is over-withholding.

marginal income tax bracket. For example, a taxpayer in the 10 percent marginal income tax bracket will have a total tax rate of 25 percent (15 percent plus 10 percent), which will be applied to the presumed profit ratio of 40 percent. Accordingly, the appropriate amount to withhold on gross receipts for that taxpayer is 10 percent of gross receipts (25 percent multiplied by 40 percent).

Table 1 provides the appropriate rate of withholding (right column) for a range of marginal income tax rates (left column), the latter of which would be based on the taxpayer's projected earnings. More detailed calculations are provided in the Appendix.

Table 1

Projected Marginal Tax Rate	Withholding Rate on Gross Receipts¹⁴⁸
0 percent ¹⁴⁹	6 percent
10 percent	10 percent
15 percent	12 percent
25 percent	16 percent
28 percent	17 percent

Implementation Details

To summarize, an appropriate withholding rate on gross receipts should be between 6 and 17 percent for most gig workers (under the assumptions discussed above).¹⁵⁰ For simplicity, policymakers might choose just one flat withholding rate - say 10 percent - for all gross receipts. The Taxpayer Advocate recommended a similar approach in her 2003 report to Congress.¹⁵¹ The Obama administration also recommended withholding for

¹⁴⁸ Calculated as follows: [15 percent + Projected Marginal Tax Rate] x 40 percent.

¹⁴⁹ A taxpayer who projects that his income will be less than or equal to the standard deduction plus personal exemptions would be considered to be in the zero bracket for income tax purposes. However, self-employment tax applies to net business income without any offset for below-the-line deductions. For example, a gig worker who earns only \$10,000 will owe no income tax but will still owe self-employment tax.

¹⁵⁰ Higher marginal rates on incomes over \$190,000 have been omitted for this purpose because most gig workers are not making that much income.

¹⁵¹ National Taxpayer Advocate, *2003 Annual Report to Congress* at 257-58, available at <https://www.irs.gov/advocate/national-taxpayer-advocates-2003-annual-report-to->

independent contractors on gross receipts, but under a voluntary regime where the payee could choose from a range of rates between 15 percent and 35 percent of gross receipts.¹⁵² However, those rates may be too high for many workers, unless realistic net profit ratios are much higher than the 40 percent average assumed here.¹⁵³

A more accurate approach than choosing one flat rate, which wouldn't entail too much additional administrative complexity, would be to vary the rate based on the taxpayer's projected earnings. The taxpayer would fill out a form not unlike a Form W-4, which would ask her to project her annual earnings from any source, including any net business income and wage income. Although it might be hard for independent contractors, especially relatively inexperienced ones, to estimate their projected net business income, they would only have to come up with a reasonable estimate within a range as wide as the marginal tax brackets.¹⁵⁴

For example, the form could have the taxpayer check a box asking which of the following categories they expect their combined net business income and wages to fall into: 0-\$10,000; \$10,001-\$20,000; \$20,001-\$50,000; etc.¹⁵⁵ Choosing a projected net income amount would surely be

congress. The report recommends a 5 percent withholding rate on "payments to independent contractors not generally maintaining an inventory or receiving payments for materials and supplies"; a 3.5 percent rate is recommended for those with inventories. *Id.* at 257. The 2005 Report to Congress recommends a similar regime that would be voluntary. National Taxpayer Advocate, *2005 Annual Report to Congress* at 391-393, available at <https://www.irs.gov/advocate/national-taxpayer-advocates-2005-annual-report-to-congress>. The rates in the 2003 Taxpayer Advocate Report were calculated based on IRS data using a similar methodology to the one employed here, using an average profit of 22 percent for sole proprietors with inventories (based on IRS data) and an average profit of 29 percent for those without inventories, and multiplying that profit by 15 percent for self-employment tax. See Written Statement of Nina E. Olsen, National Taxpayer Advocate, Hearing on "The Sharing Economy: A Taxing Experience for New Entrepreneurs" Before the Committee on Small Business, U.S. House of Representatives (May 26, 2016) at 14, available at

https://www.irs.gov/pub/tas/nta_written_testimony_the_sharing_economy_5_26_2016.pdf.

¹⁵² See Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, (Feb. 2016) at 199, available at <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>.

¹⁵³ For example, at a marginal tax rate of 15 percent, withholding 25 percent of gross receipts would assume a net profit ratio of 83 percent. [(15 percent + 15 percent) x 83 percent = 25 percent.]

¹⁵⁴ An alternative would be to ask taxpayers to project *gross* business receipts and then apply a presumed 40 percent profit ratio to derive the appropriate marginal tax rate. However, it is unclear if this would be more or less accurate than asking taxpayers to estimate their net earnings.

¹⁵⁵ Because the gross withholding rates proposed here will be based on the taxpayer's highest marginal tax rate, the categories should roughly approximate (or could exactly equal) the marginal tax brackets. Thus, for example, since the 15 percent marginal tax bracket covers taxable incomes between \$9,275 and \$37,650 for 2016 (for single filers), it wouldn't matter for purposes of withholding if a gig worker projected he'd earn \$30,000 of net income but actually earned only \$20,000. See Rev. Proc. 2015-53, *supra*

easier for taxpayers than asking them to choose an appropriate withholding rate, which might be confusing and daunting. The payer would then withhold at the appropriate rate using an IRS table based on figures like those in Table 1.

The withholding table should take into account the standard deduction and personal exemptions, which would mitigate the potential to collect too much tax.¹⁵⁶ This could be accomplished by having taxpayers opt to claim exemptions for themselves, spouse and dependents on their form as they would on a W-4. However, self-employment tax applies to net business income *before* any offset for the standard deduction and personal exemptions, so self-employment taxes would still be withheld. For example, a single taxpayer earning only \$10,000 per year from gig work with no wages or other income would not be subject to income tax and but should still be subject to withholding (at a 6 percent rate) to cover self-employment tax.

Even under an approach that varies the withholding rate based on the taxpayer's projected income, the withholding rates in Table 1 may still be too high. One reason is that the rates in Table 1 are based on the taxpayer's (projected) highest marginal tax rate, which will likely overtax net income, since lower marginal rates may apply to the first dollars of that income. A second reason is that the withholding scheme proposed here only takes into account business deductions (using an assumed 40 percent profit ratio), the standard deduction and personal exemptions, but does not take into account any other above the line deductions or itemized deductions.

On the one hand, this inaccuracy may not be troubling; especially since wage withholding also doesn't take into account a number of deductions.¹⁵⁷ In fact, not accounting for every deduction is largely how the IRS wage withholding tables achieve over-withholding for the majority of taxpayers, providing the highly popular tax refund.¹⁵⁸ However, these factors may be good reason to err on the low side when setting a range of withholding rates.¹⁵⁹ Policymakers may decide, for example, to withhold at only 14 or

note 147 (marginal tax rates for 2016). The taxpayer's projected amount would be reduced by the standard deduction and any personal exemptions they claim on their form.

¹⁵⁶ Other deductions (e.g., itemized deductions) could further lower a taxpayer's taxable income, making withholding inaccurate; but this is no different from the potential inaccuracies related to employee wage withholding.

¹⁵⁷ See Thomas, *supra* note 75, at 142.

¹⁵⁸ *Id.* However, the wage withholding tables do take into account things like personal exemptions through the claiming of allowances.

¹⁵⁹ Although it would complicate the withholding scheme, policymakers could come up with more comprehensive withholding tables that account for things like personal exemptions, and require independent contractors to claim allowances on their equivalent of Form W-4. This is generally the approach taken with wage withholding. A rougher but simpler approach would be to simply choose a slightly lower withholding rate on gross receipts, e.g., 4 percent instead of 5 percent for those in the 15 percent bracket, to account for the fact that people will have additional, non-business deductions that reduce their taxable income.

15 percent for those in the 25 and 28 percent brackets, and only 8 or 10 percent for those in the 10 and 15 percent brackets.

The withholding regime proposed here would greatly simplify the tax compliance obligations of gig workers (and other independent contractors) and should improve compliance. Rather than having to budget for taxes, make estimated tax payments, and deal with significant year-end balances, gig workers would have a small percentage of their gross receipts withheld each time they were paid (once a de minimis threshold was exceeded). For most gig workers, the obligation to make any estimated tax payments during the year would vanish, as withholding should satisfy their income and self-employment tax obligations. And at the end of the year, most would claim a tax refund with their tax return, in line with taxpayer preferences.

D. The Standard Business Deduction

Although withholding would virtually eliminate the budgeting and complexity issues associated with paying estimated and year-end taxes for many gig workers, the burden of tracking business expenses and reporting them on a tax return would remain. The latter issue is addressed in this part by the proposal for a SBD. The SBD would be a fixed amount – based on a percentage of gross receipts – that could be deducted in lieu of actual business expenses. It would, therefore, eliminate the need to track and report those expenses.

1. Why Allow a Standard Business Deduction

When it comes to gig workers deducting business expenses, the current tax regime presents three significant compliance issues for these taxpayers. First, the rules are confusing and taxpayers may make mistakes. Those mistakes are probably in the taxpayer's favor on balance (i.e., they are revenue losers).¹⁶⁰ Second, expenses are reported on an honor system and taxpayers may be tempted to cheat. Third, expense tracking and reporting is time-consuming and burdensome, even for taxpayers who are familiar with the rules. The SBD would mitigate each of these issues, reducing evasion and unintentional noncompliance and virtually eliminating tax recordkeeping requirements for many small businesses.

Surveys of gig workers have revealed that many have no idea what sorts of costs are deductible from their business receipts or how to properly record their expenses.¹⁶¹ It should be noted, however, that there are already some simplification measures built into the tax law to mitigate the complexity associated with business deductions. For example, taxpayers who use their car for business purposes can elect to take the standard mileage deduction in lieu of deducting actual car-related expenses and depreciation; the simplified rule allows them to deduct an amount equal to

¹⁶⁰ See Phillips & Plumley, *supra* note 74, at 35 (study of audit data for over 50,000 taxpayers found that, although many taxpayers report an amount close to their actual tax liability, they tend to slightly underreport, rather than over-report).

¹⁶¹ See *supra* note 68 and accompanying text.

their total business miles driven multiplied by a rate set by the IRS (currently \$0.54 for 2016).¹⁶² Similarly, a simplified home office deduction allows taxpayers to deduct \$5 per square foot for the portion of their home used exclusively for business, in lieu of deducting actual home office expenses and depreciation.¹⁶³

However, these measures cover just two of many different types of business expenses, and even the simplified rules appear to be difficult for taxpayers to apply. For example, in their study of Uber drivers, Professors Oei and Ring note that drivers who use the standard mileage deduction still face uncertainty and difficulty in tracking and calculating deductible car expenses.¹⁶⁴ In terms of tracking mileage, Uber tracks and reports the miles driven with a passenger in the car, but does not report miles driven from one ride to the next, which should also constitute a deductible mileage expense.¹⁶⁵ Additionally, Oei and Ring note that there is legal uncertainty associated with miles driven while waiting around for a new job.¹⁶⁶ The deductibility of those miles is unclear because expenses for commuting to and from work are generally considered to be nondeductible, while expenses for driving while at work generally are.¹⁶⁷

Taxpayers who are uncertain as to which expenses are deductible or how to calculate deductions will inevitably file inaccurate returns, which may deprive them of deductions that they are entitled to or shortchange the government of tax revenue. In the case of Uber drivers, for example, Oei and Ring report that many drivers calculate their standard mileage deduction based on *all* miles they drive with the Uber application turned on, even though some portion of those miles should likely be considered to be non-deductible commuter miles.¹⁶⁸

In addition to taxpayers mistakenly over-reporting deductions, a significant number are likely engaged in *intentional* over-claiming, as well. The ability to cheat by underreporting receipts has greatly diminished with the proliferation of electronic payments and the decline in cash. This means that for dishonest taxpayers, deductions are the items that are easiest to fudge without the IRS noticing. And, as discussed above, a recent empirical study of 1099-K reporting appears to confirm that many small business

¹⁶² See *supra* note 58.

¹⁶³ See Rev. Proc. 2013-13, available at <https://www.irs.gov/pub/irs-drop/rp-13-13.pdf>; see also IRS, *Simplified Home Office Deduction*, <https://www.irs.gov/businesses/small-businesses-self-employed/simplified-option-for-home-office-deduction> (last visited Oct. 26, 2016). Among other requirements, the square footage may not exceed 300 feet and the home office must be used for business on a regular basis.

¹⁶⁴ Oei & Ring, *supra* note 55, at _ .

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ See, e.g., Commissioner v. Flowers, 326 U.S. 465 (1946); IRS Publication 463, *Travel, Entertainment, Gift, and Car Expenses* 14-15 (2015), available at <https://www.irs.gov/pub/irs-pdf/p463.pdf>.

¹⁶⁸ Oei & Ring, *supra* note 55, at _ .

owners are offsetting the compliance benefits of new information reporting rules by simply reporting more business deductions.¹⁶⁹

Finally, regardless of whether taxpayers are honest or knowledgeable about the tax law, tracking and reporting business deductions is time consuming and burdensome. In the aggregate, the time and money that small business owners spend dealing with tax compliance obligations imposes a significant social cost. Further, the complexity of tracking and reporting business deductions exacerbates problems of inaccuracy. Some taxpayers may keep shoddy records and/or guess the amount of their deductions, and evidence shows they are likely to err on the side of paying less tax rather than more.¹⁷⁰ Other taxpayers likely forego deductions to which they are legitimately entitled because they are deterred by complexity.

In an analogous context, studies of non-business deductions have shown that taxpayers forego itemized deductions in favor of claiming the standard deduction, even when they would pay less tax if they itemized.¹⁷¹ These taxpayers appear to give up valuable tax benefits (millions of tax dollars in the aggregate) because they perceive the compliance cost to exceed the benefit of itemizing.¹⁷² Interestingly, one study also showed that the use of a tax return preparer did not mitigate the failure to itemize, suggesting that it's the recordkeeping burden, rather than tax return preparation, that largely deters taxpayers from itemizing their deductions.¹⁷³ Although these studies do not directly address business deductions, they demonstrate that taxpayers may forego the economic benefit of their tax deductions if perceived compliance costs are too high.¹⁷⁴

¹⁶⁹ See Slemrod et al., *supra* note 91. The authors observed that taxpayers who received a Form 1099-K in 2011 were “substantially more likely to report receipts almost exactly equal to expenses in 2011 than in 2010.” *Id.* at 22. They also note that while bunching of income and expenses could occur for legitimate reasons (e.g., claiming legitimate expenses that had been foregone in previous years), the fact that taxpayers primarily increased “Other Expenses” on Schedule C, as opposed to increasing expenses in a number of different categories, suggests noncompliance is the most likely explanation. *Id.* at 25-26.

¹⁷⁰ See *supra* note 160.

¹⁷¹ See Mark M. Pitt & Joel Slemrod, *The Compliance Cost of Itemizing Deductions: Evidence from Individual Tax Returns*, 79 AM. ECON. REV. 1224 (1989); Youssef Benzarti, *How Taxing is Tax Filing? Leaving Money on the Table Because of Compliance Costs* (Mar. 2015), DRAFT, available at https://site.stanford.edu/sites/default/files/how_taxing_is_tax_filing_benzarti_v7.pdf.¹⁷² Pitt & Slemrod, *supra* note 171, at 1224 (estimating the foregone tax savings to be \$196.2 million); Benzarti, *supra* note 171, at 3 (estimating an average of \$617 per person is foregone from failing to itemize).

¹⁷³ Benzarti, *supra* note 171, 4.

¹⁷⁴ However, there are some important differences between personal and business deductions in this context. Taxpayers who forego itemized deductions can still claim a standard deduction, whereas taxpayers who forego business deductions cannot deduct a flat amount in lieu of those deductions. But it is plausible that taxpayers may forego deducting some, though probably not all, business expenses if they don't have good records or don't want to go through the trouble of tracking and reporting them.

2. Details of the Proposal

To mitigate the overwhelming complexity associated with the current tax regime, legislators should enact a standard business deduction for gig workers and other small business owners. The SBD would work like the current, below-the-line standard deduction: taxpayers could elect to deduct the SBD from their business income in lieu of deducting actual business expenses. However, if their actual expenses exceeded the SBD, they could instead deduct those expenses. Taxpayers would subtract either the SBD or their actual business expenses from their gross business receipts to arrive at a net business income amount, to which self-employment tax would then apply under the current rules. Net business income would then be reported on Form 1040 (as it is under the current system) and would be incorporated into adjusted gross income, subject to further reduction by below-the-line deductions.

Structure and Scope of the SBD

There are several possibilities for how to determine the amount of the SBD. One is to choose a flat dollar amount (adjusted annually for inflation), like the regular standard deduction. This would effectively exempt all business receipts from tax up to the amount of the flat SBD. Another alternative is to allow taxpayers to deduct a fixed percentage of their gross business receipts.¹⁷⁵ Although there are upsides to both approaches, this Article recommends an SBD calculated as a percentage of the taxpayer's gross business receipts, with a tentative suggested percentage of 60 percent. In effect, a 60 percent SBD presumes a net profit ratio of 40 percent for any business that claims it, which is in line with average profit ratios for small Schedule C filers.¹⁷⁶

To limit any potential revenue loss associated with the SBD, and to target it at truly "small" business owners, Congress could also put a cap on gross receipts eligible for the SBD. For example, the SBD might only apply to taxpayers earning gross business receipts up to \$100,000. (The cap could instead be \$500,000, \$1,000,000, etc., depending on how many businesses policymakers want to target.)¹⁷⁷ Business owners earning more than the cap

¹⁷⁵ Interestingly, the regular standard deduction started out as a percentage of adjusted gross income, rather than a flat amount. John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COL. J. TAXL. 203, 210 (2011) (The "optional standard deduction was set at 10% of AGI, up to a maximum of \$500 for single taxpayers, \$1000 for married filing jointly (or roughly \$6250/\$12,500 in 2011 dollars.)").

¹⁷⁶ See *supra* note 145 and accompanying text. The overall average for Schedule C filers is closer to 20 percent; the 40 percent eliminates payroll deductions, which I use as an admittedly rough proxy for bigger and more sophisticated businesses. Better, nonpublic data may exist that would allow for calculation of a more accurate average profit ratio for smaller Schedule C filers (e.g., those with receipts below \$100,000).

¹⁷⁷ An alternative to having the cap turn the SBD "off" would be to allow taxpayers to deduct the SBD from the first portion of their earnings up to cap, and then any excess

would be subject to the current regime for deducting business expenses. The cap is justifiable because, at a certain level of earnings, we can expect businesses to have better capacity to efficiently track and report business expenses.¹⁷⁸

Although this Article focuses particularly on tax compliance issues in the gig economy, the SBD could be allowed for any independent contractor who would report business income under the gross receipts threshold on Schedule C.¹⁷⁹ Non-gig workers earning relatively small amounts of business income still face the same disproportionately high tax compliance costs, and eliminating any distinction between gig and non-gig workers would prevent behavioral distortions resulting from taxpayers trying to classify themselves as a gig worker to partake in the regime.

Flat versus Percentage SBD: An Example

To further explore the implications of a 60 percent SBD, and to contrast it with a flat SBD, it is useful to consider a simple example. Assume there are four taxpayers: Taxpayer 1 has \$5,000 of gross business receipts and \$4,500 of actual business expenses; Taxpayer 2 has \$5,000 of gross business receipts and \$2,500 of actual business expenses; Taxpayer 3 has \$30,000 of gross business receipts and \$27,000 of actual business expenses, and Taxpayer 4 has \$30,000 of gross business receipts and \$15,000 of actual business expenses. For simplicity, assume the sole tax rate on all income is 20 percent. Table 2 depicts the consequences of both a \$10,000 SBD and a 60 percent SBD.¹⁸⁰

earnings would be subject to the current rules for business deductions. But since the primary benefit of the SBD is to allow taxpayers to forego tracking expenses, it makes little sense to allow it for a threshold level of earnings if businesses will still have to track and report expenses above the threshold; at that point it serves as a subsidy rather than a simplification measure.

¹⁷⁸ In addition to a cap on gross receipts earned from self-employment, it may also be desirable to impose a total adjusted gross income cap of, say, \$250,000, above which the SBD would not be available. This would prevent high-income employees (e.g., law professors) who perform low-cost consulting services on the side from being able to reduce their taxable earnings from those services by 60 percent. It is also less likely that those with AGI over a certain level are participating in the gig economy.

¹⁷⁹ The SBD could be made applicable to Schedule E filers, as well, such as those who earn income from Airbnb.

¹⁸⁰ The example is oversimplified, because net business income will be subject to further reductions before arriving at taxable income (e.g., personal exemption, itemized deductions or the (regular) standard deduction). It is useful, therefore, to assume in this example that the taxpayer has income from other sources that exceeds the zero bracket created by the regular standard deduction and personal exemptions and that net business income will be subject to tax.

Table 2

	Taxpayer 1	Taxpayer 2	Taxpayer 3	Taxpayer 4
Gross Receipts	\$5,000	\$5,000	\$30,000	\$30,000
Actual Expenses	\$4,500	\$2,500	\$27,000	\$15,000
Profit ratio	10%	50%	10%	50%
Actual Net Income	\$500	\$2,500	\$3,000	\$15,000
Actual Tax (20% rate)	\$100	\$500	\$600	\$3,000
Net After \$10,000 SBD	—	—	\$20,000	\$20,000
Tax After \$10,000 SBD	0	0	\$4,000	\$4,000
Net After 60% SBD	\$2,000	\$2,000	\$12,000	\$12,000
Tax After 60% SBD	\$400	\$400	\$2,400	\$2,400

Costs and Benefits of an SBD

Although the example in Table 2 doesn't cover every scenario, there are several general principles that can be observed. First, recall that a 60 percent SBD assumes that taxpayers have a profit ratio of 40 percent. This means that imposing a 60 percent SBD creates a revenue loss to the government for any taxpayer with a net profit ratio that is higher than 40 percent. The higher the actual net profit ratio, the greater the revenue loss will be. In the above example, Taxpayer 4 has a net profit ratio of 50 percent, and accordingly pays less tax (\$2,400 as opposed to \$3,000) with a 60 percent SBD.

The reverse would be true for taxpayers with a net profit ratio below 40 percent. For example, Taxpayer 3 has only a 10 percent profit ratio, and would pay significantly more tax under a 60 percent SBD (\$2,400 instead of \$600). Thus, presumably Taxpayer 3 would forego the SBD and claim actual expenses, unless she determines that the compliance costs of claiming actual expenses exceed the tax benefit.

Because some taxpayers with lower profit ratios will presumably claim actual expenses,¹⁸¹ it's uncertain if revenue gains and losses would cancel each other out. If there is a substantial number of taxpayers with profit ratios above the 40 percent ratio assumed by the 60 percent SBD (or if taxpayers who earn more than a 40 percent ratio have substantially higher receipts than those who do not), the revenue loss could be significant. But this is not necessarily fatal.

The SBD will save significant compliance costs for affected taxpayers, and will also reduce administrative costs for the government, which must expend resources to monitor business deductions.¹⁸² Thus, the potential revenue cost of the SBD must be weighed against these reduced compliance and administrative costs. However, the potential revenue loss also highlights the need for policymakers to carefully analyze the appropriate percentage amount for the SBD: further study may reveal that 60 percent is too high (or low) and that a different percentage (e.g., 50 percent) would be a more accurate proxy for business expenses. However, while lowering the SBD would mitigate tax revenue loss, it would cause more taxpayers to claim actual expenses, which would diminish the reduction in compliance and administrative costs.

Equity Implications of an SBD

The SBD also involves trading off some degree of horizontal equity for reduced compliance and administrative costs.¹⁸³ In the above example, Taxpayer 3 has actual net income of \$3,000 while Taxpayer 4 has actual net income of \$15,000. Yet under either version of the SBD (60 percent or flat \$10,000), they pay identical amounts of tax because they earned the same amount of gross receipts. Taxpayer 3 is overtaxed with the 60 percent SBD while Taxpayer 4 is under-taxed. If Taxpayer 3 opts out of the SBD, horizontal inequity is diminished but remains; in that case, Taxpayer 3 pays tax at a 20 percent rate on actual net income while Taxpayer 4 pays \$2,400 of tax on \$15,000 of actual net income, an effective rate of 16 percent.

The same issue exists for Taxpayers 1 and 2. Again, the violation of horizontal equity is not necessarily fatal; it is a cost that must be weighed against the simplification benefit of an SBD. This is precisely the same

¹⁸¹ But, as discussed further below, other taxpayers will likely forego claiming actual expenses, even if it would result in less tax liability. *See supra* notes 171- 173 and accompanying text.

¹⁸² *Cf.* Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX L. REV. 1, 9 (1994) (The regular standard deduction lowers compliance costs because it allows for “reduced recordkeeping, effort in learning the law, and time spent completing tax forms. Administrative cost savings include a reduction in effort to process returns, the need to audit returns, and the time required to conduct audits and engage in subsequent litigation.”).

¹⁸³ *Cf.* Joel Slemrod & Shlomo Yitzhaki, *Analyzing the Standard Deduction as a Presumptive Tax*, 1 INT. TAX & PUB. FIN. 25, 27 (1994) (discussing the trade off between horizontal equity and compliance costs in the case of the regular standard deduction).

tradeoff that is made with the current standard deduction: some degree of accuracy and horizontal equity is sacrificed in exchange for the simplification benefits of foregoing itemization.¹⁸⁴

Additional Drawbacks of a Flat SBD

The flat SBD raises some additional issues. Taxpayers with gross receipts at or below the flat amount will pay no tax on their business income, as is the case with Taxpayer 1 and Taxpayer 2 in the above example. This costs the government more in lost tax revenue for those taxpayers below the threshold as compared to the percentage SBD, because taxpayers claiming the 60 percent SBD will pay tax on their presumed 40 percent profit. For example, Taxpayers 1 and 2 pay \$400 in tax with a 60 percent SBD and nothing with a \$10,000 SBD.

An upside of this approach is that it may be costless for these taxpayers to determine whether they should take the flat SBD or claim actual deductions. Whereas taxpayers claiming a 60 percent SBD would have to estimate whether their actual deductions exceeded 60 percent of their receipts, taxpayers claiming a flat \$10,000 deduction would not have to make such a calculation if their receipts were close to or under \$10,000. However, while both a flat SBD and a percentage SBD pose horizontal equity issues, the *perceived* unfairness of a flat SBD may be greater, because it will be highly salient that taxpayers making under a fixed amount of gross receipts will be exempt from tax on their business receipts. This higher salience may lead to more behavioral distortions (e.g., overinvestment in the gig economy) than would be the case with a percentage SBD.

Once the taxpayer's gross receipts exceed a certain amount,¹⁸⁵ the flat SBD would result in more revenue collected than the percentage SBD, as the benefit to the taxpayer decreases. For example, Taxpayer 3 and Taxpayer 4 make \$30,000 in gross receipts, so the \$10,000 SBD results in significantly more tax liability (\$4000) compared to the 60 percent SBD (\$2400). But as gross receipts rise significantly above the flat SBD, fewer taxpayers will claim it, as business deductions are likely to exceed the SBD. (Neither Taxpayer 3 nor Taxpayer 4 should claim the flat SBD in this example; although they might if they did not keep records.) This again means that the compliance and administrative benefits diminish. And whereas a percentage SBD could be advantageous for taxpayers at all levels of gross receipts (up to any cap imposed), a flat SBD would have a narrower reach.

¹⁸⁴ *Id.* at 28; Kaplow, *supra* note 182, at 14. In addition to simplification, the regular standard deduction is also intended to promote progressivity, as it creates a zero bracket amount. *See, e.g.*, Brooks, *supra* note 175.

¹⁸⁵ For a \$10,000 SBD, the benefit will be equivalent to an 60 percent SBD when gross receipts are \$16,667; thereafter the \$10,000 SBD is less advantageous to the taxpayer.

Coordination with Gross Receipts Withholding

An additional advantage of a 60 percent SBD is that it is easier to coordinate with gross receipts withholding than a flat SBD. A major drawback of withholding on gross receipts is that those receipts may not be an accurate indicator of net income and, therefore, taxpayers may be grossly under-withheld or over-withheld. However, if policymakers can assume a fixed net profit ratio, then net business income is easy to estimate – it is simply the assumed profit ratio multiplied by gross receipts. Once net income can be estimated, withholding on business earnings is not unlike withholding on wages. Thus, using a 60 percent SBD would allow policymakers to assume that net business income is 40 percent of gross receipts and withhold on that basis. While these assumptions won't hold up for taxpayers who don't claim the SBD, that should only be a minority of business owners if the SBD is set sufficiently high.

Further, because taxpayers who forego the 60 percent SBD typically will do so because they have expenses that exceed 60 percent of their gross receipts (i.e., a profit ratio lower than 40 percent), those taxpayers will end up over-withheld, rather than under-withheld. While this may create liquidity issues for taxpayers who are severely over-withheld, for many, it may simply increase the size of their tax refund, which should have a positive impact on tax compliance. Those taxpayers who are concerned about over-withholding could elect to reduce their withholding when they fill out the equivalent of a Form W-4 for the payer. For example, one question on that form might ask taxpayers if they expect to have business expenses that significantly exceed 60 percent of their receipts; if they answer “yes,” withholding could be reduced by one or more percentage points.

The proper withholding amount is harder to approximate with a flat SBD. The more a taxpayer's business expenses exceed the SBD, the less likely they are to claim it. And while withholding could continue to be based on an assumed profit ratio of 40 percent, far less businesses would claim exactly 60 percent in expenses as compared to when the SBD was set at 60 percent of gross receipts. Thus, withholding is more likely to be inaccurate for more taxpayers with a flat SBD.

In light its advantages over a flat SBD, this Article recommends that Congress enact a percentage SBD for small business owners earning gross receipts under a certain threshold. The remainder of this Article will assume that 60 percent is an appropriate percentage (based on IRS data on average profit ratios), but further study may suggest a different percentage.

E. Combining the Proposals: Examples

This section will expand on the example discussed above to illustrate the application of non-employee withholding in conjunction with a 60 percent SBD. For purposes of the example, consider six hypothetical taxpayers, A through F, with the gross business receipts and expenses

depicted below in Table 3. Taxpayers A, B, and C each have \$5000 of gross receipts, but have net profit ratios of 10 percent, 40 percent, and 80 percent, respectively. Taxpayers D, E, and F each have \$30,000 of gross receipts, and also have net profit ratios of 10 percent, 40 percent, and 80 percent, respectively. Each of A-F performs services as an independent contractor for a single company.

Assume further that each taxpayer is single with no dependents. Finally, assume Taxpayers A, B, and C each have \$25,000 in wage income, no other income, and no itemized deductions, which means the marginal tax rate on their business income should be 15 percent.¹⁸⁶ Accordingly, they will be subject to withholding at a rate of 12 percent of their gross receipts.¹⁸⁷ Similarly, assume no other income or deductions for Taxpayers E, F, and G, except each has wages of \$50,000, making their marginal tax rate 25 percent.¹⁸⁸ Taxpayers E, F and G will thus be subject to withholding at a rate of 16 percent of their gross receipts.¹⁸⁹

Table 3 depicts each taxpayer's SBD, tax liability, withholding, and overpayment (i.e., potential refund amount) based on the assumed facts. It is assumed that Taxpayers A and D, each of whom have a net profit ratio of 10 percent (i.e., actual expenses that exceed the 60 percent SBD) will claim actual expenses for purposes of this example, although that won't necessarily be the case. Taxpayers C and F, on the other hand, will claim the SBD because it exceeds their actual expenses. Taxpayers B and E have actual expenses equal to 60 percent of their gross receipts, so they will claim the SBD, but the result would be the same if they claimed actual expenses.

¹⁸⁶ See Rev. Proc. 2015-53, *supra* note 147 (marginal tax rates for 2016).

¹⁸⁷ See *supra* Table 1.

¹⁸⁸ *Id.*

¹⁸⁹ See *supra* Table 1.

Table 3

Taxpayer	A	B	C	D	E	F
Gross Receipts	\$5,000	\$5,000	\$5,000	\$30,000	\$30,000	\$30,000
Actual Expenses	\$4,500	\$3,000	\$1,000	\$27,000	\$18,000	\$6,000
Actual Net Income	\$500	\$2,000	\$4,000	\$3,000	\$12,000	\$24,000
Net Profit Ratio	10%	40%	80%	10%	40%	80%
Total Tax Without SBD¹⁹⁰	\$140	\$560	\$1,120	\$1,120	\$4,470	\$8,940
60% SBD	\$3,000	\$3,000	\$3,000	\$18,000	\$18,000	\$18,000
Net Income After 60% SBD	\$2,000	\$2,000	\$2,000	\$12,000	\$12,000	\$12,000
Total Tax With SBD¹⁹¹	\$560	\$560	\$560	\$4,470	\$4,470	\$4,470
Withheld Amount	\$600 (12%)	\$600 (12%)	\$600 (12%)	\$4,800 (16%)	\$4,800 (16%)	\$4,800 (16%)
Overpayment	\$460	\$40	\$40	\$3,680	\$330	\$330

Because withholding rates are based on an assumed profit ratio of 40 percent, the 60 percent SBD will provide a modest refund¹⁹² for taxpayers that claim it, as can be seen in the case of Taxpayers B, C, E, and F.¹⁹³ Those with higher expenses who forego the SBD will have a larger refund (\$460 for Taxpayer A instead of \$40; \$3,680 for Taxpayer D instead of \$330). To the extent that taxpayers have significant other deductions, their ultimate tax liability will be reduced and their refunds will increase.

¹⁹⁰ Total Tax is comprised of self-employment tax plus income tax, taking into account the deductibility of half of self-employment tax. It can be calculated by the following formula: $N(0.93T + 0.14)$, where N is net business income and T is the marginal tax rate – here, 15 percent for Taxpayers A, B, and C and 25 percent for Taxpayers D, E, and F. See Appendix. Values are rounded to the nearest \$10.

¹⁹¹ *Id.*

¹⁹² The modest refund –rather than a zero balance– results because the withholding rules proposed here assume a 15 percent self-employment tax rate and no deduction for self-employment tax, which will slightly overtax. See *supra* note 190 and Appendix.

¹⁹³ This assumes that these taxpayers do not have significant other income that is not subject to withholding, which could cause them to owe a balance.

III. ISSUES, OBJECTIONS, EXTENSIONS

Each of the proposals in this Article has potential drawbacks, which are discussed in this part. This part then considers the merits of alternatives to each proposal.

A. *The Scope of the Proposals*

To begin with, critics of the proposals here might argue that the scope of the problem is too small to merit Congressional action. They might assert, for example, that the size of the gig economy is small relative to the overall economy, and that the dollar amounts of tax involved do not merit policymakers' attention. However, there are several reasons why the reforms discussed here would be worthwhile. First, the gig economy itself is expanding and the number of American taxpayers participating is projected to grow substantially in the next several years.¹⁹⁴ As technology continues to evolve, new alternative work arrangements will also likely crop up that might not constitute "gig work" but implicate the same tax compliance and administrative issues.

Second, the reforms proposed here are relevant for more traditional small business owners, as well. On the one hand, extending the SBD to all sole proprietors might cause too much tax revenue loss past a certain threshold of earnings and, arguably, is no longer justifiable once businesses achieve the scope and scale to handle tax compliance obligations more efficiently. But there is no reason not to extend the SBD to any individually owned small business earning below a certain threshold of receipts.

Even before the advent of the gig economy, these businesses were burdened by disproportionately high tax compliance costs. IRS data also shows that, while most small businesses are operated as sole proprietorships, most sole proprietors are not high earners.¹⁹⁵ This is unsurprising, because we might expect that as businesses grow larger and more sophisticated, they employ other forms like a partnership, S-corporation, or LLC. And while there is no theoretical reason that an SBD couldn't also be applied to businesses that are conducted through an entity, if we think use of an entity is a rough proxy for size and sophistication, there is perhaps less justification for a simplified regime in that case.¹⁹⁶

Additionally, even if the aggregate dollars at stake are low relative to other pressing tax reform issues, there is merit to improving tax compliance

¹⁹⁴ See *supra* note 12; see also Oei & Ring, *supra* note 9 ("[T]o the extent new modes of production and consumption erode the traditional tax base, greater policy attention and new compliance solutions may be required.")

¹⁹⁵ See Ying Lowrey, *U.S. Sole Proprietorships: A Gender Comparison 1985-2000* 121, available at <https://www.irs.gov/pub/irs-soi/00solprop.pdf> ("[T]he average dollar value of U.S. sole proprietorship gross receipts in 1997 (\$58,000) was lower than that of all other legal forms of organization.")

¹⁹⁶ However, limiting the SBD to sole proprietorships may distort choice-of-entity decisions, in which case it may be better to institute an earnings cap applicable to any non-corporate entity.

among truly small businesses. For example, some scholars have argued that while it may not raise significant amounts of revenue in the short-term, improving tax compliance among small businesses “brings firms into the tax net, thus ensuring higher tax compliance if they expand over time.”¹⁹⁷ Further, reciprocity theory suggests that improving compliance among one group of taxpayers may have positive spillover effects that boost compliance more broadly.¹⁹⁸

B. *Objections and Alternatives Related to Withholding*

There are several constituencies that may object to non-employee withholding for gig workers and other independent contractors. First, the parties required to withhold may object because they do not want to incur the additional cost associated with tax withholding. However, for larger platform companies like Uber or TaskRabbit, the benefits of withholding for workers may exceed the financial costs of withholding. This is because simplifying workers’ tax compliance obligations may encourage work effort in general and make platform companies more attractive businesses to work for.¹⁹⁹ Notably on this point, Etsy has recently advocated for optional tax withholding for its workers (and other gig workers), which number over 1 million.²⁰⁰

Even for those payers that wouldn’t necessarily benefit financially, the costs of withholding are relatively modest in the technological age. Affected payers would already have payroll systems in place for issuing 1099s, so it is unlikely that imposing a withholding requirement would be overly burdensome. Further, economies of scale likely exist that make payer withholding less costly on an aggregate basis as compared to the cost of individual workers remitting taxes during the year.

Others may object to expanding withholding on theoretical grounds, arguing that it reduces the perceived burden of taxes and gives the government too much power to tax.²⁰¹ Critics of withholding have also noted that a tax refund essentially amounts to an interest-free loan to the

¹⁹⁷ Anuradha Joshi, Wilson Prichard & Christopher Heady, *Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research*, 50 J. DEV. STUD. 1325, 1329 (2014) (“More simply, it’s a matter of building a culture of tax compliance.”).

¹⁹⁸ See Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and the Law*, 102 MICH. L. REV. 71, 81 (2003) (“If most other individuals seem to be paying their taxes, then evasion will provoke either guilt, shame, or both in the reciprocator who covets the respect of others and of himself. If, in contrast, most individuals appear to be evading, then complying won’t make her feel guilty or ashamed at all; it will make her feel like a sucker.”).

¹⁹⁹ See *supra* notes 126- 132 and accompanying text.

²⁰⁰ Etsy, *Economic Security for the Gig Economy: A Social Safety Net That Works for Everyone* 4, 8-9 (Fall 2016), https://extfiles.etsy.com/advocacy/Etsy_EconomicSecurity_2016.pdf.

²⁰¹ See, e.g., Aradha Krishna & Joel Slemrod, *Behavioral Public Finance: Tax Design as Price Presentation*, 10 INT. TAX & PUB. FIN. 189 (2003) at 194.

government.²⁰² But those concerns are outweighed by the fact that withholding has a profoundly positive impact on tax compliance, making it one of the most powerful and important tax enforcement mechanisms at the government's disposal.

For example, in the case of wage withholding, the compliance rate is nearly perfect at ninety-nine percent.²⁰³ And as discussed above in Part II.C.1, withholding provides benefits that go beyond the deterrence advantages of third-party information reporting because it helps resolve liquidity and budgeting issues that may arise when taxpayers file their returns. Additionally, refunds resulting from tax withholding appear to have powerful framing effects that positively influence compliance. Further, notwithstanding arguments that withholding concedes too much taxing power to the government, it may be in line with taxpayer preferences. Although more empirical work should be done to understand taxpayers' withholding preferences, it appears they prefer receiving a refund to owing a balance, in part to avoid uncertainty and complexity in ascertaining their tax liability.²⁰⁴

The most serious challenge to non-employee withholding is that finding an appropriate rate at which to withhold on gross receipts may turn out to be difficult as a practical matter. In the case of wage withholding, it is easier to approximate taxable income because employees tend to have few, if any, deductible business expenses. Other large deductible expenses like mortgage interest or IRA contributions can be accounted for on the employee's W-4 or will result in a larger refund for the taxpayer. Although the vast majority of taxpayers subject to withholding receive refunds (with the average refund being approximately \$3000²⁰⁵), it does not appear that wage withholding results in major liquidity issues for most taxpayers.

But the same might not be true in the case of withholding for independent contractors. Calculating an appropriate withholding rate necessitates making some assumption about business expenses. And while the 40 percent presumed profit ratio suggested here would hopefully result in an appropriate amount of withholding for most affected taxpayers, it would result in over-withholding for those small business owners who make little or no profit. And for some of those over-withheld taxpayers, lack of access to the withheld funds until tax season could cause financial hardship, particularly if their business involves significant cash expenses during the year.

Although important, these concerns about accuracy are not insurmountable. It should be noted that any withholding regime—even wage withholding—is not entirely accurate. The challenge is finding the right balance between withholding enough tax to reap the compliance advantages,

²⁰² See, e.g., Richard L. Doernberg, *The Case Against Withholding*, 61 *Tex. L. Rev.* 595, 623 (1982).

²⁰³ See *supra* note 78.

²⁰⁴ See *supra* notes 111 - 115 and accompanying text.

²⁰⁵ Thomas, *supra* note 75, at 142 n.181.

and not withholding so much tax as to wreak havoc on taxpayers' finances. It's possible that in the case of independent contractors like gig workers, further study of tax data may reveal a more appropriate presumed profit ratio based on average or modal values. Such a study is beyond the scope of this Article, but it suffices to say for this purpose that this information is ascertainable. Further, if non-employee withholding were combined with a 60 percent SBD, then accuracy would be significantly easier to achieve for those taxpayers who claimed the SBD. But even if an SBD were not politically feasible, non-employee withholding as a standalone policy continues to have merit.

1. Alternative: Setting Rates Low

In addition to basing the withholding rate on historic profit ratios, policymakers could mitigate the potential for over-withholding by setting rates slightly lower than what would be estimated for accuracy purposes. The problem with this approach, however, is that it may impose an artificially low ceiling on what the government collects, if taxpayers who are under-withheld systematically fail to pay additional balances. On the other hand, collecting withheld taxes with a ceiling may still be a net positive relative to the current system. But given that taxpayers express preferences for refunds and appear to be more compliant when they do not owe a balance, systematic under-withholding would appear not to be a preferable solution.

2. Alternative: Making Withholding Optional

Another approach, which may alleviate potential over-withholding concerns and would also respond to those who reject withholding on theoretical grounds, would be to make non-employee withholding optional for the payee. The downside of this approach is that, if a significant number of workers opted out of withholding, then the compliance, efficiency, and revenue benefits would be diminished. On the other hand, making withholding elective would allow those who do not prefer withholding and/or receiving a refund to opt out, leaving in place a regime that better reflects overall preferences. Such a regime may also be more accurate if the taxpayers who opt out tend to be the ones who make little or no profit and don't ultimately owe taxes.

If an optional withholding regime was deemed to be preferable, either for the aforementioned reasons or for political purposes, withholding should be the default. In other words, workers would be given the option to opt *out* of withholding, but would be subject to withholding if they did not make an affirmative election. This would ensure that workers who chose to not have

their taxes withheld were expressing a true preference, rather than exhibiting a status quo bias.²⁰⁶

C. *Objections and Alternatives Related to the SBD*

Calculating an appropriate percentage for the SBD comes with the same practical challenges that calculating a withholding rate does and, as mentioned above, further study may indicate that a higher or lower percentage is better targeted. But even assuming that a 60 percent SBD will approximate business expenses for the largest number of affected taxpayers, an SBD still may impose efficiency and revenue costs that must be weighed against its benefits.

As discussed above in Part II.D.2, an elective SBD may reduce tax revenues because taxpayers with expenses that are below the 60 percent threshold would claim it while those that are above the threshold would not claim it, meaning more deductions would be claimed overall. It's not clear that this would be the case in practice, however, because some taxpayers above the 60 percent threshold may still choose the SBD, analogous to taxpayers who currently forego itemization in lieu of the standard deduction. Those taxpayers may be acting rationally if the cost of tracking and reporting business expenses exceeds the benefit of foregoing the SBD.

The principal argument behind the SBD, however, is that any potential revenue loss would be outweighed by the social gains resulting from reduced compliance burdens for taxpayers and reduced administrative costs for the IRS. Potential revenue loss could also be offset by improved taxpayer compliance (i.e., reduced evasion), which would enhance revenue collection. Whether an SBD would improve overall tax compliance among independent contractors, however, is uncertain and merits further study.

1. Effect on Compliance

One source of uncertainty is whether a significant number of noncompliant taxpayers would forego the SBD in order to claim a higher amount of expenses, attempting to “zero out” their income or come close to it. The SBD proposed here would be elective, so if taxpayers truly incurred business expenses that exceeded 60 percent of their gross receipts, they would be able to deduct those actual expenses and the overall measurement of their taxable income would be more accurate. But if a disproportionate number of taxpayers who forego the SBD are noncompliant taxpayers who are *over-claiming* expenses, then the potential revenue loss would be exacerbated by this evasion. However, there are several reasons that noncompliant types might forego this strategy and still claim the SBD.

First, if withholding is implemented, most taxpayers will be claiming a refund when they prepare their tax returns. Because taxpayers facing a gain

²⁰⁶ For a discussion of the status quo bias, *see generally* Daniel Kahneman, Jack L. Knetsch & Richard Thaler, *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. ECON. PERSP. 193 (1991).

tend to be more compliant overall, the framing advantage created by withholding may dissuade the over-claiming of expenses, as compared to the case where taxpayers over-claim expenses to avoid paying a balance when they file their return.

Second, the presence of an SBD would allow the IRS to focus its enforcement resources on a smaller group of taxpayers who don't claim it, effectively making those who claim the SBD "audit-proof." Even those taxpayers who would otherwise be prone to cheating may perceive that they will avoid IRS scrutiny more effectively by claiming the SBD and that, conversely, claiming expenses in excess of the SBD will invite IRS scrutiny. Accordingly, there is reason to think that implementation of the SBD may result in a relatively small number of taxpayers over-claiming expenses, thus positively influencing compliance overall.

2. Alternative: A Mandatory SBD

If further study reveals that, when given the option to take an SBD, a significant number of taxpayers will continue to over-claim expenses, an alternative policy would be to make the SBD mandatory. In other words, rather than giving taxpayers the option to claim actual expenses in excess of the SBD, all covered taxpayers would be required to calculate their net business income by subtracting the SBD from gross receipts. This is essentially equivalent to a tax on gross receipts, with a rate based on 40 percent of gross receipts.²⁰⁷

There are attractive upsides to a mandatory SBD. First, revenue loss would be mitigated or potentially eliminated, because the SBD would impose a ceiling on deductible expenses. If a significant number of taxpayers were previously claiming more than 60 percent of their gross receipts in deductions, a mandatory SBD could raise revenue. And if a significant percentage of those claiming more than 60 percent were noncompliant, a mandatory SBD may also result in a more accurate tax system. Mandating a 60 percent SBD would also significantly reduce administrative costs from the IRS's perspective, as it would eliminate the need to continue to monitor those taxpayers who forego the SBD.

However, a mandatory SBD suffers an important drawback in that it would overtax those small business owners who incurred expenses in excess of the SBD. Perhaps most salient would be the fact that a mandatory SBD could tax those who earned no net business income. For example, a taxpayer

²⁰⁷ Similarly, Logue and Vettori discuss the merits and drawbacks of a "modified gross receipts tax," which would tax small businesses on a portion of gross receipts based on a presumed profit ratio; the ratio would vary by industry based on historic profit ratios. As noted by the authors, varying the profit ratio by industry would be more accurate than a flat gross receipts tax, but would create line drawing issues and behavioral distortions. Logue & Vettori, *supra* note 75, at 129-135. For further discussion of gross receipts taxes used in other countries, see Victor Thuronyi, *Presumptive Taxation*, in 1 TAX LAW DESIGN AND DRAFTING 10 (Victor Thuronyi ed., 1996), available at <http://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch12.pdf>.

who earned \$10,000 in gross receipts and incurred \$10,000 of business expenses would have no economic income, yet would have to report \$4,000 of taxable business income.

One response to this critique is that the tax law frequently sacrifices accuracy and equity in the name of administrative ease and simplicity. In an analogous context, an employee may incur significant non-deductible expenses associated with her employment and yet still pay tax on her gross wages. She might, for example, purchase suits to wear to work, pay for gas or public transportation to commute to and from work, purchase a printer to make it easier to work from home, or enroll in educational classes to further her career. Yet clothing and commuting expenses are generally treated as nondeductible consumption, and otherwise deductible business expenses like the printer or classes won't reduce her income if they don't exceed the threshold for miscellaneous itemized deductions.²⁰⁸ Elsewhere in the tax code, floors on certain itemized deductions also prevent taxpayers from reducing their taxable income notwithstanding the fact that they are economically worse off having incurred those expenses, such as the 10 percent floor on deducting medical expenses.²⁰⁹

Accordingly, one might argue that, on the whole, small business owners are not worse off than many other taxpayers who have to forego deductions for true economic costs in the name of efficiency. However, the preceding examples are somewhat distinguishable. Nondeductible commuting and clothing costs may involve some element of personal consumption and the taxpayer often has control over the amount of the expense. This is less likely to be the case for "pure" business expenses.

Additionally, while employees are denied deductions for some business-related expenses, the 2 percent floor ensures that most major expenses would be deductible and lessens the likelihood that denied deductions would create liquidity issues. On the other hand, denying business owners deductions in excess of 60 percent of their gross receipts may result in the denial of significant deductions for business owners and create tax liability when they have netted no cash, potentially creating liquidity problems.

Regardless of whether similar inequities exist in the tax law, they are likely not as salient as a mandatory SBD would be, because the latter would represent a major departure from our current tax structure. The perceived unfairness of imposing an income tax on businesses with no net income would likely make it a political nonstarter. In contrast, an elective SBD is a familiar concept analogous to the regular standard deduction. An elective SBD is also more likely to be viewed as a pro-taxpayer measure: it vastly simplifies compliance for those that want to take it, and those that want to forego it have the option.

²⁰⁸ See *supra* notes 37 & 167; IRS Publication 529, *Miscellaneous Deductions* 7-8 available at <https://www.irs.gov/pub/irs-pdf/p529.pdf> (clothing generally not deductible if suitable for every day use).

²⁰⁹ I.R.C. § 213(a).

A mandatory SBD is also likely to lead to more behavioral distortions than an elective SBD. A mandatory SBD would encourage investment in low cost sectors and discourage investment in high cost sectors, even if those sectors lead to high economic returns.²¹⁰ This distortion should be mitigated with an elective SBD. Although taxpayers might be more reluctant to invest in high cost businesses if they prefer the simplicity of being able to claim the SBD, business owners who are given the option to deduct all actual costs should be more willing to participate in high cost industries or undertake risks when costs are uncertain.

3. Potential Behavioral Distortions with an Elective SBD

Overall, an elective SBD is preferable to a mandatory SBD. However, the efficiency of an elective SBD must also be considered relative to the current regime. The SBD might distort the decision between employment and self-employment, as well as decisions about the size of one's business.

For gig workers (or other sole proprietors) that incur very few business expenses, the SBD is clearly favorable because it allows them to deduct 60 percent of their receipts even if their actual deductions would be much lower. Employed taxpayers performing similar services, on the other hand, generally cannot deduct business expenses. The SBD would create a strong incentive, then, for taxpayers in low cost industries who have the option to be self-employed to opt out of employment or to characterize employment-like relationships as self-employment. Such a distortion could cause overinvestment in some sectors and underinvestment in others, would result in additional revenue loss, and could encourage noncompliance if taxpayers seek to incorrectly categorize themselves as self-employed.

Notwithstanding these incentives, the magnitude of such distortions is uncertain. First, there are already some tax advantages to self-employment, like the ability to deduct minor business expenses that aren't deductible by employees and, for dishonest taxpayers, greater ease in underreporting taxable income. While the SBD would make self-employment more attractive in some industries (those with high profit ratios), it's unclear how much this would add to existing incentives. Further, there are many non-tax reasons that taxpayers may prefer employment, such as job security, sick leave, paid vacations, and health insurance and other benefits. Presumably many individuals would prefer to retain their employment status because they believe these benefits outweigh whatever tax benefit would be realized from the SBD. Further, many taxpayers likely take whatever work is available to them, and might not have the option to move back and forth between employment and self-employment in the same industry.

In addition to potential distortions between employment and self-employment, applying the SBD to only "small" businesses below a threshold of receipts requires line drawing, which will also create

²¹⁰ Cf. Logue & Vettori, *supra* note 75, at 128 (discussing the inefficiency of a gross receipts tax).

distortions, either in the investments made or the amount of receipts reported.²¹¹ To see why this is so, imagine a 60 percent SBD that applies only to businesses that earn at or below \$100,000 in gross receipts. Assume that a taxpayer incurs \$10,000 of fixed costs to produce receipts somewhere in the neighborhood of \$100,000. If he has precisely \$100,000 in receipts, his tax under the SBD is based on \$40,000 of net income. If he earns \$100,001, his tax is based on his true net income of \$90,001, resulting in an extremely high marginal tax rate on the additional dollar of income.²¹²

But although the SBD threshold would likely impact reporting behavior for some taxpayers,²¹³ it seems less likely that the threshold would have a significant impact on investment decisions. Taxpayers choosing among investments at or around the threshold level of receipts probably cannot accurately predict exactly where their receipts would come out and, thus, it seems unlikely they would choose one business over the other because of the SBD.

For those considering an investment well above the threshold for the SBD, the analysis is different. When considering two alternative businesses with high profit ratios, where one would qualify the taxpayer for the SBD and one would not, the business that qualified for the SBD would result in a lower effective tax rate and a higher after-tax rate of return as compared to the one that did not qualify.²¹⁴ But choosing a business that would generate low receipts over one that would generate high receipts would only be rational if the taxpayer could invest his remaining funds at a return that would exceed the after-tax return on the bigger business. In the real world, it is unclear how many small, individual business owners make decisions this way. It seems plausible that many individuals choose the line of business they think will be most profitable (and perhaps enjoyable), preferring a larger absolute return even if it comes at a higher effective tax rate. Given the relative lack of sophistication of many gig workers, it's also

²¹¹ The potential problem of taxpayers segregating lines of business into multiple “small” businesses could be addressed by applying the threshold and SBD in the aggregate to each individual taxpayer.

²¹² One response to this cliff effect is to make the 60 percent SBD apply in all cases to the first \$100,000 of gross receipts, with the taxpayer's actual profit ratio applying thereafter. However, this would generate revenue loss without an offsetting reduction in compliance and enforcement costs, because taxpayers over the threshold would still have to track business expenses and the IRS would still have to monitor them.

²¹³ For example, a taxpayer who earns \$100,001 of receipts may simply report that he earned \$100,000 so he can claim the SBD. However, this wouldn't be possible if all receipts were subject to 1099 reporting.

²¹⁴ As an example, consider an SBD with a \$100,000 threshold. A taxpayer who earns \$200,000 in gross receipts with a 90 percent profit ratio would have a higher effective tax rate than a taxpayer with the same profit ratio who earns \$100,000, because the SBD would enable the latter to claim 60 percent in expenses while the first taxpayer could claim only 10 percent. Thus, the first taxpayer would pay tax on \$180,000 of net income, while the second would pay tax on \$40,000 in reported income, when actual net income is \$90,000.

questionable whether the lower effective tax rate imposed by the SBD would even enter into their calculus.

In any event, these potential efficiency costs must be weighed against the advantages of an SBD. The lower effective tax rate imposed on those who benefit from the SBD may offset efficiency costs to some degree because it should reduce the overall tax-induced distortion to choose leisure over work for those benefitted taxpayers.²¹⁵ Furthermore, the costs of behavioral distortions induced by a gross receipts cap would ideally be outweighed by the reduction in compliance and administrative costs resulting from the SBD. In an analogous context, this assumption underlies the small-firm exemption available in most countries with a value added tax: firms have similar incentives to reduce reported or actual receipts to fall below the VAT exemption threshold, yet policymakers deem the costs outweighed by the administrative and compliance advantages of the exemption.²¹⁶

In sum, the efficiency and revenue costs of an elective SBD are uncertain, and policymakers would be wise to undertake further study of taxpayer responses to an SBD before implementing such a policy on a broad level. However, there is reason to think that behavioral distortions would be modest, that evasion would decline, and that potential revenue loss would be offset by a vast reduction in compliance and administrative costs.

IV. CONCLUSION

The current small business tax regime – one in which individuals are expected to adhere to burdensome recordkeeping and filing requirements and pay taxes on an honor system – is rife with costs. Perhaps most indicative of the regime’s shortcomings is the fact that the government collects less than half of the tax owed by individual small business owners.²¹⁷ But the digitization of commerce has given Congress the tools to vastly simplify tax compliance and enforcement for gig workers and other types of small business owners.

While neither proposal discussed here is a panacea, implementing gross receipts withholding along with a standard business deduction should reduce noncompliance and make the tax system significantly more efficient. And while each of these proposals has merit as a standalone policy, gross receipts withholding based on a presumed 40 percent profit ratio would be

²¹⁵ Cf. Logue & Vettori, *supra* note 75, at 141 (pointing out that an optional presumptive tax regime would “reduce the potential work/leisure distortion” because taxpayers have the option to pay less tax).

²¹⁶ “The conventional wisdom among VAT experts is that the administrative and compliance costs savings from exempting firms with revenues below some moderate threshold outweighs the efficiency cost of this approach. For this reason, most countries that operate a VAT do exempt firms with turnover below a certain threshold....” Joel Slemrod & Jon Bakija, *TAXING OURSELVES: A CITIZEN’S GUIDE TO THE DEBATE OVER TAXES* 248 (4th ed. 2008).

²¹⁷ See *supra* note 82 and accompanying text.

harmonious with a standard deduction equal to 60 percent of gross receipts. Although further study may reveal a more accurate presumed net profit percentage, the underlying structure of the proposals would remain the same. What's more, these proposals represent reforms that should transcend party lines and provide clear benefits to both the government and taxpayers alike.

Appendix

For business owners, otherwise allowable business deductions are fully deductible above the line. Taxpayers report these deductions on Schedule C and use that form to calculate net business income, N (i.e., gross business receipts minus business deductions). Taxpayers must report and pay self-employment taxes at a rate of 15.3 percent on this net business income (N), although the net income subject to self-employment tax is reduced slightly because taxpayers can deduct half of their potential self-employment tax liability from net business income before calculating their self-employment tax.²¹⁸ Self-employment tax liability can thus be expressed as:

$$\text{Self-Employment Tax Liability} = (0.153) 0.9235 \times N = 0.14N$$

Additionally, half of a taxpayer's self-employment tax is also deductible for income tax purposes, so less than 100 percent of net business income (N) is subject to income tax:

$$\text{Deductible Portion of Self-Employment Tax} = 0.14N/2 = 0.07N$$

$$\text{Net Business Income After Deduction for Self-Employment Tax} = 0.93N^{219}$$

Assuming T represents the taxpayer's applicable tax rate, then:

$$\text{Income Tax Liability} = T \times 0.93N$$

Thus, total tax liability owed on net business income – accounting for both income and self-employment taxes – can be expressed as:

$$\text{Total Tax} = 0.14N + T(0.93N) = N(0.93T + 0.14)$$

For purposes of calculating withholding rates, total tax liability can be expressed as a function of gross receipts (G), using a taxpayer's projected marginal tax rate (T) and a presumed profit ratio of 40 percent:

$$\text{Total Tax} = 0.40G(0.93T + 0.14)$$

²¹⁸ The result of the deduction for half of potential self-employment tax liability is that the 15.3 percent self-employment tax rate is applied to 92.35 percent of net business income. See *supra* note 33; see also IRS Schedule SE, *supra* note 39.

²¹⁹ The deduction for half of self-employment tax ($0.07N$) from net business income (N) can be expressed as $N - 0.07N = 0.93N$.