ARTICLE

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, this 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 could 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 at little cost, it is time for policymakers to institute a more modern tax enforcement regime for small businesses.

† Assistant Professor of Law, UNC School of Law. I am grateful to Lily Batchelder, John Coyle, Lilian Faulhaber, J. Clifton Fleming, Jacob Goldin, Itai Grinberg, Rachel Gurvich, Andrew Hayashi, Daniel Hemel, Kristin Hickman, Michael Knoll, Omri Marian, Eric Muller, Shu-Yi Oei, Jason Oh, Peter Reilly, Emily Satterthwaite, Richard Schmalbeck, Daniel Shaviro, Steven Sheffrin, Gladriel Shobe, Keith Taylor and his colleagues at New Zealand's Inland Revenue Department, Courtney Thomas, David Walker, and Larry Zelenak, as well as participants at workshops at BYU Law School, Columbia Law School, Duke University School of Law, Georgetown Law, UC Irvine School of Law, University of Minnesota Law School, NYU School of Law, and Tulane University Law School for helpful discussions, comments, and feedback on this Article.

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 still maintaining the freedom to set their own hours and choose 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 continues to 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 tax law purposes, 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 $8,000 per year must file the same

1 *See* SARAH A. DONOVAN, DAVID H. BRADLEY & JON O. SHIMABUKURO, CONG. RESEARCH SERV., R44365, *What Does the Gig Economy Mean for Workers?* 1 (2016) ("[G]ig jobs may yield benefits relative to traditional employment in terms of the ease of finding employment and greater flexibility to choose jobs and hours.").

2 *See id.* ("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 earned income in the gig economy as of September 2015, and over 10 million reported having done so in the past 3 years. *See* DIANA FARRELL & FIONA GREIG, JP MORGAN CHASE & CO. INST., PAYCHECKS, PAYDAYS, AND THE ONLINE PLATFORM ECONOMY 29 (2016). These numbers are expected to increase by millions over the next decade. CAROLINE BRUCKNER, KOGOD TAX POLICY CENTER, SHORTCHANGED: THE TAX COMPLIANCE CHALLENGES OF SMALL BUSINESS OPERATORS DRIVING THE ON-DEMAND PLATFORM ECONOMY 3 (2016).

4 *See* BRUCKNER, *supra* note 3, at 5 ("[I]n 2015, more than 75% of Lyft drivers reported working less than 15 hours per week, and more than half of Uber drivers worked less than 10 hours per week.").

complex tax forms and make the same quarterly tax filings as a seasoned, 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. Many gig workers do not consider themselves to be business owners and have never filed business-related tax returns; thus 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 also likely leads to lower tax compliance, which in turn leads 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 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. 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 the SBD from her gross receipts,[5] 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, as well as increase efficiency by reducing the time, financial cost, and anxiety associated with tax compliance.

While this Article focuses specifically on gig workers to illustrate how the business landscape has changed in recent years, the proposals could apply

5 This Article primarily discusses an SBD equal to sixty percent of gross receipts, which is based on historic average profit ratios for small sole proprietorships of around forty percent. However, it also considers alternatives, such as a variable SBD based on whether the worker is in a labor-only industry (e.g., childcare) or a labor-plus-capital industry (e.g., driving a car). *See infra* Section II.D.

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 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.

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 previously were not, which can greatly improve tax enforcement. Second, the role of platform companies as online intermediaries enables tax authorities to gather information about multiple taxpayers from a single source.

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

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 id.* at 2. For a description of twenty-six "prominent online intermediary companies," see SETH HARRIS & ALAN B. KRUEGER, HAMILTON PROJECT, A PROPOSAL FOR MODERNIZING LABOR LAWS FOR TWENTY-FIRST CENTURY WORK: THE "INDEPENDENT WORKER" 28-33 (2015).

for and purchase goods or services. At the same time, 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 "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 absent from traditional employment but may come at the expense of high startup costs and income insecurity. But in recent years, online platforms have broadened the opportunity for individuals to become self-employed by vastly reducing these startup 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 three 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]

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9 For a more in-depth discussion of the gig economy, including its impact on tax compliance and strategies to promote compliance, see generally Shu-Yi Oei & Diane Ring, *Can Sharing Be Taxed?*, 93 WASH. U. L. REV. 989 (2016).

10 *See* DONOVAN ET AL., *supra* note 1, at 2.

11 *Id.*

12 From 2005 to 2015, the number of alternative work arrangements in the United States rose from 14.2 million to 23.6 million, an increase of 66.5 percent. BRUCKNER, *supra* note 3, at 2 (citing Lawrence F. Katz & Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States, 1995–2015* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 22667, 2016). The number of participants in the gig economy has increased nearly forty-seven times between 2012 and 2015, with gig earnings increasing tenfold. FARRELL & GREIG, *supra* note 3, at 21.

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

14 *See The Sharing Economy: A Taxing Experience for New Entrepreneurs Part I: Hearing Before the H. Comm. on Small Bus.*, 114th Cong. 38 (2016) (statement of Caroline Bruckner, Managing Director, Kogod Tax Policy Center) [hereinafter Testimony of Professor Caroline Bruckner] (estimating that seven million individuals will work in the platform economy by 2020).

For many gig workers, platform earnings are a secondary source of income, often supplementing wages.[15] For workers providing services (e.g., driving or running errands), a recent study showed average monthly earnings of $533 ($6396 annually), which represented about a third of the total monthly income of those workers.[16] For those who lease assets or sell goods (e.g., renting a house or selling jewelry), average earnings were just $314 per month ($3768 annually), representing 20 percent of total income.[17] These lower income amounts, generally less than $10,000 per year for most gig workers,[18] reflect less than full-time hours invested in gig work. In one survey of gig workers, 72 percent reported that they work for platform companies less than 10 hours per week, while 92 percent reported working for platforms 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 as 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.[23] Instead, I assume the status quo will remain in place for the

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15 *See* FARRELL & GREIG, *supra* note 3, at 24 (noting that the platform earnings were "sizable" even if not the primary source of income); *see also* Emilie Jackson et al., *The Rise of Alternative Work Arrangements: Evidence and Implications for Tax Filing and Benefit Coverage* 16 (Office of Tax Analysis, Working Paper No. 114, 2017) (reporting that 39 percent of gig workers are primarily wage earners, 19.5 percent earn a mix of wage and gig income, and 33 percent earn primarily gig income).

16 FARRELL & GREIG, *supra* note 3, at 24.

17 *See id.* The average Airbnb host is found to earn $7530 annually, significantly higher than average earnings for those leasing assets or selling goods. BRUCKNER, *supra* note 3, at 7.

18 For example, an Office of Tax Analysis study found that gig workers gross an average of $20,000 per year, but that actual profit averaged about $6000. Jackson et al., *supra* note 15, at 19.

19 BRUCKNER, *supra* note 3, at 5. 88 percent of gig workers surveyed earned less than $15,000 from online platforms in 2015, with 74 percent earning less than $5000. *Id.*

20 Oei & Ring, *supra* note 9, at 1042-45.

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 gig worker classification claims in federal and state courts, see *id.* at 8-9.

23 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, e.g.*, HARRIS & KRUEGER, *supra* note 8 (proposing an "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

foreseeable future (i.e., that gig workers are independent contractors rather than employees). Thus, in Part III, I argue for tax reforms that do not depend on gig workers being classified as employees. But first, this subsection provides a brief overview of the tax implications of non-employee[24] 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.

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 most 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]

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 wages and employers bearing responsibility for another 7.65 percent on those wages.[30] In addition

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

24 The terms "non-employee" and "independent contractor" are interchangeable for this purpose.

25 I.R.C. § 3402 (2012).

26 § 6654(c).

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 n.39 (2008) (at least three quarters of taxpayers claim refunds).

28 § 6654(c)(2).

29 § 6654(a). 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. § 6654(d). However, the penalty doesn't apply if the amount of taxed owed is less than $1000. § 6654(e)(1).

30 *See* §§ 3101(a)–(b) (representing tax on employees of 6.2 percent for Social Security plus 1.45 percent for Medicare); §§ 3111(a)–(b) (representing same tax on employers). Additional Medicare taxes (0.9 percent) apply for employees paid more than $200,000 per year, and social security taxes are not required after the first $127,200 of wages for 2017. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., PUB. 15, CAL NO. 10000W, (CIRCULAR E), EMPLOYER'S TAX GUIDE 24-25, 33 (2018). The employer may also have to pay federal

to paying half of the employment tax, the employer withholds the employee's share of employment taxes and pays them to the IRS,[31] 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.[32] Self-employed workers must include payments for self-employment tax in their quarterly estimated tax payments.

Despite more onerous filing and employment tax obligations, there is a major tax advantage to non-employee status if the worker 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.[33] This means taxpayers can generally take those deductions in full (assuming they are otherwise allowable under the Internal Revenue Code (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.[34] This means that taxpayers will only take those deductions if, combined with other itemized deductions, the total amount exceeds the standard deduction.[35] 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) two percent of the taxpayer's adjusted

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unemployment taxes on the first $7000 of wages at a rate that varies based on the amount of state unemployment contributions made. *Id.* at 37.

31 I.R.C. § 3102 (2012).

32 Self-employment taxes apply if an individual earns at least $400 during the year from self-employment, at a rate of 12.4 percent for social security (subject to the same $127,200 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* Topic Number 554—Self-Employment Tax, INTERNAL REVENUE SERV., https://www.irs.gov/taxtopics/tc554.html [https://perma.cc/A3XS-DNPT]. However, 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 only 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.

33 § 62(a)(1). Additionally, half of self-employment tax is deductible in computing the taxpayer's adjusted gross income. *Id.*

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

35 §§ 63(a)–(b). For 2017, the standard deduction for a single taxpayer is $6350. *In 2017, Some Tax Benefits Increase Slightly Due to Inflation Adjustments, Others Are Unchanged*, INTERNAL REVENUE SERV., https://www.irs.gov/uac/newsroom/in-2017-some-tax-benefits-increase-slightly-due-to-inflation-adjustments-others-are-unchanged [https://perma.cc/G5HA-NLTB].

gross income.[36] The practical effect of these limitations is that most minor employee business expenses are not deductible. Further, in recent tax legislation, Congress temporarily repealed all miscellaneous itemized deductions, including employee business expenses,[37] until December 31, 2025. Thus, from 2018 to 2025, employee business expenses are entirely nondeductible without regard to the amount.[38]

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 C[39]), which adds significant time and complexity to tax return preparation.[40] 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 non-deductible.

Finally, the Tax Cuts and Jobs Act of 2017 created an additional tax advantage for non-employee workers. Specifically, new Code section 199A provides for a deduction of 20 percent of the net business income of any non-corporate business, including businesses operating as sole proprietorships.[41] For example, a gig worker who nets $50,000 from gig work after expenses could deduct up to $10,000[42] (20 percent of $50,000) on her tax return.[43] Although certain limitations on the deduction apply to those with taxable incomes above $157,500 ($315,000 for married taxpayers filing joint returns),[44] the

36 I.R.C. § 67 (2012).

37 Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 11045 (amending § 67) [hereinafter Tax Cuts and Jobs Act].

38 *Id.*

39 INTERNAL REVENUE SERV., SCHEDULE C (FORM 1040), PROFIT OR LOSS FROM BUSINESS (2017).

40 Self-employed taxpayers generally must also fill out Schedule SE related to their self-employment taxes. *See* INTERNAL REVENUE SERV., SCHEDULE SE (FORM 1040), SELF-EMPLOYMENT TAX (2017). Some taxpayers participating in the 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* INTERNAL REVENUE SERV., SCHEDULE E (FORM 1040), SUPPLEMENTAL INCOME AND LOSS (2017).

41 Tax Cuts and Jobs Act, *supra* note 37, § 11011. Like most of the other tax provisions applicable to individuals, the deduction is scheduled to sunset at the end of 2025. I.R.C. § 199A(i) (2012).

42 The deduction cannot exceed 20 percent of taxable income (less any net capital gain), which will be less than net business income if the taxpayer doesn't have income from other sources. *See* § 199A(a)(1). So, for example, a taxpayer with pass-through business income of $50,000 but taxable income of only $20,000 (after deductions) would only be able to deduct $4,000, not $10,000.

43 The deduction is a below-the-line deduction (i.e., it reduces taxable income not adjusted gross income), but is available to both itemizers and non-itemizers. *See* Tax Cuts and Jobs Act, *supra* note 37, § 11011(b).

44 *See* § 199A(e)(2) (providing that threshold amounts are adjusted for inflation). For taxpayers with incomes over the threshold amount, the deduction phases out and is eventually eliminated in

majority of gig workers do not earn enough to be impacted by those limits, and should be able to take advantage of the section 199A deduction. The deduction is *not* available to taxpayers who are employees.[45] In essence, section 199A provides for a lower effective tax rate on earnings of independent contractors as compared to the tax imposed on equivalent earnings of employees. While this makes gig work more advantageous from a tax perspective, section 199A will no doubt add additional complexity to tax return preparation and to the calculation of estimated taxes for gig workers.

2. Information Reporting for Gig Workers

Because they generally treat gig workers as independent contractors,[46] platform companies are not required to withhold income taxes or pay employment taxes with respect to these workers.[47] However, the Code does impose certain information reporting requirements for independent contractors that are relevant in this context. While these information reporting requirements generally help gig workers track their gross receipts, ambiguities in the current regime leave many workers without access to tax information from platform companies.

Information reporting generally describes the process by which third parties issue year-end information statements (often on Form 1099) to certain private parties with whom they have transacted, while simultaneously transmitting that information to the IRS.[48] For example, a bank at which a taxpayer has an account will send a Form 1099-INT at the end of the tax year

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certain circumstances. First, high earning taxpayers cannot claim the deduction if they work in a "specified service business" (including fields such as law, health, and investment advisory services). §§ 199A(d)(1)–(3). Second, for those with income over the applicable threshold, the deduction is limited by the amount of W-2 wages paid by the business and/or by the amount of depreciable business property held by the business. §§ 199A(b)(2)–(3). For a helpful summary of these rules, see generally *Section 199A Deductions—Pass Thru Tax Breaks*, WATSON CPA GROUP, https://www.watsoncpagroup.com/Section199A.pdf [https://perma.cc/A946-NP5N].

45 *See* § 199A(d)(1) (defining a "qualified trade or business" as "any trade or business other than [either] a specified service trade or business, or the trade or business of performing services as an employee").

46 This Article uses "independent contractor" and "small business owner" interchangeably; both refer to non-employee workers, and the tax law essentially treats an independent contractor as a "business owner" by requiring a Schedule C to be filed. *See Self-Employed Individuals Tax Center*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/self-employed-individuals-tax-center [https://perma.cc/H3HJ-HSJR] (defining self-employed as one who "carr[ies] on a trade or business as a sole proprietor or an independent contractor").

47 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 full-time employees to operate its business, like financial analysts, lawyers, office managers, etc.

48 *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).

to inform the taxpayer of how much taxable interest his account earned that year and will also provide that information to the IRS.[49] The IRS, in turn, will automatically "match" the information with the taxpayer's tax return to ensure that the interest income is reported.[50]

Two information reporting provisions 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.[51] 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.[52] Importantly for this purpose, payers that are considered to be third party settlement organizations—that is, non-bank entities that make payments for goods or services on behalf of others through a central account (PayPal, for example)[53]—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.[54] Thus, for platform companies like Uber, who appear to qualify as third party settlement organizations,[55] 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.[56]

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

49 *See* Treas. Reg. § 1.6049-1(a)(1)(i) (as amended in 1983).

50 *Cf.* Lederman, *supra* note 48, at 1738 n.20 (describing the IRS's pursuance of discrepancies that it finds as part of the information reporting process).

51 *See* I.R.C. § 6041(a) (2012). 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 or to payments made to a corporation. *See* INTERNAL REVENUE SERV., 2018 INSTRUCTIONS FOR FORM 1099-MISC 7 (2018).

52 *See* I.R.C. § 6050W(a) (2012); Treas. Reg. § 1.6050W-1(a) (2010).

53 I.R.C. § 6050W(b)(3).

54 § 6050W(e).

55 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 a bank for purposes of the 1099-K reporting rules, meaning there is no $20,000/200 transaction reporting threshold. *See* § 6050W(b)(4)(A).

56 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.

requirements apply, the 1099-K reporting requirements trump.[57] But that creates a surprising result: the section 6050W rules, which were intended to expand information reporting,[58] effectively eliminate information reporting for transactions under $20,000 as long as a third party settlement organization is involved.[59]

This strange loophole has created uncertainty amongst taxpayers and tax professionals.[60] 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.[61] 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.[62]

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57 *See* Treas. Reg. § 1.6041-1(a)(1)(iv) (2017) ("Transactions that . . . otherwise would be subject to reporting under both sections 6041 and 6050W are reported under section 6050W and not section 6041.").

58 *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE "HOUSING ASSISTANCE TAX ACT OF 2008" AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON JULY 23, 2008, at 60-61 (2008) (explaining that section 6050W, which was enacted by the Housing Assistance Tax Act of 2008, 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).

59 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) (2010). 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, e.g.*, 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, 249-50 (2014) (outlining multiple interpretations of this statutory scheme); Oei & Ring, *supra* note 9, at 1037 (same); *cf.* 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 [https://perma.cc/9S5Z-3E95] (noting the confusion created by the statutory ambiguity).

60 *See* Oei & Ring, *supra* note 9, at 1034-38 (exploring the ambiguities in tax forms issued by ridesharing companies and the confusion over which reporting requirements apply); Erb, *supra* note 59.

61 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.

62 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 Tax Lives of Uber Drivers: Evidence from Internet Discussion Forums*, 8 COLUM. J. TAX. L. 56, 65 (2017) (explaining that, beginning in 2015, Uber "issu[ed] Form 1099-K to drivers for all driving payments, no matter how small").

The result of some companies using the $20,000/200 reporting threshold is that substantially fewer gig workers are receiving information statements than if platform companies were issuing Form 1099s to workers receiving more than $600.[63] Recall that the majority of gig workers earn under $10,000 per year from platform companies, which does not trigger the $20,000 threshold for 1099-K reporting.[64] 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 and can deduct up to 20 percent of their net business income under new section 199A. For an Uber driver, for example, this might mean deducting gas, car repairs, and depreciation on her car as business expenses,[65] all before calculating the section 199A deduction. 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, how much they earn in the gig economy,[66] or whether 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

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

64 *See supra* notes 15–19 and accompanying text.

65 In lieu of deducting car-related expenses (like gas and depreciation), drivers can elect to claim the standard mileage deduction, which is calculated at a fixed rate (currently $0.545 for 2018) per mile driven in a business capacity. *See* Treas. Reg. § 1.274-5(j)(2) (as amended in 2010); I.R.S. News Release IR-2017-204 (Dec. 14, 2017). For a more in-depth discussion of deductible driver expenses and related issues, see Oei & Ring, *supra* note 9, at 1009-13.

66 One 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* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., FORM 1040 INSTRUCTIONS 2017, at 10 (2018) (mandating that, for the year 2016, a taxpayer must file a return if she "had net earnings from self-employment of at least $400"); INTERNAL REVENUE SERV., 2017 INSTRUCTIONS FOR SCHEDULE SE (FORM 1040) 1 (2017) (instructing persons with "net earnings of $400 or more as a self-employed person" to pay self-employment tax).

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 and financially inexperienced,[67] and work only part-time for platform companies.[68] Because they are often unaware that the tax law considers them to be business owners,[69] many gig workers don't realize that they must pay estimated taxes or that they are subject to self-employment taxes.[70] 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.[71] 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.[72] 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.[73]

Business expenses are also particularly challenging for gig workers. In one survey, nearly half of gig workers didn't know about "*any* tax deductions, expenses or credits that could be claimed related to their on-demand platform income."[74] Even those who are aware of the rules surrounding deductible

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67 BRUCKNER, *supra* note 3, at 10.

68 *See supra* note 19 and accompanying text.

69 *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.").

70 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. *Id.* 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.

71 *See* 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.").

72 *See, e.g.*, I.R.C. § 6651(a)(2) (2012) (mandating a five percent penalty for failure to pay tax reported on a return more than one month late); § 6654(a) (mandating a penalty for the underpayment of tax); § 6601 (mandating interest payments for "underpayment, nonpayment, or extensions of time for payment, of tax").

73 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—which appears to be a source of confusion for some drivers. *See* Oei & Ring, *supra* note 62, at 87.

74 BRUCKNER, *supra* note 3, at 12 (emphasis added).

expenses often struggle to apply them to their own situations.[75] This uncertainty gives workers headaches throughout 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 gig workers report that they do not receive tax assistance from the platform company,[76] and many report spending between ten and thirty-five hours preparing their tax returns.[77]

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 bear disproportionately high compliance costs[78] relative to their business income, including recordkeeping, seeking information about their taxes, and preparing tax returns.[79] This compliance burden imposes additional costs that go beyond the time and expense imposed on the workers themselves. High compliance burdens also likely lead to less accurate tax returns filed by gig workers, resulting in less revenue collected by the government.[80] 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 to potentially prosecute or otherwise penalize offenders.

In a broad sense, these compliance issues are neither new nor unique. Small business owners have always exhibited low compliance rates compared

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75 For a fascinating study of this issue in the context of Uber drivers, see Oei & Ring, *supra* note 62. 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.

76 *See* BRUCKNER, *supra* note 3, at 13 (finding sixty-nine percent of surveyed workers reported not receiving tax assistance from the platform company).

77 *Id.* at 13-14.

78 *See, e.g.*, Martin Sullivan, *Tax Challenges for the Uber Economy*, FORBES (Jul. 14, 2015), https://www.forbes.com/sites/taxanalysts/2015/07/14/tax-challenges-for-the-uber-economy [https://perma.cc/N9AR-C85R] ("[T]he sharing economy will be bearing significantly larger-than-average tax compliance costs.").

79 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.

80 *See* Mark Phillips & Alan Plumley, *Effort and Compliance as Endogenous Taxpayer Decisions* 35 (Paper for 2014 NTA Annual Conference, Nov. 6, 2014), https://www.ntanet.org/wp-content/uploads/proceedings/2014/141-phillips-plumley-effort-compliance-endogenous-taxpayer-decisions.pdf [https://perma.cc/6T4G-72DN]] ("[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."); *see also* Kathleen DeLaney Thomas, *User-Friendly Taxpaying*, 92 IND. L.J. 1509, 1533-44 (2017) (suggesting ways in which policymakers can simplify tax system interactions to encourage compliance).

to wage earners,[81] in part due to opportunity and in part due to the complexity associated with the business tax regime.[82] Several commentators have identified the efficiency costs and inequity associated with this noncompliance.[83] 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 various ways. By dramatically lowering the cost of entry, platform companies have enabled millions of individuals to become business owners with little to no startup cost. This has allowed more individuals to undertake non-employee work than ever before, often on a part-time basis. In addition, advances in technology have changed the way that business owners receive and make payments as well as how they 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 gig workers.

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81 *See* Kyle D. Logue & Gustavo G. Vettori, *Narrowing the Tax Gap Through Presumptive Taxation*, 2 COLUM. J. TAX L. 100, 108 (2011) (highlighting that "individuals who ran their own businesses as sole proprietorships in 2001 remitted, in the aggregate, only 43% of the income taxes they actually owed"). *See generally* Kathleen DeLaney Thomas, *Presumptive Collection: A Prospect Theory Approach to Increasing Small Business Tax Compliance*, 67 TAX L. REV. 111, 112-13 (2013) (discussing the reasons for the disparity in the overall compliance rate between wage earners and the self-employed).

82 *Compare id.* at 112 (suggesting noncompliance may be due to sole proprietors having more opportunities to evade), *and* Logue & Vettori, *supra* note 81, at 109 (same), *with* Phillips & Plumley, *supra* note 80, at 2 (noting that the complexity involved in meeting tax obligations is a factor in compliance), *and* Thomas, *supra* note 80, at 1526 (same).

83 *See, e.g.*, Joseph Bankman, Commentary, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 514 (2007) (noting that "non-collection of tax due creates efficiency and fairness problems"); *accord* Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Business and Tax Evasion*, 20 STAN. L. & POL'Y REV. 37, 48 (2009) ("Nonpayment of self-employment taxes is estimated to comprise $39 billion, or sixteen percent of the gross tax gap, and is widely thought to be associated with underreporting of business income."); Thomas, *supra* note 81, at 113-14 (stating that "individual small business noncompliance . . . results in a significant revenue loss, causes an inequitable shift of the tax burden from noncompliant small businesses to compliant taxpayers, and distorts taxpayer preferences among different types of businesses").

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 highly effective.[84] For individual business owners, however, 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 also expend resources to keep records and make the appropriate tax filings himself, or to retain the services of another person to do so. It is 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 incurred expenses that 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.[85] 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

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84 *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., TAX GAP ESTIMATES FOR THE YEARS 2008–2010 fig.1 (2016) (finding a 99 percent compliance rate when withholding is present and 93 percent compliance rate when "substantial information reporting" is present).

85 *See* Thomas, *supra* note 81, at 113 (noting that "small businesses dealing in cash" can easily avoid "information reporting and withholding requirements").

opportunity to conceal or conveniently forget about receipts, particularly cash receipts.[86] Even in the unlikely event[87] that the taxpayer is audited, the IRS has a much harder time detecting income when there is no 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, would 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 99 percent, compliance among sole proprietors is below 50 percent.[88] The data also indicates that the majority of evasion among business owners has traditionally involved understating cash receipts.[89]

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.[90] The ease of access to part-time gig work through online platforms, along with relatively low startup 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"[91] 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.[92] 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

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86 The compliance rate among cash businesses has been estimated to be as low as 19 percent. *See A Closer Look at the Size and Sources of the Tax Gap: Hearing Before the Subcomm. on Taxation & IRS Oversight of the S. Comm. on Fin.*, 109th Cong. 14 (2006) (statement of J. Russell George, Treasury Inspector General for Tax Administration, U.S. Department of Treasury).

87 In 2015, the IRS audited less than 3 percent of individual returns with business income under $1,000,000. *See* U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., 2015 DATA BOOK tbl.9a (2016).

88 *See* Thomas, *supra* note 81, at 112. These percentages are based on the ratio of income actually reported to income that should have been reported. *See, e.g.*, U.S. DEP'T OF TREASURY, *supra* note 84, at fig.1 n.2.

89 *See* Thomas, *supra* note 81, at 113, 128 n.109 (stating that underreporting of gross income is much more prevalent than overstating deductions).

90 *See supra* notes 15–19 and accompanying text.

91 The IRS's definition of "small business" is one with receipts under $10 million. *See Small Business and Self-Employed Tax Center*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-and-self-employed-tax-center [https://perma.cc/TW7U-KJGU].

92 *See supra* subsection I.B.3.

additional time and effort that would not otherwise be expended but for the tax law. 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 even 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 declining[93] and, along with it, taxpayers' ability to hide their receipts from the government.[94] Second, and relatedly, the use of technology to facilitate payments for goods and services interjects third parties into transactions between buyers and sellers.[95] An example of such a third party is the website Etsy, which offers an online marketplace for individuals to promote and sell handmade goods that consumers may browse and ultimately purchase. This is important from the government's perspective because those third parties can provide information to the government about transactions in contexts where third party 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.[96]

Underreporting business receipts, which once was 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. Unfortunately, this doesn't mean that tax evasion among business owners is obsolete. Rather, it appears that many determined tax evaders 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.[97] The overstatement of deductions—previously a much smaller problem than

93 *See* James Alm & Jay A. Soled, *W(h)ither the Tax Gap?*, 92 WASH. L. REV. 521, 531 (2017) ("The emergence 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 end."); *see also* Jeffrey H. Kahn & Gregg D. Polsky, *The End of Cash, the Income Tax, and the Next 100 Years*, 41 FLA. ST. U. L. REV. 159, 163 (2014) (describing how e-payment technologies are reducing the need for cash).

94 *See id.* at 163-65 ("E-payments automatically leave an electronic trail for every transaction, which decreases the risk of non-reporting of income.").

95 *See id.* at 165 (noting that e-payments must be made through a third-party intermediary).

96 *See supra* subsection I.B.2.

97 Joel Slemrod et al., *Does Credit-Card Information Reporting Improve Small-Business Tax Compliance?* 22-23 (Nat'l Bureau of Econ. Research, Working Paper No. 21412, 2015) ("[T]axpayers whose reported receipts rose due to Form 1099-K also increased expense reporting, substantially diminishing its effect on overall tax revenues, and possibly diminishing the effect on reporting compliance by offsetting more accurate receipts reporting with less accurate expense reporting.").

understated receipts[98]—has essentially become the new tax enforcement challenge for the IRS in the wake of recent technological advancements.

3. Examples of Tax Evasion

Consider two hypothetical examples that illustrate the evolution of small business tax evasion. First, consider a restaurant owner who earned $400,000 in gross receipts in a year, half ($200,000) of which was in cash. Assume the restaurant owner also had $150,000 of legitimate business expenses. A dishonest restaurant owner might intentionally omit much—or all—of the cash receipts from both his 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), and all $150,000 of his business expenses, resulting in net business income of $50,000, which would be subject to income and self-employment taxes.[99] Although his true net business income from the restaurant was $250,000,[100] 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 ($2500),[101] assume the driver incurred $5000 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 $8000 of car-related expenses, for net business income of just $2000[102] instead of $5000.[103] 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

98 *See supra* note 89 and accompanying text.

99 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 199A deduction, the standard deduction, or itemized deductions. *See* I.R.C. § 63 (2012) (defining "taxable income").

100 $400,000 (gross receipts) – $150,000 (business expenses) = $250,000 (net business income).

101 The typical Uber commission is 20 percent, though it varies by city, and Uber also deducts other amounts, such as a "Safe Ride Fee." *See* Oei & Ring, *supra* note 62, at 63. All of these fees paid to Uber are deductible by the driver from the gross amount on Form 1099-K.

102 $12,500 (gross receipts) – $2500 (deductible fee to Uber) – $8000 (claimed car-related expenses) = $2,000 net business income.

103 $12,500 (gross receipts) – $2500 (deductible fee to Uber) – $5000 (actual car-related expenses) = $5000 net business income.

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, rather than the much higher $20,000/200 transaction threshold. Second, Congress should enact legislation that would allow for tax withholding on payments to 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 gig workers earning receipts below a certain threshold. In combination, these modifications should improve tax compliance while drastically reducing the time and resources gig workers spend dealing with their tax obligations.

B. *Expanded Information Reporting*

Any tax reform proposal for gig economy workers must include expanded information reporting, an issue that has been raised by several other commentators.[104] To briefly reiterate those arguments: information reporting is crucial to tax compliance; section 6050W's application to platform companies is somewhat unclear;[105] 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.[106]

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 would such third-party reporting aid in the government's enforcement efforts, it would also greatly assist the gig workers themselves by serving as a method 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

104 *See, e.g.*, Oei & Ring, *supra* note 9, at 1059 ("Legislators and regulators must act quickly to close loopholes as they arise," with respect to 1099-K reporting); Oei & Ring, *supra* note 62, at 106 ("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 93, 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.").

105 *See supra* subsection I.B.2.

106 The $20,000 threshold was likely intended for third party payment processors like PayPal. *See* Erb, *supra* note 59.

transaction threshold[107] and others may soon follow suit. Additionally, given the attention that the 1099-K reporting "loophole" has received and the ease with which it could be rectified, the odds of clarification in this area are high.[108] 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.[109] 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.[110] But withholding provides additional 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 proposed 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,[111] gig workers may have a particularly difficult time dealing with their tax obligations because they tend to be inexperienced, are 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.[112] Even workers who are able to

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107 *See supra* note 62 and accompanying text.

108 However, legislation proposed in the Senate in 2017, which would have required a $1000 reporting threshold for all platform companies, was not enacted as part of the final tax reform bill. *See* NEW GIG Act of 2017, S. 1549, 115th Cong. (2017).

109 *See, e.g.*, U.S. DEP'T OF TREASURY, *supra* note 84 (reporting a 93 percent compliance rate when "substantial information reporting" is present).

110 *See supra* subsection I.B.2 (describing the process by which third parties issue year-end information statements).

111 *See supra* subsection I.B.3.

112 *See supra* note 72 (explaining the various penalties for failing to pay taxes).

come up with funds to pay their year-end tax burden may be forced to shift their consumption patterns or asset allocations to meet their obligations.[113] To address these concerns, Congress should enact legislation requiring platform companies to withhold income and self-employment taxes from gig workers' gross earnings.[114]

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,[115] most workers would have no obligation to pay quarterly estimated taxes.[116] 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.[117] This is the treatment currently afforded to wage earners, most of whom do not have to worry about their tax compliance obligations during the year.

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 that there is generally no interest paid on tax refunds.[118] 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.[119] Refunds may also serve as a form of

113 *See* HARRIS & KRUEGER, *supra* note 8, at 18 (describing how tax payments and penalties "can cause fluctuations in consumption and asset allocations").

114 Legislation proposed in the Senate in 2017 would have required withholding by platform companies of 5 percent of gig workers' gross earnings, on up to $20,000 of earnings. However, the withholding provision was not enacted as part of the final tax reform bill in 2017. *See* NEW GIG Act of 2017, S. 1549, 115th Cong. (2017). While 5 percent withholding would have been a step in the right direction, this rate may have been too low, as discussed further below.

115 Gig workers, like any independent contractor, are generally paid periodically. *See, e.g.*, Don Reisinger, *Uber Will Instantly Pay Drivers in Need*, FORTUNE (Mar. 17, 2016), http://fortune.com/2016/03/17/uber-instant-pay/ [https://perma.cc/QG2H-RERU] (noting that 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).

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

117 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 62, at 97.

118 *See, e.g.*, Benjamin C. Ayers, Steven J. Kachelmeier & John R. Robinson, *Why Do People Give Interest-Free Loans to the Government? An Experimental Study of Interim Tax Payments*, 21 J. AM. TAX'N ASS'N 55, 71 (1999); 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'N ASS'N 93, 108-09 (2007).

119 *See* Bobek et al., *supra* note 118, at 99 ("Approximately 40 percent of respondents reported that they enjoyed receiving a refund and expressed 'dread' . . . at paying taxes when they file their

forced savings for lower income taxpayers, helping them purchase durable goods, such as appliances.[120] 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.[121] Rather than constituting an irrational preference, it seems that the psychological benefits of receiving a refund outweigh its financial cost for many taxpayers.[122]

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.[123] This phenomenon is consistent with prospect theory, which generally predicts that individuals tend to be risk-seeking when facing a loss and they tend to be risk-averse when facing a gain.[124] In the context of taxes,

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return."); *see also* Ayers et al., *supra* note 118, at 56, 70 (finding that taxpayers prefer to overpay for various reasons, including inexperience and uncertainty).

120 *See* Michael S. Barr & Jane K. Dokko, *Paying to Save: Tax Withholding and Asset Allocation Among Low- and Moderate-Income Taxpayers* 8 & n.5 (Fin. & Econ. Discussion Series, Working Paper No. 2008-11, 2008), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1327119 [https://perma.cc/9ETG-32D6] ("Tax refunds may finance different types of consumption, such as durable goods purchases, if 'mental accounting' plays a role in individuals' decision-making.").

121 *See* Bobek et al., *supra* note 118, at 93, 109.

122 *See id.* at 109 ("Those who preferred to receive a refund perceived little financial benefit to reducing their withholding and were primarily influenced by emotional issues such as anxiety about unexpectedly owing money when they filed a tax return.").

123 *See, e.g.*, Paul Corcoro & Peter Adelsheim, *A Balance Due Before Remittance: The Effect on Reporting Compliance* 1, 28, *in* RECENT RESEARCH ON TAX ADMINISTRATION AND COMPLIANCE: SELECTED PAPERS GIVEN AT THE 2010 IRS RESEARCH CONFERENCE (June 29-30, 2010) ("There is evidence that balance-due taxpayers have been found to understate their taxes more often than refund-due taxpayers."); Richard Dusenbury, *The Effect of Prepayment Position on Individual Taxpayers' Preferences for Risky Tax-Filing Options*, 16 J. AM. TAX'N ASS'N 1, 2 (1994) ("[T]axpayers selected significantly riskier filing positions and reported less income in the payment-due case than in the refund case."); Henk Elffers & Dick J. Hessing, *Influencing the Prospects of Tax Evasion*, 18 J. ECON. PSYCHOL. 289, 291 (1997) (describing the psychological incentives for taxpayers regarding refunds); Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating*, 11 J. ECON. PSYCHOL. 341, 355 (1990) ("Noncompliance was more likely to occur, occurred on more occasions, and involved larger amounts of money among subjects confronting the prospect of an additional tax payment after withholding."); A. Schepanski & T. Shearer, *A Prospect Theory Account of the Income Tax Withholding Phenomenon*, 63 ORG. BEHAV. & HUM. DECISION PROCESSES 174, 183-84 (1995) (describing the "withholding phenomenon" and that evidence "indicates that underwithholding has a greater effect on detracting from taxpayer compliance than overwithholding does on enhancing it"); *see also* Otto H. Chang, Donald R. Nichols & Joseph J. Schultz, *Taxpayer Attitudes Toward Tax Audit Risk*, 8 J. ECON. PSYCHOL. 299, 304 (1987) (discussing the prospect theory and suggesting that taxpayers "exhibit different tax evasion behaviors"); Per Engstrom et al., *Tax Compliance and Loss Aversion*, 7 AM. ECON. J. 132, 133 (2015) (studying Swedish taxpayers and finding that "[t]hose with a deficit would consequently be more inclined to take (legal or illegal) actions in order to reduce their tax liability").

124 *See generally* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

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.[125] 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.[126] Thus, putting gig workers in a refund position when they file their tax return should result in more honest tax reporting by these workers.

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.[127] 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[128] 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 means that withholding can be accomplished at a lower cost than ever before.[129] These cost savings would inure to the benefit of the government as well, which would now have a smaller group of players to monitor, and those players (the platform

125 *See* Thomas, *supra* note 81, at 131-35 (applying Kahneman and Tversky's prospect theory analysis to a taxpayer's decision to comply or evade tax collection under various circumstances).

126 *See, e.g.*, Corcoro & Adelsheim, *supra* note 123, at 23 ("The individual is willing to underreport their tax liability to reduce a perceived loss when compared to the risk aversion to maintain a perceived gain."); Thomas, *supra* note 81, at 138-39 ("[C]ompliance improves among *all* types of taxpayers when they face a refund as compared to a balance due.").

127 *See* 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 ("Tax withholding by intermediaries would reduce workers' administrative burden of paying income and social insurance taxes . . . . [W]ithholding services provided by intermediaries would also be economically efficient and improve compliance with tax laws.").

128 *See, e.g.*, *"The Sharing Economy": A Taxing Experience for New Entrepreneurs Part I: Hearing Before the H. Comm. on Small Business*, 114th Cong. 5 (2016) (testimony of Joseph V. Kennedy, Senior Fellow, Information Technology and Innovation Foundation) ("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.").

129 *See, e.g.*, Kahn & Polsky, *supra* note 93, at 159 ("Technological improvements have made third-party reporting and withholding more efficient, which has allowed these mechanisms to become more pervasively used.").

companies) would be much more likely to have sophisticated recordkeeping and accounting systems in place.[130]

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 cost.[131] If workers feel uncertain or intimidated about the tax compliance costs[132] associated with gig work, they may reduce their hours in response or be deterred from participating in gig work altogether.

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.[133] In the study, subjects were given a choice between taking part in a leisure activity or working on a task for wages.[134] Some subjects saw the wage presented as a *gross wage* minus a tax (i.e., a "partitioned price"); in other words, they were required to figure out the net after-tax wage themselves.[135] Others were presented with *net wage* information ("inclusive price") along with the partitioned price. The authors found that subjects were more willing to choose work over the leisure activity 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."[136]

130 *See* Slemrod, *supra* note 27, at 266 (discussing the efficiency-enhancing role of firms in the tax withholding system).

131 Some platform companies have indicated a desire to do more to help workers with tax compliance obligations, but that they are reluctant to do so. *See, e.g.*, BRUCKNER, *supra* note 3, at 16 (discussing Airbnb's 2015 announcement that it would begin collecting and remitting state and local taxes in certain jurisdictions). 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 obligation to pay minimum wage and overtime, for example).

132 *See "The Sharing Economy"*, *supra* note 128, at 4 ("Workers need to make a number of important decisions including . . . how much to withhold . . . . They need to determine what expenses are deductible and begin keeping the necessary records. And they need to complete their tax filings in a timely manner.").

133 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, 217 (2013).

134 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 207-08. A second experiment varied the net wage. *Id.*

135 *Id.* at 210.

136 *Id.* at 214. 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 complicating the wage description 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 217; *see also* Johannes Abeler & Simon Jäger, *Complex Tax Incentives*, 7 AM. ECON. J. 1, 24-25 (2015) (finding 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).

The study's findings are relevant to gig workers because tax withholding essentially provides workers with an inclusive wage presentation. Every time they receive their paychecks, they can view which portion went to taxes and what their net compensation is.[137] 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),[138] because many workers don't even know what the appropriate tax rate will be. Thus, it is possible the uncertainty and complexity associated with receiving gross compensation payments actually reduce labor supply and that tax withholding can mitigate this effect.

Lastly, there is a precedent for requiring tax withholding by platform companies. At least twelve countries in the Organisation for Economic Co-operation and Development (OECD) require withholding on some payments to independent contractors.[139] 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.[140]

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137 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 Fooken & Melanie Steinhoff, *Behavioral Effects of Withholding Taxes on Labor Supply* 6-7, 21 (Sch. of Econ., Univ. of Queensland Discussion Papers Series No. 589, 2018), http://www.uq.edu.au/economics/abstract/589.pdf [https://perma.cc/4RST-3NZB].

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. Notably on this point, the study by Becker, Fooken, and Steinhoff found that work effort, while decreasing after imposition of high withholding taxes, *increased* in the period after receipt of a refund. *Id.* at 16.

138 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 133, app. 2.

139 Slemrod, *supra* note 27, at 263. The OECD is a group of thirty-five countries with high levels of economic development.

140 *See Airbnb: Generating $2 Billion in Potential Tax Revenue for America's Cities*, AIRBNB CITIZEN (Jan. 21, 2016), https://www.airbnbaction.com/airbnb-generating-2-billion-in-potential-tax-revenue-for-americas-cities [https://perma.cc/869E-FNXD]; *see also* Alison Griswold, *Why Airbnb Desperately Wants to Pay Hotel Taxes*, SLATE (Feb. 13, 2015), http://www.slate.com/articles/business/moneybox/2015/02/airbnb_hotel_taxes_why_does_the_sharing_economy_startup_want_to_pay_them.html [https://perma.cc/Q7U7-JAMR] (describing Airbnb's motivations for tax collection, including the opportunity to gain the favor of local governments).

2. Details of the Proposal

As discussed above, the current tax rules require that employers withhold income taxes and payroll taxes on wages paid to employees, but there is no such requirement for payments to independent contractors. Thus, under the current regime, whether platform companies must withhold taxes on payments to gig workers depends entirely on whether the workers are independent contractors or employees. Although there may be many valid reasons to classify gig workers as employees[141] or to create a new, third category of worker that is a hybrid of the two,[142] resolving that issue is beyond the scope of this Article. Additionally, from a practical perspective, it may take many years before the legal disputes are resolved.[143]

But the stakes of tax withholding do not have to be so high. Congress could enact legislation providing specifically for *non-employee* withholding on certain payments to independent contractors. This change would require withholding regardless of the classification of gig workers as employees or independent contractors, and could be enacted in the short-term without having to account for the multitude of non-tax considerations wrapped up in employee status. As discussed further below, workers who do not want their taxes withheld would be able to opt out or elect to reduce their withholding amounts.

a. *Scope of Withholding*

Non-employee withholding would not have to be limited to the gig economy. While large platform companies like Uber and Etsy are good candidates for acting as withholding agents, those independent contractors who don't technically qualify as "gig workers" should also be able to partake in the benefits of withholding.[144] However, carving out the proper scope of withholding for independent contractors requires defining a dollar threshold, identifying the

141 Some commentators have pointed out that gig workers receive no protection from workplace discrimination. *See, e.g.*, HARRIS & KRUEGER, *supra* note 8, at 7 (discussing the different "protections and benefits . . . at stake" depending on whether one is classified as en employee or independent contractor).

142 *See supra* note 23 (detailing a framework to create a third category of worker called "independent worker").

143 *See, e.g.*, Maya Kosoff, *Why the "Sharing Economy" Keeps Getting Sued*, VANITY FAIR (Nov. 9, 2017), https://www.vanityfair.com/news/2017/11/postmates-worker-classification-lawsuit [https://perma.cc/L7JB-RMUF] (describing a litany of lawsuits involving the employment status of gig workers, including workers at GrubHub, Uber, Lyft, and Postmates).

144 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 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 the distinction between platform companies and payment processors).

payers that are required to withhold, and identifying the payees for whom withholding is required. A sensible starting point here is section 6041 of the Code, which establishes a similar framework for 1099-MISC information reporting.

First, there should be a *de minimis* threshold under which withholding is not required. A logical approach is to use the same $600 threshold that exists for 1099-MISC reporting;[145] in other words, withholding would only be required once gross payments to an independent contractor reach at least $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.

In terms of identifying the relevant payers, independent contractor withholding should apply only to payments made in the course of the payer's business, meaning it would not be required of individuals who are purchasing goods or services for personal purposes.[146] For example, a business that hires a handyman to make occasional repairs would withhold taxes in addition to the issuing a 1099-MISC to the handyman (as currently required). An individual hiring a house painter for her personal residence, on the other hand, would not be required to withhold (nor is she required to issue a 1099 under the current tax law).

In terms of identifying the relevant payees, the goal would be to identify individual workers and not business entities that may also have their own withholding obligations in the same transaction. For example, a law firm that hires Uber to drive its employees home should not be required to withhold taxes on its payment to Uber, but Uber should be required to withhold on its payment to the driver. A simple, albeit imperfect, way to address this is to require withholding only on payments to individual payees and not entities. Section 6041 has a similar rule that exempts payments to corporations from information reporting. The rule proposed here would be broader in that it would also exempt businesses operating in other entity forms (e.g., a Limited Liability Company). Presumably, the vast majority of gig workers and other,

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145 *See* I.R.C. § 6041(a) (2000); *see also About Form 1099-MISC, Miscellaneous Income (Info Copy Only)*, INTERNAL REVENUE SERV., https://www.irs.gov/forms-pubs/about-form-1099-misc-miscellaneous-income [https://perma.cc/57LK-KG5S].

146 The withholding legislation could be similar in scope to 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.

small independent contractors are not operating as entities and thus would be able to benefit from withholding.[147]

b. *Self-Employment Taxes*

Independent contractor withholding should 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.[148] 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.

c. *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.

Choosing a withholding rate depends on several factors: the worker's expected annual income, her expected deductions, and her marginal tax rate. In the context of wage withholding, the IRS uses proxies to help estimate these three factors. First, the IRS projects expected income 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 Form W-4 and claim allowances for certain things like dependents, spouses, and child care expenses, which approximate personal exemptions and other deductions.[149] Finally, using the employee's projected income and the number of allowances, IRS withholding tables

147 Concerns about single member Limited Liability Companies could be assuaged by allowing those independent contractors the option to opt in to withholding.

148 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.

149 INTERNAL REVENUE SERV., FORM W-4 (2017). Under the Tax Cuts and Jobs Act, *supra* note 37, personal exemptions are repealed for tax years 2018–2025, which will require a new version of Form W-4.

apply marginal tax brackets to determine the amount that employers should withhold from each paycheck.[150]

There are, of course, instances where wage withholding is not accurate. For example, Form W-4 does a poor job accounting for marriage penalties for two working spouses making similar incomes. Moreover, 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.[151]

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 than for wage earners. This is partly because the former may have 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 they can deduct their business expenses and potentially claim a section 199A deduction. 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 form other than the W-4 should be used for independent contractor withholding. Additionally, because it is 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 employee withholding tables. Accordingly, the remainder of this subsection discusses a proposal for a schedule of non-employee withholding rates, where one rate in the schedule would apply to all of an independent contractor's gross receipts. As detailed below, the gross receipts withholding rates are derived by: 1) having taxpayers project their net

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150 U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., PUB. 15, CAL NO. 10000W, (CIRCULAR E), EMPLOYER'S TAX GUIDE 44-47 (2018).

151 *See* Thomas, *supra* note 81, at 142 n.180 (explaining that wage withholding tables are designed to intentionally over-withhold).

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 of 40 percent (which would apply in all cases). The goal is to have withholding cover all of taxpayers' income and self-employment tax obligations and provide a modest refund.

d. *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 determine: (1) how much of each gross payment represents net income and (2) how much tax is owed on that net income.

i. 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 ratio[152] 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 profit ratio is approximately 22.7 percent.[153] However, the overall average takes into account various industries (such as retail stores and warehouses) that may not be relevant for this purpose, as 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 workers and other small independent contractors, and eliminating payroll expenses, the weighted average net profit ratio for sole proprietors rises to approximately 40

152 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 $6,000 of expenses would have a profit ratio of 40 percent.

153 *See SOI Tax Stats, Nonfarm Sole Proprietorship Statistics*, INTERNAL REVENUE SERV., https://www.irs.gov/uac/soi-tax-stats-nonfarm-sole-proprietorship-statistics [https://perma.cc/P9C2-27PF] (analyzing Table 1, Nonfarm Sole Properietorships: Business Receipts, Selected Deductions, Payroll, and Net Income, by Industrial Sectors, Tax 2014).

percent.[154] This is consistent with a recent study of self-employed taxpayers conducted by the Office of Tax Analysis (OTA), in which average profit ratios were approximately 38 percent for sole proprietors with more than $5000 in expenses.[155] However, it should be noted that for taxpayers who specifically identified as gig workers in the OTA study, profit ratios were closer to 30 percent.[156]

Using a profit ratio of 40 percent instead of 30 percent to calculate withholding for gig workers could result in over-withholding for some of those workers, which may or may not be desirable (as discussed further below). To address this potential inaccuracy, policymakers could calculate different withholding schedules for gig workers versus non-gig workers. Taking this approach to the extreme, they could also calculate different withholding schedules on a sector-by-sector basis, which would be more accurate but entail more complexity. But because the withholding scheme proposed here is optional for taxpayers, and because it would be vastly simpler, this Article proposes that one presumed profit ratio of 40 percent should apply to all independent contractors. If policymakers deem it

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154 Calculations showing weighted net profit ratios after exclusion for payroll expenses are on file with the author and are based on 2014 data made publicly available by the IRS. *Id.* Sectors considered were: non-store retailers; lessors of real estate; couriers and messengers; transit and ground transportation; specialized design services; computer systems design 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.

155 Jackson et al., *supra* note 15, at 34 tbl.6. The OTA study separates sole proprietors with significant business expenses (over $5000) from those without significant business expenses (less than $5000) and reveals an interesting trend. For taxpayers who were either primarily self-employed or earning a mix of employment and self-employment income, profit ratios were 38 percent for those with significant expenses. However, for those without significant expenses, profit ratios were approximately 90 percent, likely reflecting those taxpayers engaged in low-cost, labor-intensive industries. Overall profit ratios, taking into account both the significant expense group and the insignificant expense group, were 49 percent for those with mixed wage/self-employment income and 44 percent for those who earned primarily self-employment income, which is still somewhat in line with the 40 percent average discussed above. *See id.* (analyzing data provided for in Table 6). Overall, this means that taxpayers in the low expense group would likely be under-withheld if a 40 percent profit ratio were assumed.

156 *See id.* (based on ratio of profits to gross receipts). However, the authors of the study acknowledge certain limitations with respect to the data on gig workers. First, the data omits gig workers who did not receive a Form 1099 from a platform company or who did not self-identify as a gig worker by naming a specific platform or using a specific phrase (e.g., "ride sharing"). *Id.* at 15. Second, income and expense data for gig workers may also include other, non-gig work. *Id.*

preferable to limit withholding to only gig workers, a 30 percent presumed profit ratio may be more appropriate.

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.

ii. 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.[157] For purposes of simplicity, this discussion assumes that a 15 percent self-employment tax rate applies to all of the taxpayer's net business income.

In addition to self-employment tax, taxpayers must pay income tax at the applicable marginal rates provided under the Code. The appropriate income tax 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 tax rate. For example, if a single taxpayer projects that he will earn $70,000, the appropriate marginal income tax rate is 22 percent for 2018.[158]

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 $70,000 (putting her in the 22 percent income tax bracket), her total tax rate for purposes of withholding will be 37 percent (15 percent for self-employment tax plus 22 percent for income tax).

Finally, by combining the 40 percent presumed profit ratio and the total tax rate, we can derive a single, flat rate to withhold on gross receipts for each marginal income tax bracket. For the taxpayer in the preceding paragraph with a total tax rate of 37 percent, the appropriate withholding rate would be 15 percent of gross receipts (37 percent times 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.

157 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 32 (discussing the self-employment tax).

158 *See* Tax Cuts and Jobs Act, *supra* note 37, § 11001 (creating new tax brackets).

Table 1

Projected Marginal Tax Rate	Withholding Rate on Gross Receipts[159]
0 percent[160]	6 percent
10 percent	10 percent
12 percent	11 percent
22 percent	15 percent
24 percent	16 percent

e. *Implementation Details*

To summarize, an appropriate withholding rate on gross receipts should be between 6 and 16 percent (under the assumptions discussed above).[161] For simplicity, policymakers might choose just one flat withholding rate—say 10 percent—for all gross receipts. The Taxpayer Advocate, Nina Olson, recommended a similar approach in her 2003 report to Congress.[162] The Obama Administration also recommended withholding for independent

159 Calculated as follows: [15 percent + Projected Marginal Tax Rate] x 40 percent, rounded to the nearest whole number.

160 A taxpayer who projects that his income will be less than or equal to the standard deduction 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.

161 Higher marginal rates on incomes over $157,500 have been omitted for this purpose because most gig workers are not earning that much income.

162 NAT'L TAXPAYER ADVOCATE, 2003 ANNUAL REPORT TO CONGRESS 257-58 (Dec. 31, 2003). 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. NAT'L TAXPAYER ADVOCATE, 2005 ANNUAL REPORT TO CONGRESS 391-393 (Dec. 31, 2005). 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. *"The Sharing Economy: A Taxing Experience for New Entrepreneurs": Hearing Before the H. Comm. on Small Business*, 114th Cong. 14 (2016) (statement of Nina E. Olsen, National Taxpayer Advocate).

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.[163] 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.[164] On the other hand, a recent Senate proposal for mandatory withholding by platform companies at a flat rate of 5 percent would likely have resulted in under-withholding for many gig workers.[165]

Instead of choosing one flat rate, a more accurate approach that would not entail too much additional administrative complexity would be to vary the withholding rate based on the taxpayer's projected earnings. The taxpayer would fill out a form similar to 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 produce a reasonable estimate within a range as wide as the marginal tax brackets.

For example, the form could have taxpayers check a box asking which of the following categories they expect their combined net business income and wages to fall into: 0–$12,000; $12,001–$22,000; $22,001–$50,000; etc.[166] Choosing a projected net income amount would surely be 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, which would mitigate the potential to collect too much tax. Self-employment tax, however, applies to net business income *before* any offset for the standard deduction, 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 but should still be subject to withholding (at a 6 percent rate) to cover self-employment tax.

163 *See* U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2017 REVENUE PROPOSALS 199 (Feb. 2016). It should be noted that past legislative proposals to impose mandatory independent contractor withholding have not had success. For example, in 2011, Congress repealed prospective legislation that would have imposed withholding at a rate of 3 percent of gross receipts on payments to government contractors over $10,000. *See* Pub. L. No. 112-56, 125 Stat. 711 (2011).

164 For example, at a marginal tax rate of 12 percent, withholding 25 percent of gross receipts would assume a net profit ratio of 92.5 percent. [(15 percent + 12 percent) x 92.5 percent = 25 percent.]

165 *See supra* note 114.

166 Because the withholding rates proposed here would be based on the taxpayer's highest marginal income tax rate, the categories should roughly approximate (or could exactly equal) the marginal tax brackets. Thus, for example, since the 22 percent marginal tax bracket covers taxable incomes between $38,701 and $82,500 for 2018 (for single filers), it wouldn't matter for purposes of withholding if a gig worker projected he'd earn $60,000 of net income but actually earned only $50,000.

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) and the standard deduction, but does not take into account any other above-the-line deductions or itemized deductions.

Further, new Code section 199A deduction adds another layer of complexity and potential inaccuracy to withholding. For workers who derive all of their income from gig work (or other non-employee work), the deduction may[167] apply to their entire net income,[168] which would be relatively simple to factor into a withholding calculation. (Estimated net income would simply be reduced by 20 percent.) But because the section 199A deduction does not apply to employment income, it would be difficult to adjust the total net income of workers who earn a combination of employment and non-employment income. This might not matter for many workers: as long as the section 199A deduction doesn't move the taxpayer from one marginal bracket to another, the withholding calculation would not be impacted. But it is possible that some taxpayers at the bottom of one bracket would be moved to a lower bracket by virtue of the section 199A deduction, and not accounting for this could result in significant over-withholding.[169]

On the one hand, these potential inaccuracies may not be troubling, especially since wage withholding also doesn't take into account a number of deductions.[170] 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.[171] However, these factors may be good reason to err on the low side when setting a range of withholding

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167 But for some workers, the deduction will be 20 percent of taxable income, which will be less than 20 percent of net gig income. *See supra* note 42 and accompanying text.

168 This assumes the worker earns less than the $157,500/$315,000 threshold. *See supra* note 44 and accompanying text.

169 As an example, consider a single gig worker with $60,000 of net earnings from gig work. After the standard deduction and a deduction for half of self-employment tax, the worker would have $43,761 of taxable income, putting her in the 22 percent tax bracket. But factoring in the 199A deduction would mean an additional $8752 deduction (20 percent of $43,761, since this is less than 20 percent of $60,000), resulting in $35,009 of taxable income, putting her in the 12 percent tax bracket. For the 2018 standard deduction and tax brackets, see Tax Cuts and Jobs Act, *supra* note 37, §§ 11001, 11021.

170 *See* Thomas, *supra* note 81, at 142.

171 *Id.*

rates. Policymakers may decide, for example, to withhold at only 12 or 13 percent for those in the 22 and 24 percent brackets, and only 8 or 9 percent for those in the 10 and 12 percent brackets.[172]

f. *Opt-Out*

If withholding rates are too high, independent contractors may face serious liquidity constraints until they receive their tax refund. Other independent contractors may prefer to handle estimated tax payments on their own without interference from the government; this may be particularly true of experienced business owners or those with seasonal income fluctuations. To address these concerns, Congress should make non-employee withholding optional for the payee. The form that a worker provides to the payer could contain an additional line that allows the worker to elect no withholding, or to provide a reduced (or increased) withholding rate of her choice.

Importantly, withholding at rates provided by the government should be the default. In other words, workers would be given the option to opt *out* of withholding or to change their withholding rate, but would be subject to the withholding regime described above if they did not make an affirmative election. This would ensure that workers who chose not to have their taxes withheld were expressing a true preference, rather than exhibiting a status quo bias.[173] Since withholding would only apply to individual taxpayers, workers could also opt out simply by forming an entity.

The downside of optionality 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.

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

172 Another "back-of-the-envelope" method to account for the new section 199A deduction would be to reduce all projected marginal income tax rates by 20 percent. For example, a taxpayer projected to be in the 22 percent tax bracket (based on her estimated net income) would instead be projected to have a marginal income tax rate of 17.6 percent. Adding 15 percent for self-employment tax would result in a total tax rate of 32.6 percent, which would reduce projected withholding from 15 percent (see Table 1 above) to 13 percent. The same calculation could be done for each marginal income tax rate in Table 1.

173 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).

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 would 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 could 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 Section by the proposal for a standard business deduction (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).[174] 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.[175] 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; this simplified rule allows taxpayers to deduct an amount equal to their total business miles

174 *See* Phillips & Plumley, *supra* note 80, at 29 (discussing studies of audit data for over 55,000 taxpayers from 2006 to 2010 which found that, although many taxpayers report an amount close to their actual tax liability, they tend to slightly underreport, rather than overreport).

175 *See supra* note 74 and accompanying text.

driven multiplied by a rate set by the IRS (currently $0.545 for 2018).[176] Similarly, a simplified home office deduction allows taxpayers to deduct $5.00 per square foot for the area-based portion of their home used exclusively for business, in lieu of deducting actual home office expenses and depreciation.[177]

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.[178] 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.[179] Additionally, Oei and Ring note that there is legal uncertainty associated with miles driven while waiting for a new job.[180] 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.[181]

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.[182]

In addition to taxpayers mistakenly over-reporting deductions, a significant number are likely engaged in *intentional* over-claiming of deductions. The ability to cheat by underreporting receipts has greatly diminished with the proliferation of electronic payments and the decline in

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176 *See supra* note 65 (discussing the standard mileage deduction).

177 *See* Rev. Proc. 2013-13; *see also Simplified Home Office Deduction*, INTERNAL REVENUE SERV., https://www.irs.gov/businesses/small-businesses-self-employed/simplified-option-for-home-office-deduction [https://perma.cc/2W6W-H8ZH]. Among other requirements, the square footage may not exceed 300 square-feet and the home office must be used for business on a regular basis. *Id.*

178 Oei & Ring, *supra* note 62, at 78-82, 80-81.

179 *Id.*

180 *Id.*

181 *See, e.g.*, Comm'r of Internal Revenue v. Flowers, 326 U.S. 465, 471 (1946) (articulating that the Tax Court below "disallowed . . . deductions on the ground that they represent living and personal expenses rather than traveling expenses incurred while away from home in the pursuit of business"); U.S. DEP'T OF TREASURY, INTERNAL REVENUE SERV., PUB. 463, CAT. NO. 11081L, TRAVEL, ENTERTAINMENT, GIFT, AND CAR EXPENSES 15 (2017) ("While you can't deduct the costs of . . . trips [to and from home], you can deduct the costs of going from one client or customer to another.").

182 Oei & Ring, *supra* note 62, at 78-82.

the use of cash. This means that for dishonest taxpayers, deductions are the items that are easiest to strategically manipulate without the IRS noticing. And, as discussed above, a recent empirical study of 1099-K reporting appears to confirm that many small business owners are offsetting the compliance benefits of new information reporting rules by simply reporting more business deductions.[183]

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 impose 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.[184] 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.[185] 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.[186] Interestingly, one study also showed that the use of a tax return preparer did not mitigate the failure to itemize, suggesting that it is the recordkeeping burden, rather than tax return preparation, that largely deters taxpayers from itemizing their deductions.[187] Although these studies do not directly address business

183 Slemrod et al., *supra* note 97. 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 (such as 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.

184 *See* Phillips & Plumley, *supra* note 80, at 35.

185 *See* Mark M. Pitt & Joel Slemrod, *The Compliance Cost of Itemizing Deductions: Evidence from Individual Tax Returns*, 79 AM. ECON. REV. 1224, 1224 (1989) ("[T]here exist taxpayers who would save money by itemizing but who chose not to. We postulate that they so choose because the compliance cost of itemizing exceeds the tax savings that can be obtained."); *see also* Youssef Benzarti, How Taxing is Tax Filing? Leaving Money on the Table Because of Compliance Costs 2 (Mar. 2015) (unpublished manuscript) (finding "that taxpayers could save money by itemizing and are aware of it but still claim the standard deduction").

186 *See* Pitt & Slemrod, *supra* note 185, at 1224 (estimating the foregone tax savings to be $196.2 million); Benzarti, *supra* note 185, at 3 (estimating that an average of $617 per person is foregone from failing to itemize).

187 Benzarti, *supra* note 185, at 4.

deductions, they demonstrate that taxpayers may forego the economic benefit of their tax deductions if the perceived compliance costs are too high.[188]

2. Details of the Proposal

To mitigate the overwhelming complexity associated with the current tax regime, legislators should enact a standard business deduction (SBD) for gig workers. 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 (such as the section 199A deduction).

a. *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.[189] Although there are upsides to both approaches (discussed further below), this Article recommends an SBD calculated as a percentage of the taxpayer's gross business receipts.

The proper percentage of gross receipts for the SBD depends on who can claim it. If made available to all independent contractors, a 60 percent SBD may be a sensible choice in light of the withholding proposal discussed above. A 60 percent SBD presumes a net profit ratio of 40 percent, which is in line

188 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.

189 Interestingly, the regular standard deduction started out as a percentage of adjusted gross income, rather than a flat amount. *See* John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 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." (footnote omitted)).

with average profit ratios for small Schedule C filers.[190] If the SBD were limited only to gig workers,[191] the OTA study indicates that a slightly higher SBD (closer to 70 percent) might be more appropriate.[192]

An even more accurate approach would be to separate gig workers into two categories: those who engage in labor-only businesses and those who engage in businesses that involve both labor and capital.[193] Examples of the former are businesses that require little to no materials or supplies and that are based almost solely on the worker's services, such as childcare or housecleaning. Examples of the latter would be businesses like ride-sharing or apartment rentals, where taxpayers incur more significant expenses related to the use of their property or from the purchase of materials and supplies. The goal of this approach would be to carve out those taxpayers for whom an SBD would be a windfall. For example, OTA's study indicates that sole proprietors without significant business expenses (under $5000), who likely engage in labor-only industries like childcare, have profit ratios averaging 90 percent, while those with more significant expenses (over $5000) have profit ratios closer to 40 percent. Policymakers could, therefore, create two SBDs. One could be a 10 percent SBD for workers in certain, specified industries known to be mostly service-oriented. All other businesses would be subject to a higher SBD of 60 percent.[194]

The drawbacks of using two different percentages include having to define the labor-only businesses, along with potential gamesmanship if taxpayers who are properly classified as service providers seek an improper classification to benefit from the larger SBD. These costs would have to be weighed against the benefits of a more accurate regime, particularly given that a single SBD for all gig workers would result in revenue loss when claimed by taxpayers with minimal expenses. For the sake of simplicity, the remainder of this discussion analyzes a single-rate SBD of 60 percent of gross receipts, but the same principles discussed below would apply if two or more rates were used.

The SBD could theoretically apply to any type of independent contractor, regardless of whether she works for a platform company. Non-gig workers

190 *See supra* note 154 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).

191 It may be difficult to define gig workers for this purpose. One imperfect but administrable approach could be to limit the SBD to workers who received income from specifically identified platform companies.

192 *See supra* note 156 and accompanying text.

193 In that case, withholding could be based on these two categories as well, with two different schedules of withholding rates offered.

194 In theory, there could be many different SBDs, based on each particular industry. However, the costs of this approach (complexity, line-drawing, gaming) likely outweigh the benefits.

earning relatively small amounts of business income still face the same disproportionately high tax compliance costs that gig workers do, 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. On the other hand, extending the SBD to all independent contractors magnifies potential revenue loss and efficiency costs (discussed further below). The most workable approach may be to start small, for example, by offering the SBD to gig workers only or only to workers in a few, narrowly defined industries. If such a regime proved successful, the SBD could gradually be expanded to include more types of small businesses.[195]

b. *Earnings Cap*

To limit any potential revenue loss associated with the SBD, and to target it at truly "small" business owners, Congress should 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.[196] Business owners earning more than the cap would be subject to the current regime for deducting business expenses. The cap would be justifiable because, at a certain level of earnings, we can expect businesses to have better capacity to efficiently track and report business expenses.

In addition to a cap on gross receipts earned from self-employment, it may also be desirable to impose a total income cap above which the SBD would not be available. For example, the SBD might only be available for taxpayers whose adjusted gross income is less than $150,000. This would prevent high-income employees who earn relatively small amounts of independent contractor income from using the SBD when they likely incurred little to no expenses. An example of such an individual might be a professor who receives a small honorarium for speaking. Taxpayers with adjusted gross income over a certain level are also less likely to be participating in the gig economy.

195 Further, there is no theoretical reason that an SBD couldn't also be applied to small businesses that are conducted through an entity like an LLC. However, if we think the use of an entity is a rough proxy for size and sophistication, there is perhaps less justification for a simplified regime in that case. On the other hand, 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.

196 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 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.

c. *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 $5000 of gross business receipts and $4500 of actual business expenses; Taxpayer 2 has $5000 of gross business receipts and $2500 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.[197]

Table 2

	Taxpayer 1	Taxpayer 2	Taxpayer 3	Taxpayer 4
Gross Receipts	$5000	$5000	$30,000	$30,000
Actual Expenses	$4500	$2500	$27,000	$15,000
Profit ratio	10%	50%	10%	50%
Actual Net Income	$500	$2500	$3000	$15,000
Actual Tax (20% rate)	$100	$500	$600	$3000
Net After $10,000 SBD	—	—	$20,000	$20,000
Tax After $10,000 SBD	0	0	$4000	$4000
Net After 60% SBD	$2000	$2000	$12,000	$12,000
Tax After 60% SBD	$400	$400	$2400	$2400

197 The example is oversimplified, because net business income will be subject to further reductions before arriving at taxable income (e.g., 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 that net business income will be subject to tax.

d. *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 ($2400 as opposed to $3000) 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 ($2400 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,[198] it is 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.[199] Thus, potential revenue loss from 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. But 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.

198 But, as discussed above, other taxpayers will likely forego claiming actual expenses, even if it would result in less tax liability. *See supra* notes 185–187 and accompanying text.

199 *Cf.* Louis Kaplow, *The Standard Deduction and Floors in the Income Tax*, 50 TAX L. REV. 1, 9 (1994) (arguing that 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.").

e. *Equity Implications of an SBD*

The SBD also involves trading off some degree of horizontal equity for reduced compliance and administrative costs.[200] In the above example, Taxpayer 3 has actual net income of $3000 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 undertaxed. 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 $2400 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; rather, it is a cost that must be weighed against the simplification benefit of an SBD. This is precisely the same 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.[201]

f. *Additional Drawbacks of a Flat SBD*

The flat SBD raises some additional issues. Taxpayers with gross receipts at or below the flat amount would pay no tax on their business income, as is the case with Taxpayer 1 and Taxpayer 2 in the above example. This would cost 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 would 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

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

201 *Id.* at 28; *see also* Kaplow, *supra* note 199, at 19-20 ("A higher threshold [for itemizing] sacrifices equity . . . but reduces compliance and administrative costs."). 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 189, at 205 ("The progressivity purpose . . . is served by having a relatively large amount of otherwise taxable income go untaxed, through what is in essence a zero-percent tax bracket made of the standard deduction and personal exemptions.").

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,[202] 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.

g. *Coordination with Gross Receipts Withholding*

An additional advantage of a percentage 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

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

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.

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 fewer 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 of its advantages over a flat SBD, this Article recommends that Congress enact a percentage SBD for gig workers 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 12 percent.[203] Accordingly, assume that they will be subject to withholding at a rate of 11 percent of their gross receipts.[204] 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 22 percent.[205]

203 *See* Tax Cuts and Jobs Act, *supra* note 37, § 11001 (establishing a 12 percent marginal tax rate for single filers making between $9,525 and $38,700).

204 *See supra* tbl.1.

205 *See* Tax Cuts and Jobs Act, *supra* note 37, § 11001(a) (establishing a 22 percent marginal tax rate for single filers making between $38,700 and $82,500).

Assume that Taxpayers E, F and G are thus subject to withholding at a rate of 15 percent of their gross receipts.[206]

Table 3 below 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 has 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 will not 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.

Table 3

Taxpayer	A	B	C	D	E	F
Gross Receipts	$5000	$5000	$5000	$30,000	$30,000	$30,000
Actual Expenses	$4500	$3000	$1000	$27,000	$18,000	$6000
Actual Net Income	$500	$2000	$4000	$3000	$12,000	$24,000
Net Profit Ratio	10%	40%	80%	10%	40%	80%
Total Tax[207] Without SBD	$130	$500	$1010	$1030	$4140	$8270
60% SBD	$3000	$3000	$3000	$18,000	$18,000	$18,000
Net Income After 60% SBD	$2000	$2000	$2000	$12,000	$12,000	$12,000
Total Tax With SBD	$500	$500	$500	$4140	$4140	$4140
Withheld Amount	$550 (11%)	$550 (11%)	$550 (11%)	$4500 (15%)	$4500 (15%)	$4500 (15%)
Overpayment	$420	$50	$50	$3470	$360	$360

206 *See supra* tbl.1.

207 The "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 income tax rate—here, 12 percent for Taxpayers A, B, and C and 22 percent for Taxpayers D, E, and F. Values are rounded to the nearest $10.

Because withholding rates are based on an assumed profit ratio of 40 percent, the 60 percent SBD will provide a modest refund[208] for taxpayers that claim it, as can be seen in the case of Taxpayers B, C, E, and F.[209] Those with higher expenses who forego the SBD will have a larger refund ($420 for Taxpayer A instead of $50; $3,470 for Taxpayer D instead of $360). To the extent that taxpayers have significant other deductions, their ultimate tax liability will be reduced and their refunds will increase.

To simplify the example, the section 199A deduction is not incorporated into the taxpayers' tax liability in Table 3. Doing so would require extra steps in calculating the tax due, but does not significantly alter the example or change the overall application of the SBD.[210]

III. Issues and Objections

Each of the proposals in this Article has potential drawbacks, which are discussed in this Part.

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 in it is projected to grow substantially in the next several years.[211] 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.

208 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 207.

209 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.

210 Because the section 199A deduction is taken below the line, after calculating net business income, it does not affect the calculation of the SBD and should not impact a taxpayer's decision to claim (or not claim) the SBD. The total tax due would be adjusted by reducing net business income (after application of either the SBD or actual expenses) by the lesser of: (i) 20 percent of net business income or (ii) 20 percent of taxable income less net capital gain. The deduction applies for purposes of calculating income tax, but not self-employment tax.

211 *See supra* note 12; *see also* Oei & Ring, *supra* note 9, at 1054 ("[T]o the extent the new modes of production and consumption erode the traditional tax base, greater policy attention and new compliance solutions may be required.").

Second, the reforms proposed here are also relevant for more traditional small business owners. 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. However, if the SBD can be successfully implemented for gig workers, it could eventually be expanded to cover other small businesses owners earning below a certain threshold of receipts.

Additionally, even if the aggregate dollars at stake are low relative to other pressing tax reform issues, there is merit to improving tax compliance 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 "bring[s] firms into the tax net, thus ensuring higher tax compliance if they expand over time."[212] Further, reciprocity theory suggests that improving compliance among one group of taxpayers may have positive spillover effects that boost compliance more broadly.[213]

B. *Objections 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.[214] Notably on this point, Etsy has recently advocated for optional tax withholding for its workers (and other gig workers), which number over 1 million.[215]

Even for those payers that would not 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

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212 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).

213 *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 herself. If . . . most individuals appear to be evading, then complying *won't* make her feel guilty or ashamed at all.").

214 *See supra* notes 133–36 and accompanying text.

215 ETSY, ECONOMIC SECURITY FOR THE GIG ECONOMY 4, 8-9 (2016).

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.[216] Critics of withholding have also noted that a tax refund essentially amounts to an interest-free loan to the government.[217] 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 99 percent.[218] And as discussed above in subsection 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.[219] Further, because the withholding regime proposed here would allow for an opt-out, those taxpayers who prefer not to receive a refund could elect to pay estimated taxes instead.

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. This concern about accuracy is important but is not insurmountable. It should be noted that no withholding regime—even wage withholding—is entirely accurate. The vast majority of employees receive significant tax refunds (with the average refund being approximately $3000[220]), yet it does not appear that wage withholding results in major liquidity issues for most taxpayers. Further, employees can alter their form W-4 to increase or decrease their withholding to bring it more in line with

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

217 *See, e.g.*, Richard L. Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595, 623 (1982) ("Since the IRS normally computes overwithholding refunds without interest, the system causes taxpayers to forego the use of their funds during the year without compensation.").

218 *See supra* note 84.

219 *See supra* notes 118–122 and accompanying text.

220 Thomas, *supra* note 81, at 142 n.181.

their personal circumstances; independent contractors would be given an analogous option under the regime proposed here.

The main challenge is finding the right balance between withholding enough tax to reap the compliance advantages, 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.

C. *Objections 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, or that having multiple SBDs is preferable. 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 subsection 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, 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. An SBD implemented in conjunction with information reporting and withholding would be even more cost-effective, as these latter measures would undoubtedly reduce tax evasion and enhance revenue collection. Whether an SBD standing on its own would reduce tax evasion, however, is uncertain and merits further study.

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 *overclaiming* expenses, then the potential revenue loss would be exacerbated by this evasion. However, there are several reasons that even 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 tend to be more compliant overall, the framing advantage created by withholding may dissuade the overclaiming of expenses, as compared to the case where taxpayers overclaim 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 do not 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 overclaiming expenses, thus positively influencing compliance overall.

Even if the SBD reduces tax evasion, the efficiency of such a regime must be considered. The SBD might distort the decision between employment and self-employment, as well as decisions about the size of one's business. Further, if the SBD is limited only to gig workers, it may distort investment in the gig economy.

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 gig workers or as otherwise 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 are not 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 is 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 distortions, either in the investments made or the amount of receipts reported.[221] 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 taxed is based on his true net income of $90,001, resulting in an extremely high marginal tax rate on the additional dollar of income.[222]

But although the SBD threshold would likely impact reporting behavior for some taxpayers,[223] 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 alterative 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

221 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.

222 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.

223 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.

lower effective tax rate and a higher after-tax rate of return as compared to the one that did not qualify.[224] 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 is also 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 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.[225]

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.

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

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224 Consider an SBD with a $100,000 threshold as an example. 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.

225 *See* JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES 248 (4th ed. 2008) ("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.").

regime's shortcomings is the fact that the government collects less than half of the tax owed by individual small business owners.[226] 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 for gig workers 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 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.

226 *See supra* note 88 and accompanying text.

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