

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6315

To: Members, Committee on Small Business
From: Committee Staff
Date: May 23, 2016
Re: Hearings: "The Sharing Economy: A Taxing Experience for New Entrepreneurs, Part I and Part II"

On Tuesday, May 24, 2016, at 11:00 A.M. in Room 2360 of the Rayburn House Office Building, the Committee on Small Business will meet for Part I of a hearing to discuss the tax challenges presented by the sharing economy. Part I will feature a private-sector panel of experts. Part II of the same hearing, featuring a government witness, will be held on Thursday, May 26, at 10:00 A.M. in the same location.

I. Introduction

For thousands of years, efforts have been made to bring buyers and sellers together. As far back as ancient Greece, merchants gathered in the Athenian agora where buyers came to make purchases.¹ Today, those same gathering places for merchants can be found in flea markets or shopping malls. However, these gathering places developed in an era long before the advent of Internet technology and advanced wireless mobile devices.

The Internet, smartphones, and global positioning satellite (GPS) locators enable buyers and sellers to connect in ways that would have astounded the ancient Greeks and even the car-conscious mid-20th century American consumer. Rather than inventing a new idea, these businesses utilize new technologies to create "new marketplaces to access familiar things in better ways."² This platform allows buyers and sellers to exchange goods with incredible efficiency, as the buyer no longer must make a trip to a store and the seller is able to obtain customers without setting up a traditional storefront thereby reducing barriers to entry. Twenty years ago, "the first generation of digital peer-to-peer platforms, such as eBay, began providing users with infrastructure to buy and sell from each other directly and circumvent traditional outlets."³

Unlike the two millennia that separate the ancient agora from the 20th century flea market, technological advances occur so rapidly that first generation platforms, such as eBay, have themselves dramatically evolved. Today, these businesses have further evolved, expanding beyond the purchase and sale of goods into the service industry, allowing consumers to find everything from chefs to handymen to car services to short-term residential rentals.

As with all significant evolutions, these developments do not come without growing pains. The first challenge is to define the phenomenon. A whole host of terms have been adapted to describe this "new" framework: sharing/shared, gig, on-demand, peer-to-peer, online platform, collaborative, or Uber economy. In common parlance, these terms tend to be used fairly interchangeably. However, some experts have

¹ Donald Dixon, *Retailing in Classical Athens: Gleanings from Contemporary Literature and Art*, J. OF MACROMARKETING, Spring 1995, at 74.

² Emily Badger, *The Rise of Invisible Work*, THE ATLANTIC CITIES, Oct. 31, 2013, available at <http://www.theatlanticcities.com/jobs-and-economy/2013/10/rise-invisible-work/7412/>.

³ John Hagel and John Seely Brown, *What the Sharing Economy Means for Business*, TECHONOMY, July 9, 2013, available at <http://techonomy.com/2013/07/what-the-sharing-economy-means-for-business/>.

assigned very specific definitions to one or more of these terms.⁴ In short, not everyone is using the same language to mean the same thing. Whatever you call it, and however narrowly or broadly you define it, the phenomenon is growing exponentially.

A second challenge is to fully understand and adapt to the changing nature of the American worker. While companies like TaskRabbit, Uber, Lyft, Etsy, and Airbnb have changed the way consumers buy services, they have also provided unprecedented freedom and independence to those who provide those services. These workers want to set their own hours and decide which jobs to take. They may work with more than one platform company. They are the new face of small business entrepreneurs, and their numbers are growing. Unfortunately, our current laws are a poor fit for this emerging model.

II. Current Law

Our labor laws have not kept up with the demands and realities of the sharing economy.⁵ Our laws at the federal, state, and local level continue to hinge on the historical distinction between an employee and an independent contractor.⁶ Ironically, this distinction has its roots in tort law and has little to do with the specific purpose of most labor laws.⁷ These outdated laws impose unnecessary costs on the sharing economy by introducing uncertainty into the relationship between the platform company and the worker and by discouraging flexibility within that relationship.⁸

This is particularly problematic in the application of the tax code. The Internal Revenue Service (IRS) relies on the common-law distinction by examining the facts as they pertain to three broad categories (11 factors):

- **Behavioral Control** – whether the business has the right to direct or control how the work is done through: 1) instructions given to the worker; and 2) training provided to the worker.
- **Financial Control** – whether the business has a right to control business aspects of the job based on: 1) the extent to which the worker has unreimbursed business expenses; 2) the extent of the worker's investment; 3) the extent to which the worker seeks out other opportunities to make his or her services available; 4) how the worker is paid; and 5) the extent to which the worker can realize a profit or loss.
- **Type of Relationship** – as evidenced by: 1) written contract(s) indicating the relationship the parties intend to create; 2) whether the business provides the worker with employee-type benefits (e.g., insurance, paid leave, retirement plan); 3) permanency of the relationship; and 4) the extent to which the services performed by the worker are a key aspect of the regular business of the company.⁹

This very fact-intensive, case-by-case analysis creates a great deal of uncertainty and serves as a deterrent to the very behaviors that society should want to encourage, e.g., access to training, benefits, and/or withholding. Additionally, the IRS does not examine these factors from a neutral perspective. The IRS can and does reclassify independent contractors; it clearly prefers employees.¹⁰ While the IRS will periodically step up audit activity related to improperly classifying employees as independent contractors, they do not, by

⁴ See Joseph V. Kennedy, *Three Paths to Update Labor Law for the Gig Economy* 5 (Apr. 2016) available at <https://itif.org/publications/2016/04/18/three-paths-update-labor-law-gig-economy> [hereinafter Kennedy], see also JP MORGAN CHASE & CO., PAYCHECKS, PAYDAYS, AND THE ONLINE PLATFORM ECONOMY: BIG DATA ON INCOME VOLATILITY 5 (Feb. 2016) available at <https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf> [hereinafter JP Morgan].

⁵ Kennedy, *supra* note 4 at 2.

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ INTERNAL REVENUE SERVICE (IRS), TAX TOPIC – TOPIC 762 INDEPENDENT CONTRACTOR VS. EMPLOYEE (Dec. 2015), available at <https://www.irs.gov/taxtopics/tc762.html>; IRS, PUBLICATION 15-A: EMPLOYERS' SUPPLEMENTAL TAX GUIDE 7-8 (2016), available at <https://www.irs.gov/pub/irs-pdf/p15a.pdf>; IRS, PUBLICATION 1779: INDEPENDENT CONTRACTOR OR EMPLOYEE (Rev. 3-2012).

¹⁰ Robert W. Wood, *IRS Expands Independent Contractor Amnesty*, FORBES (Mar. 1, 2013).

contrast, go after companies for improperly classifying independent contractors as employees and reclassify in the other direction.

Either a company or a worker can request a ruling from the IRS using an IRS Form SS-8. About 90% are generally submitted by workers.¹¹ The IRS' clear bias is in favor of an employer-employee relationship, triggering withholding. In one year, 72% of all Form SS-8 requests produced rulings that the workers were employees.¹² The issue of worker status is one of the most consequential determinations there is.¹³ An unfavorable ruling can result in crushing retroactive liability.¹⁴

The reason for the IRS' strong preference for employees is simple: the agency perceives that it will collect more tax and collect it earlier if an employer-employee relationship exists and the employer is required to withhold employment and income taxes.¹⁵ In fact, a 2013 report by the Treasury Inspector General for Tax Administration (TIGTA) found that "approximately \$1.2 million in employment taxes may not have been properly reported or paid" for the 2009 tax year.¹⁶ However, on the other side of the ledger, a poll done by GoodApril, an Intuit company, found that independent contractors who received 1099s missed approximately \$7.5 billion in tax savings based on legitimate business expenses, largely because of lack of record-keeping.¹⁷

III. The Problem for New Entrepreneurs

A growing number of students, parents, retirees, and others are being drawn to the flexibility and independence afforded by the sharing economy.¹⁸ When defined as "economic activities involving an online intermediary that provides a platform by which independent workers or sellers can sell a discrete service or good to customers,"¹⁹ 4.2% of adults, or 10.3 million people, earned income on the platform economy during the three-year period from October 2012 to September 2015.²⁰ To put this number in perspective, it is larger than the total population of New York City.²¹ Even more significant is the fact that this number grew 47-fold over the three-year period.²²

Despite the fact that the sharing economy is the fastest growing segment of the labor market, "surprisingly little has been done to understand the tax compliance challenges this new frontier presents" or how it "impacts Treasury and IRS' ability to fairly and efficiently administer the U.S. tax code."²³ Most of these new entrepreneurs do not have any experience with the relevant tax record-keeping and business filing obligations.²⁴ A recent survey of those who earned income working with an on-demand platform in 2015 found astonishing results with regard to the respondents' tax obligations on that income:

- 34% did not know whether they were required to file quarterly-estimated payments

¹¹ Robert W. Wood, *IRS Inspector Urges Crackdown on Mislabeling "Independent Contractors,"* FORBES (July 30, 2013).

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION (TIGTA), EMPLOYERS DO NOT ALWAYS FOLLOW INTERNAL REVENUE SERVICE WORKER DETERMINATION RULINGS (2013-30-058) (2013), available at <https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf> [hereinafter TIGTA Report].

¹⁷ Derek Davis, *Tabby Makes Sure That 1099 Independent Contractors Never Overpay Taxes,* SUPERB CREW (Feb. 20, 2015), available at <http://www.superbcrew.com/tabby-makes-sure-that-1099-independent-contractors-never-overpay-taxes/>.

¹⁸ Kennedy, *supra* note 4 at 2.

¹⁹ JP Morgan, *supra* note 4 at 5.

²⁰ *Id.* at 7.

²¹ *Id.*

²² *Id.*

²³ Caroline Bruckner, Statement at National Taxpayer Advocate Public Forum 2-3 (May 17, 2016) [hereinafter Bruckner Statement].

²⁴ Martin A. Sullivan, *Tax Challenges for the Uber Economy,* The Tax Analysts Blog (July 13, 2015) [hereinafter Sullivan].

- 36% did not know what kind of records they needed to keep for tax purposes
- 43% had no idea how much they would owe in taxes and did not set aside money for taxes
- 47% were unaware of applicable tax deductions, expenses, or credits
- 69% did not receive any tax guidance from the company with which they worked²⁵

These workers represent a rapidly-growing class of small business owners whose needs have largely been ignored by Treasury and the IRS. As a result, when they do file their taxes, they are often overpaying as a result of insufficient record-keeping and/or lack of awareness of legitimate mechanisms (e.g., deductions or credits) to lower their tax bills.²⁶ Many fail to file altogether. A significant number face potential audit and penalty exposure for lack of compliance with tax rules they don't understand.²⁷

Part of the problem is inconsistent reporting requirements. Some platform providers rely on the Form 1099-K,²⁸ which is designed for payment card and third party network transactions.²⁹ A 1099-K is required to be issued if the platform company electronically paid out gross payments that exceed \$20,000.³⁰ The IRS does not seem to have envisioned use of the 1099-K to report income to platform workers.³¹

Other companies issue Form 1099-MISC, which is more commonly used to report payments to independent contractors. The filing threshold for Form 1099-MISC is, by contrast, only \$600, a number that has not changed since 1954.³²

Neither of these forms was designed to accommodate sharing economy transactions and the increasing frequency with which they occur. As a result, many workers receive no end-of-the-year reporting at all, or they're not quite sure what to do with what they do get. This gives rise to a situation where sharing economy workers are bearing tax compliance costs that are significantly higher than average.³³ These workers would frequently welcome tax assistance or training,³⁴ but companies are loath to provide it – even though they just as frequently would be happy to do so – for fear of having the entire relationship reclassified.³⁵

IV. Conclusion

The IRS needs to get past its historical bias against these new entrepreneurs – based on the outmoded and rigid framework of employee versus contractor – and instead focus on ways to improve awareness and education to increase voluntary, accurate tax code compliance. This is important not only because of the tremendous growth of this sector of the labor market, but because that growth, married with a lack of understanding of how the tax code applies to them, could have very significant tax gap implications going forward.³⁶ Beyond that, “failure to implement rational tax policy can have serious consequences for job creation and economic growth.”³⁷ This hearing will examine the tax issues faced by sharing economy participants in greater detail and explore potential solutions to address these unique challenges.

²⁵ Bruckner Statement, *supra* note 23 at 4.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Targeted Tax Reform: Solutions to Relieve the Tax Compliance Burden(s) for America's Small Businesses: Hearing before the United States Senate, Committee on Small Business and Entrepreneurship*, 114th Congress, First Session (July 22, 2015) (testimony of Caroline Bruckner) [hereinafter Bruckner Testimony].

²⁹ IRS, INSTRUCTIONS FOR FORM 1099-K (2016).

³⁰ IRS, UNDERSTANDING YOUR FORM 1099-K (Jan. 27, 2016), available at <https://www.irs.gov/businesses/understanding-your-1099-k>.

³¹ *Id.*

³² Bruckner Testimony, *supra* note 28 at 3.

³³ Sullivan, *supra* note 24.

³⁴ Kennedy, *supra* note 4 at 7.

³⁵ Kennedy, *supra* note 4 at 10.

³⁶ Bruckner Statement, *supra* note 23 at 4.

³⁷ Sullivan, *supra* note 24.