KOGOD SCHOOL of BUSINESS
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"The Sharing Economy: A Taxing Experience for New Entrepreneurs Part I"

U.S. House of Representatives
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Thank you for the invitation to join you to discuss the tax compliance challenges of small businesses driving the sharing economy. My name is Caroline Bruckner and I am a tax professor on the faculty at American University's Kogod School of Business. As part of my responsibilities at American University, I am also the Managing Director of the Kogod Tax Policy Center, which conducts non-partisan research on tax and compliance issues specific to small businesses and entrepreneurs. The Center develops and analyzes solutions to tax-related problems faced by small businesses and promotes public dialogue concerning tax issues critical to small businesses and entrepreneurs.

Prior to my appointment at Kogod, I served from 2009 until 2014 on the staff of the U.S. Senate Committee on Small Business and Entrepreneurship (the "Committee"), ultimately as Chief Counsel. During my tenure with the Committee, I handled tax, labor and budget issues, and worked with small business stakeholders across the country and political spectrum to develop small business tax legislation, including the Small Business Jobs Act of 2010 (P.L.111-240), which provided more than $12 billion of tax relief for small businesses.

At Kogod, we are currently focused on the tax and compliance issues impacting America's latest iteration of self-employed small business owners who are renting rooms, providing ride-sharing services, running errands, and selling goods to consumers in business transactions coordinated online and through app-based platforms developed by companies such as Airbnb, Etsy, Uber, Lyft, Taskrabbit, Instacart and others (the "sharing economy" or "on-demand platform economy"). Although the on-demand platform economy has experienced extraordinary growth since its inception, surprisingly little has been done to understand the tax compliance challenges this new frontier presents, or how the on-demand platform economy impacts Treasury and IRS' ability to fairly and efficiently administer the U.S. tax code.[1] Our research, which we released in a report titled, "Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy," targets the tax compliance challenges of these small businesses and endeavors to shed light on these issues as Congress moves forward with tax reform.

Having spent more than a year investigating this growing problem, we report on what the existing literature has yet to acknowledge: that, for tax purposes, on-demand platform economy service providers and sellers are, in fact, small business owners. And there are millions of them working and earning income in ways that are not readily identifiable by existing government research or publicly-available taxpayer filings.[2] In particular, we explore why it's tough to measure how pervasive the tax problems of these small businesses are because existing government research and methodologies for measuring the smallest of small businesses fall short. We argue that these issues should be considered by Congress and the IRS—not only because millions of American taxpayers are needlessly burdened trying to comply with an antiquated, outdated tax system—but also because inaction has very real implications on Treasury and IRS' ability to fairly and efficiently collect taxes. A number of findings we review in our research are particularly relevant to today's discussion, including: the scope of the on-demand economy workforce, their average monthly income and hours worked.

- <u>Scope of the On-Demand Platform Economy</u>: More than 2.5 million Americans are earning income in the on-demand platform economy as small business owners every month.[3] "Even at the low end, both in terms of participation and dollars earned, [on-demand] platforms grew by about 50% per year, making it by far the *fastest growing segment of the labor market*."[4] In fact, the number of individuals operating as small businesses in the on-demand platform economy is set to double to seven million Americans by 2020, if not more.[5] The explosive growth of the on-demand platform economy is the latest example of a 66.5% increase in alternative work arrangements for U.S. workers from 14.2 million in 2005 to 23.6 million in 2015.[6]

- <u>Average Income of On-Demand Economy Small Businesses</u>: Although people do cycle in and out of the on-demand platform economy, during the months in which people are actively using platforms to earn income, their earnings "represented a sizeable but still secondary source of income." Average monthly income from active participation ranges from $533 to $314, with the higher amounts usually stemming from working in connection with platforms such as Uber, Handy, TaskRabbit (labor platforms) as opposed to other platforms such as eBay, Airbnb (capitol platforms or sellers and accommodation providers).[7]

- <u>Average Hours Worked of On-Demand Economy Small Businesses</u>: Although studies to date have identified a core constituency of small business operators (ranging from 25% to 30%) that tend to work for on-demand platforms full-time and earn more, by and large, the majority of individuals in the on-demand platform economy work 12 hours per week.[8]

Notwithstanding the on-demand platform economy's unprecedented growth and adoption by more than 86.5 million U.S. adults as consumers and service providers and sellers in just a few short years,[9] the economic activity and growth of these small business owners has largely gone unacknowledged by most government measures for tracking small business activity.[10] In fact, many of these taxpayers don't necessarily realize they are small business owners or what their tax filing obligations are until tax time or they receive an IRS notice.

As part of our research, we spoke with dozens of individuals currently participating in the on-demand economy and initiated a survey of members of the National Association of the Self-Employed (NASE). Our survey was designed to gauge existing self-identified self-employed workers' participation in the on-demand economy (e.g., how many hours worked; how much income earned) as well as respondents' understanding of their tax filing obligations (e.g., whether respondents kept records for their expenses or received a Form 1099 from their on-demand platform company).[11]

Our intention in conducting the survey was not to prepare a statistically reliable estimate of the entire American population of the self-employed or freelancers or all workers in the on-demand platform economy. Instead, our objective was to assess whether tax compliance challenges exist—even among a group of taxpayers, who, by their own self-selection as members of NASE, are self-employed small business owners. During March 2016, NASE invited approximately 40,000 members to participate in the survey and received 518 responses.

The population we surveyed can be generally considered experienced, self-employed taxpayers when viewed in terms of their NASE membership, and yet their responses indicate a significant lack of understanding and information available regarding self-employed tax filing obligations in addition to undue tax compliance burdens for reporting income earned in the on-demand platform economy. Specifically, our survey revealed that among respondents who had earned income working with an on-demand platform company in 2015, which was approximately 22% of all of our respondents:

- Approximately one-third did not know whether they were required to file quarterly-estimated payments with the IRS on their on-demand platform income;
- 36% did not understand what kind of records were needed for tax purposes for business income and expenses generated from working with a sharing economy partner;
- 43% were unaware as to how much they would owe in taxes and did not set aside money for taxes on that income; and
- Almost half did not know about any tax deductions, expenses or credits that could be claimed related to their on-demand platform income.

Taken together with our additional research, our findings suggest that, at best, many small business owners are shortchanged when filing their taxes; at worst, they fail to file altogether. Moreover, a significant percentage of these taxpayers could face potential audit and penalty exposure for failure to comply with filing rules that are triggered by relatively low amounts of earned income.

Under current tax rules, when self-employed taxpayers are expected to owe at least $1,000 in taxes and aren't subject to withholding, advance payments of estimated tax are due to the IRS throughout the year in the form of quarterly-estimated payments.[12] It just doesn't take that much income to trip over these filing requirements.

> Consider if a ride-sharing driver netted $7,500 in income from working with an on-demand platform in 2015. That amount alone could translate to $1,039 just in self-employment tax due ($859 Social Security tax and $201 Medicare tax), which, in turn, would trigger quarterly-estimated payment obligations—without even calculating any income tax owed. It's not so hard to imagine a taxpayer who went to file taxes in April 2016 and learned, not only did she fail to make quarterly-estimated payments in 2015 on her ride-sharing income, but that she also owed estimated taxes for the first quarter of 2016.

Costs to taxpayers can also be quantified in terms of time spent preparing returns and chasing down answers to complex tax questions from the IRS. In her annual report to Congress, the National Taxpayer Advocate noted that during the 2015 tax filing season, only 37% of taxpayer calls routed to customer service representatives overall, and the hold time for taxpayers who got through averaged 23 minutes.[13]

We heard time and again from taxpayers, on-demand platform companies and tax preparers that small businesses operating in the on-demand economy "generally want to be honest and pay what they owe, but the tools and resources don't exist."[14] Indeed, more than 60% of our survey respondents who worked for an on-demand platform company in 2015 reported that they did not receive a Form 1099-K or Form 1099-MISC from their on-demand platform, which likely means the IRS didn't either.[15] This is not surprising given that it is entirely consistent with both the Form 1099-MISC filing instructions and the statutory requirements for filing a Form 1099-K. Nevertheless, evidence from our research suggests that the existing information reporting regime results in a lack of information that correlates to an undue burden on a significant portion of the 2.5 million on-demand platform economy operators in terms of compliance costs. Almost half of our survey respondents indicated that they spent between 10 to 35 hours or more preparing their taxes for 2015.

The current tax administration system isn't working for a significant percentage of on-demand platform small business operators or Treasury or IRS. At the root of this problem is a lack of information and understanding of tax filing obligations, which is compounded by an information reporting regime that results in widespread confusion. And these tax compliance challenges are only going to continue to grow and impact more and more self-employed small business owners. Indeed, as some financial industry analysts have observed, "the vast majority of U.S. entrepreneurial activity is small—nano small, [a]nd the ranks of self-employed 'solopreneurs' are growing fast, with 53 million Americans freelancing today, and upwards of 66 million Americans, or 40% of the workforce by 2020."[16] To be fair, not all of the millions of Americans who are projected to be freelancing by 2020 would necessarily be small businesses in the on-demand economy, but a good percentage of them will be.[17] At the same time, tax practitioners report that "while many do not know it, renting a home short-term is basically running a small business and this requires tax compliance."[18] And make no mistake, the individuals who are earning income from powering the on-demand platform economy are carrying on a trade or business as small business owners for U.S. tax purposes.[19]

Our assessment of the general confusion state of play when it comes to filing taxes on income earned from on-demand platform work was consistently reinforced by interviews with tax preparers, industry experts and our survey. At a minimum, the IRS should explore strategies in which it could leverage third parties and/or revise the information reporting regime to eliminate the guesswork that serves as the basis for many of the tax returns filed for income earned participating in the sharing economy. Everyone is losing under the current rules. Both on-demand economy players and the IRS deserve greater efficiency and less hassle. We can do better. Again, I thank you for the opportunity to join today's discussion and for the work you do on behalf of America's small businesses.

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[1] A primary reason for why policymakers, tax and labor experts, and the online platforms companies have been slow to tackle the simmering tax issues underlying this evolving marketplace is the looming question of whether workers who provide services for customers via online platforms are really misclassified employees. Those issues are currently being litigated in courts in a number of jurisdictions across the country. We argue that because the research to date consistently shows that millions of taxpayers are participating in the on-demand platform economy as small business owners, and millions more are set to join their ranks, for purposes of tax reform, review of the existing tax compliance challenges these taxpayers face is warranted, notwithstanding the outcome of a specific misclassification case. *See* Johana Bhuiyan, *Why the Uber Drivers' Lawyer Settled Their Fight to Become Employees*, <re/code> (Apr. 30, 2016), http://recode.net/2016/04/30/uber-drivers-employees-contractors-lawyer.

[2] *See e.g., Letter from the U.S. Department of the Treasury to Sen. Mark Warner*, Tax Analysts (Oct. 27, 2015) Doc 2015-25376.

[3] Diana Farrell & Fiona Greig, *Paychecks, Paydays, and the On-demand Platform Economy: Big Data on Income Volatility*, JP Morgan Chase Institute, (February 2016), https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf.

[4] JP Morgan Chase Institute, *The Online Platform Economy: What is the Growth Trajectory?* Insight blogpost, (May 2, 2016), https://www.jpmorganchase.com/corporate/institute/institute-insights.htm.

[5] Steve King & Carolyn Ockels, Emergent Research Survey of On-Demand Economy (ODE) Workforce (2016) (unpublished raw data). *See also,* Rob Wile, *There Are Probably Way More People in the 'Gig Economy' Than We Realize*, Fusion (July 27, 2015),

http://fusion.net/story/173244/there-are-probably-way-more-people-in-the-gig-economy-than-we-realize/.

[6] Lawrence F. Katz & Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015*, (Mar. 29, 2016), http://scholar.harvard.edu/files/lkatz/files/katz_krueger_cws_v3.pdf?m=1459369766.

[7] Farrell, *supra* at n. 3.

[8] *See* King, *supra* at n. 5. *See also,* Farrell*, supra* at n. 3.

[9] Catherine Sullivan Burson-Marsteller, *Forty-Five Million Americans Say They Have Worked in the On-Demand Economy, While 86.5 Million Have Used It,* Aspen Institute, (Jan. 6, 2016) http://www.aspeninstitute.org/news/2016/01/06/forty-five-million-americans-say-they-have-worked-demand-economy-while-865-million.

[10] This is not altogether surprising given that while nonemployer small businesses constitute "nearly three-quarters of all businesses…they contribute less than 4% of overall sales and receipts data…[and] due to their small economic impact, these firms are excluded from most other Census Bureau statistics." *Nonemployer Statistics,* Census Bureau (2016), https://www.census.gov/econ/nonemployer/index.html.

[11] 2016 Kogod Survey of National Association of the Self-Employed Membership (April 2016) (unpublished raw survey data, National Association of the Self-Employed).

[12] *Form 1040 Estimated Tax for Individuals*, Internal Revenue Service (Apr. 16, 2016), https://www.irs.gov/uac/Form-1040-ES,-Estimated-Tax-for-Individuals-1.

[13] *National Taxpayer Advocate Service,* Internal Revenue Service (Apr.4, 2016) http://www.taxpayeradvocate.irs.gov/reports/fy-2016-objectives-report-to-congress/news-release.

[14] Interview with Derek Davis, Founder, www.sharedeconomycpa.com (Apr. 13, 2015). Davis is the Founder of www.sharedeconomycpa.com, a company he launched in 2014 to specialize in providing tax preparation services for individuals participating in the on-demand platform economy. Since its founding, SharedEconomyCPAcom has grown 300%.

[15] The current instructions to the Form 1099-MISC clearly state that "[p]ayments made with a credit card or payment card and certain other types of payments, including third party network transactions, must be reported on Form 1099-K…and are not subject to reporting on Form 1099-MISC." *2016 Instructions to Form 1099-MISC*, Internal Revenue Service, https://www.irs.gov/pub/irs-pdf/i1099msc.pdf. At the same time, the Form 1099-K has its own the 200 transaction/$20,000 income threshold for payments made by credit card. *2016 Instructions to Form 1099-K*, Internal Revenue Service (2016), https://www.irs.gov/pub/irs-pdf/i1099k.pdf. Taken together with the instructions for the filing requirements for Form 1099-MISC, the existing information reporting regime effectively creates a $19,399 tax reporting loophole, which is the different between $20,000 and $601—the income thresholds for Forms 1099-K and 1099-MISC. Kelly Phillips Erb, *Credit Cards, the IRS, Form 1099-K and the $19,399 Reporting Hole*, Forbes Magazine (Mar. 28, 2016) http://www.forbes.com/sites/kellyphillipserb/2014/08/29/credit-cards-the-irs-form-1099-k-and-the-19399-reporting-hole/#369f81916c37.

[16] Arjan Schutte & Colleen Poynton. *1099 Problems And W2s Ain't One: The 1099 Economy's Problems, Advantages, and Outlook,* CB Insights Blog. (Sept. 15, 2015) https://www.cbinsights.com/blog/1099-economy-opportunities-threats (*citing, Intuit 2020 Report,* Intuit (Oct. 2010) http://http-download.intuit.com/http.intuit/CMO/intuit/futureofsmallbusiness/intuit_2020_report.pdf).

[17]Anna Louie Sussman & Josh Zumbrun, *Contract Workforce Outpaces Growth in Silicon-Valley Style 'Gig' Jobs,* The Wall Street Journal (Mar. 25, 2016) http://www.wsj.com/articles/contract-workforce-outpaces-growth-in-silicon-valley-style-gig-jobs-1458948608 . *See also*, Katz & Krueger Report, *supra* at n. 6.

[18] David McAfee, *Airbnb, Hosts Face Compliance Issues, Practitioners Say*, Bloomberg BNA Daily Tax Report (Oct. 22, 2015), http://news.bna.com/dtln/DTLNWB/split_display.adp?fedfid=78043755&vname=dtrnot&wsn=512146000&searchid=27264877&doctypeid=1&type=date&mode=doc&split=0&scm=DTLNWB&pg=0.

[19] Carrying on a trade or business has been defined by the courts and IRS administrative guidance as the act of "engag[ing] in the selling of goods or services," as a "livelihood or in good faith to make a profit," in a "regular, frequent and continuous" manner. (*Deputy v. DuPont*, 308 U.S. 488 (1940). Clear profit motive of small businesses has been confirmed by industry surveys that have

identified the desire to make more money as the primary reason the majority of people work in the on-demand platform economy. *See* Emergent Research Survey, *supra* at n. 5. Further, in explaining what a trade or business is for purposes of determining whether a taxpayer is self-employed, the IRS Self-Employed Individuals Tax Center explains that a taxpayer does "not have to carry on regular full-time business activities to be self-employed…[h]aving a part-time business in addition to your regular job or business also may be self-employment." *Business Activities*, Internal Revenue Services (Apr. 16, 2016), https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Business-Activities).