Improving Social Security Coverage and Retirement Benefits for Independent Contractors

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Executive Summary

Independent contractors (ICs) of all kinds experience many of the same risks as workers in standard employment relationships, but face them without the same rights, benefits, and social insurance protections afforded to traditional employees. Social Security, being a reliable source of retirement income even for those with limited employment-based retirement options, fills a crucial role in preparing ICs for retirement. Yet several factors coalesce to create a policy challenge to ensuring adequate Social Security income for these workers. Reasons for ICs' lower Social Security coverage and benefits include lower earnings, episodic work, and poor tax compliance. This paper provides a background of the policy mechanism for covering ICs through Social Security, explores the reasons why the system leaves gaps in coverage for ICs, and offers six categories of policy options to improve Social Security coverage and retirement benefits for these workers.

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Introduction

For generations, labor market participants in the United States such as business owners, people practicing skilled trades, and consultants have worked for themselves without a traditional employer. In the last few decades, economists have witnessed companies' increased use of nonstandard workers,[1] a group which includes independent contractors. More recently, the online platform economy has created new forms of independent contracting known as "gig work." Independent contractors (ICs) of all kinds face many of the same risks as workers in standard employment relationships, but face them without the rights, benefits, and social insurance protections afforded to traditional employees. In particular, ICs lack collective bargaining rights, employer-provided disability and health insurance, workers' compensation and unemployment insurance coverage, and employer contributions to Medicare and Social Security. This paper focuses on policy options for better integrating independent contractors into Social Security, specifically its retirement protections.[2]

For high-earning independent contractors (ICs), tax-subsidized private savings vehicles like solo 401(k)s and various types of Individual Retirement Accounts (IRAs) may facilitate a secure retirement.[3] However, for most low- and middle-income workers – whether employee or IC – these savings vehicles have not been able to provide retirement security, and the prospects for ICs are even more uncertain.[4] Only about half of households have any assets in 401(k)-style accounts, and 31% have assets in IRA-style accounts.[5] Among those with such assets, the median account balance is $60,000, and is $120,000 for households nearing retirement.[6] Even the $120,000 accumulated for retirement will not go very far. Using conservative estimates, $120,000 in retirement savings would provide a 65-year-old man with a life annuity of about $680 a month.[7] Independent contractors face even greater challenges to achieving a secure

[1] David Weil, 2014, *The Fissured Workplace: How Work Became So Bad for So Many and What Can be Done to Improve It*, Cambridge, MA: Harvard University Press.

[2] In addition to providing old-age insurance, Social Security also provides disability and life-insurance ("survivors") benefits. For more, see Elliot Schreur and Benjamin Veghte, "Social Security: One System, Two Funds, Three Insurance Protections," National Academy of Social Insurance, November 2016, https://www.nasi.org/sites/default/files/research/Social_Security_One_System.pdf

[3] People with self-employment income can choose to create their own retirement plan. The options include a SEP IRA (short for "Simplified Employee Pension"), a SIMPLE IRA (short for "Savings Incentive Match Plan for Employees"), or a "Solo 401(k)." However, only 1 million tax filers have chosen to contribute to these plans out of 25 million tax filers with self-employment income, for a take-up rate of about 4 percent. Internal Revenue Service (IRS), 2017, Statistics of Income (SOI)—2015 Individual Income Tax Returns, Line Item Estimates, https://www.irs.gov/pub/irs-soi/15inlinecount.pdf.

[4] Natalie Sabadish and Monique Morrissey, 2013, "Retirement Inequality Chartbook: How the 401(k) revolution created a few big winners and many losers," http://www.epi.org/publication/retirement-inequality-chartbook/.

[5] Federal Reserve Board, 2017, 2016 Survey of Consumer Finances, Washington, DC: Board of Governors of the Federal Reserve System.

[6] Federal Reserve Board, 2017, Report on the Economic Well-Being of U.S. Households in 2016, Washington, DC: Board of Governors of the Federal Reserve System.

Federal Reserve Board, 2017, 2016 Survey of Consumer Finances, Washington, DC: Board of Governors of the Federal Reserve System.

[7] Estimate based on the federal government's Thrift Savings Plan Single Life Annuity Calculator

retirement. Not only do such workers have more volatile incomes, which inhibits their ability to save for the long-term,[8] they also lack the workplace retirement benefits that could support their retirement security. Employees are more likely to accumulate retirement assets in designated work-related retirement accounts than are independent contractors. Only about 4 percent of tax filers with self-employment income, like independent contractors, have chosen to contribute to the 401(k) plans specifically carved out for them in the tax code.[9] These ICs, many with low and volatile incomes, and without employment benefits, are precisely the group whose ranks have experienced growth in recent decades.

Social Security, being a reliable source of retirement income even for those with limited individual assets, fills an even more crucial role in retirement security for ICs, whose source of income tends to expose them at higher rates than other workers to the risks of financial volatility and the lack of savings in retirement. Yet several factors coalesce to create a policy challenge to ensuring adequate Social Security income for these workers. The most apparent of these factors may be the absence of an employer with whom to share the responsibility for making Social Security contributions, a situation that further limits ICs' disposable income available to save for retirement through other means. Yet a number of other practical and institutional barriers impede sufficient Social Security coverage and benefits. This paper analyzes these barriers, and explores options for improving Social Security coverage and benefits for the diverse range of workers in the independent workforce.

Part I. Social Security Coverage and Benefits for Independent Contractors

During much of the last century, it was generally accepted that protections for a worker's health, income security, and retirement would be delivered through the worker's employer. Retirement benefits provided by employers included traditional pensions and defined-contribution savings plans, but for many workers the most significant contributor to their retirement security was, and remains, the protection provided by Social Security.

As originally enacted, Social Security covered only employees, not independent contractors. In 1950, Congress extended Social Security protections to the self-employed.[10] Since then, ICs

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[8] Jonathan Morduch and Rachel Schneider, 2017, *The Financial Diaries; How American Families Cope in a World of Uncertainty*, Princeton University Press.

[9] Of the 25 million people with self-employment income, only 1 million claimed the deduction for a self-employed SEP, SIMPLE, or Solo 401(k) plan in 2015. IRS, 2017, 2015 SOI Line Item Estimates.

[10] In the Social Security Act Amendments of 1950, Congress extended Social Security coverage beginning in 1951 to non-farm self-employed workers "other than doctors, lawyers, engineers, and members of certain other professional groups" (Wilbur J. Cohen and Robert J. Myers, 1950, "Social Security Act Amendments of 1950: A Summary and Legislative History," Social Security Bulletin, Vol. 13, No. 10, https://www.ssa.gov/policy/docs/ssb/v13n10/index.html). Coverage of ICs was further extended to self-employed farmers and other professions in 1954 (Social Security Administration, n.d., "Detailed Chronology of Social Insurance & Social Security," https://www.ssa.gov/history/chrono.html). Self-employed workers now contribute to Social Security under the Self Employment Contributions Act (SECA), which was passed in 1954. The current tax structure, which developed through a series of evolutions, is described in Patricia E. Dilley, 2000, "Breaking the Glass Slipper: Reflections on the Self-Employment Tax," *Tax Lawyer* Vol. 54, No. I,

have been required to pay an approximation of both the employee's and employer's shares of Social Security contributions.[11] The current system for assessing these contributions operates under the rules of the Self Employment Contributions Act (SECA), which regulates both Social Security and Medicare contributions for the self-employed. The flat-rate 15.3 percent SECA contribution rate represents a sizable tax obligation for many self-employed workers.[12]

Who are Independent Contractors?

Workers who earn at least part of their total income by selling their labor through the operation of their own business are considered independent contractors. Someone who earns income by operating her own retail business selling goods to the general public would not usually be considered an independent contractor. The key difference for the population we are concerned with is the selling of labor rather than goods, or put a different way, the generating of income primarily from the return on labor rather than capital.

Independent contractors are a subset of sole proprietors, who, in turn, are a subset of the self-employed. The Social Security Act defines self-employment income as earnings from a trade or business, or through a partnership.[13] Approximately 32 million people had self-employment income in 2015 based on this definition.[14] Of these, 25.2 million were sole proprietors (the rest had partnership income). These are people who filed an Internal Revenue Service (IRS) tax form

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https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1173&context=facultypub.

[11] Ever since the self-employed were first required to contribute to Social Security, Congress has struggled to approximate for self-employed workers the equivalent of the combined employer-employee costs of Social Security applicable on the wages paid to employees. This is no easy task. The principle of Social Security is to insure workers' labor income, and Congress has wrestled with the intricate tax problems that arise when applying this principle to income earned by workers who are also their own employer. The SECA system applicable today more closely approaches parity between the tax bases than the rough approximation of 75 percent of the combined employer-employee rate that was applicable to the self-employed in 1951. Yet tax analysts still identify disparities between the tax bases applicable to employees and to self-employed workers even under the current system (James R. Nunns, 2014, "Costly Error in Payroll Tax Computation for the Self-Employed," Tax Policy Center, http://www.taxpolicycenter.org/publications/costly-error-payroll-tax-computation-self-employed).

[12] The contribution system is described in detail in the following section, "How Social Security Covers Independent Contractors." The obligation to pay both the employer and employee portions of Social Security and Medicare contributions is lessened to some degree by an allowed deduction from gross income for income-tax purposes in the amount of the employer-equivalent portion of a self-employed worker's Social Security contribution. This deduction lowers the tax burden for taxpayers with sufficient income to have positive income-tax liability.

[13] 42 U.S.C. 411, https://www.ssa.gov/OP_Home/ssact/title02/0211.htm.

[14] Throughout the paper, we will refer to "people" or "workers" when discussing tax-filing data, even though the proper term would often be "tax filers." The IRS data technically show that there are a certain number of "tax filers" with income from an independent trade or business or a partnership, not "people," because some tax-filing units are married couples. However, just because a married tax unit may show income from these sources does not mean that this tax unit is properly counted as containing two self-employed people. Only one may be operating the business. Whether one or both people in a married couple are self-employed is impossible to observe through the aggregated tax data. We refer to "tax filers" as "people" for simplicity.

Schedule C (of Form 1040).[15] Among sole proprietors (Schedule C filers), those who sell their labor (rather than goods) are independent contractors.[16]

The Bureau of Labor Statistics (BLS) estimates that there are 10.6 million workers whose primary source of income is from independent contracting.[17] These independent contractors make up 6.9 percent of the employed workforce. While this estimate is a useful starting place for understanding the role of ICs in the economy, it misses a sizable population of workers whose total income includes earnings from independent contracting, but who do not consider those earnings to be their primary source of income. The share of workers with any self-employment earnings, measured by tax filings, has been rising since 2000, even as survey data, like those on which BLS relies, have indicated declines.[18] According to the IRS, in 1995, 13.8 percent of the employed workforce earned income through self-employment.[19] Ten years later, in 2005, the share had risen to 15.7 percent. By 2015, 17.4 percent of employed workers earned at least some of their income in this way. Not all workers with income earned through self-employment are ICs, but the trend in earnings from self-employment suggests a growth in alternative sources of income, including through independent contracting. As a point of comparison, BLS reports that the percent of the workforce whose main source of income comes from work as an independent contractor has levelled off. In 1995, workers who earned income primarily as ICs made up 6.7 percent of the total employed labor force.[20] Ten years later, in

[15] There were 25.2 million Schedule Cs filed in 2015 (IRS, 2017, 2015 SOI Line Item Estimates, "total schedules filed," p. 36). 6.5 million tax filers indicated on Schedule E, Part II that they were engaged in a partnership in 2015 (p. 48). Not all of these individuals were required to make Social Security contributions. The self-employment tax is due only for those whose share of profit from a sole-proprietorship or partnership exceeds $400 (IRS, Schedule SE (Form 1040), line 4, https://www.irs.gov/pub/irs-pdf/f1040sse.pdf). Not all Schedule C or E filers have made a profit; these schedules can also be used to file a business loss. Taxes, including the SET, are not paid on losses. For these reasons, SSA reports a lower number of self-employed workers: 19.4 million (SSA, 2017, *Annual Statistical Supplement, 2016*, Table 4.B2, https://www.ssa.gov/policy/docs/statcomps/supplement/2016/4b.html#table4.b2). Still, it is more useful to focus on the 25.2 million estimate as a representation of the number of sole proprietors because the filing of Schedule C, even with zero or negative net income, is an indication that the tax filer is engaged in a business enterprise and thus should be considered to be at least partially self-employed.

[16] We exclude people with income from partnerships from our definition of independent contractors because, by definition, these people are engaged in business with someone else and are thus, strictly speaking, not "independent." Furthermore, partnerships, whether explicitly established by contract or implied, are usually more formal business ventures, in which each partner shares in the business's profits.

[17] Bureau of Labor Statistics, 2018, "Contingent and Alternative Employment Arrangements — May 2017," https://www.bls.gov/news.release/pdf/conemp.pdf.

[18] Katz and Krueger, 2016.

[19] In 1995, 16.2 million tax filers reported business income, requiring Schedule C to be filed. (The actual number of Schedule Cs completed differs slightly.) In 2005, 21.1 million reported business income, and in 2015 (the most recent year in which data are available) 24.7 million did. (IRS, 2018, "SOI Tax Stats - Individual Income Tax Returns Publication 1304," Tables 1.3 and 1.4, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-returns-publication-1304-complete-report.) The number of filers claiming business income in each of these years is divided by total nonfarm employment in July of that year (1995: 117.4 million; 2005: 134.3 million; 2015: 142.0 million), as reported by BLS (BLS, various dates, "Employment, Hours, and Earnings from the Current Employment Statistics survey," https://www.bls.gov/ces/). This method was used by Katz and Krueger (2016) as a point of comparison to CPS estimates of self-employment.

[20] Sharon R. Cohany, 1996, "Workers in Alternative Employment Arrangements," Office of Employment and Unemployment Statistics, Bureau of Labor Statistics, https://www.bls.gov/opub/mlr/1996/10/art4full.pdf.

2005, 7.4 percent of the employed labor force were independent contractors.[21] But by 2017, the share had declined slightly from its 2005 level to 6.9 percent.[22] The 10.6 million ICs who make up this 6.9 percent of the employed workforce are concentrated in industries such as professional and business services, construction, financial activities, education and health services, and retail trade.[23] In the future, BLS projects strong growth for the self-employed (including ICs) in low-wage occupations such as personal care, grounds maintenance, and transportation.[24]

How Social Security Covers Independent Contractors

All workers with earned income are legally required to contribute to Social Security. This is true not only for wage-and-salary workers employees, but also for individuals running a small business, selling crafts, driving for Uber, or offering consulting services.[25] However, for a variety of reasons discussed in the next part of this paper, Social Security coverage and benefits of ICs lag behind those of wage-and-salary workers.

How employees (and their employers) pay in to Social Security and Medicare
Workers and their employers contribute equal amounts to Social Security each year. Both pay 6.2 percent of the worker's wages up to a maximum amount (the Maximum Taxable Earnings), which is adjusted each year to keep up with changes in the economy. In 2018, the maximum amount is $128,400.[26]

Workers and their employers also contribute equal amounts into the Medicare Hospital Insurance (Medicare Part A) trust fund. Each pay 1.45 percent of the worker's wages annually. Unlike the payroll tax for Social Security, which only applies to earnings up to an annual maximum, the Medicare Hospital Insurance tax is levied on total earnings. The Affordable Care Act increased revenue for Medicare Part A through an additional 0.9 percent Medicare tax on earnings above certain thresholds ($200,000/individual and $250,000/couple).

How ICs pay in to Social Security

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[21] Bureau of Labor Statistics, 2005, "Contingent and Alternative Employment Arrangements", news release, July 27, 2005, https://www.bls.gov/news.release/pdf/conemp.pdf.
[22] Bureau of Labor Statistics, 2018, "Contingent and Alternative Employment Arrangements — May 2017," https://www.bls.gov/news.release/pdf/conemp.pdf.
[23] Ibid.
[24] Elka Torpey and Brian Roberts, 2018, "Small-Business Options: Occupational Outlook for Self-Employed Workers," Bureau of Labor Statistics, https://www.bls.gov/careeroutlook/2018/article/self-employment.htm. For additional evidence of the low wages of some ICs, see Lawrence Mishel, 2018, "Uber and the Labor Market: Uber Drivers' Compensation, Wages, and the Scale of Uber and the Gig Economy," Economic Policy Institute, https://www.epi.org/publication/uber-and-the-labor-market-uber-drivers-compensation-wages-and-the-scale-of-uber-and-the-gig-economy/.
[25] All of these types of work generate earnings known as "earned income." Earned income is distinguished from unearned income for tax purposes. Unearned income includes income from capital gains, dividends, interest, and gifts, and is not subject to payroll or self-employment taxes.
[26] The maximum amount does not apply to Medicare contributions. Both employers and employees contribute 1.45 percent of all a workers' wages to Medicare.

Independent contractors contribute to Social Security and Medicare through the self-employment tax (SET). Since ICs have no employer, they pay both the employer and the employee shares of the Social Security and Medicare contributions. Specifically, ICs pay 12.4 percent of their earnings up to the maximum taxable amount for Social Security (currently $128,400 per year) and 2.9 percent of all their earnings (without an income cap) for Medicare. This amounts to a total SET of 15.3 percent of earnings up to $128,400 and 2.9 percent on income over $128,400. An IC is also subject to the 0.9 percent Additional Medicare Tax if his or her total wages, compensation, and self-employment income (together with that of his or her spouse if filing a joint return) exceed the threshold amount for the individual's filing status ($200,000/individual and $250,000/couple). The SET is paid in addition to any applicable federal income tax owed. Income tax owed by most ICs in 2018 is likely to be lower than it would have been otherwise due to a new deduction for pass-through business income put in place by the Tax Cuts and Jobs Act of 2017.[27]

Independent contractors pay both the employer and employee shares of Social Security and Medicare, but they can deduct the employer's share of the contribution from their taxable income, thereby approximating parity between the SET treatment of ICs and the payroll tax treatment of employers and employees. The 15.3 percent SET is calculated on 92.35 percent of an IC's net income.[28]

Part II: Problems with Social Security Coverage and Benefits of Independent Contractors

In theory, IC status should not affect Social Security coverage or benefits. ICs are obligated to pay the SET to provide Social Security coverage for themselves, just as are employees. When the Social Security Administration computes an individual's retirement or disability benefits, it counts income earned through self-employment and from wages the same.

In reality, however, a number of factors contribute to lower Social Security coverage and benefits for ICs. First, income is generally lower for ICs than for employees. Since a worker's income is the predominant factor in determining Social Security benefits, lower overall earnings will generally result in lower benefits. Second, the fact that ICs do not receive a steady paycheck, but instead must seek out contracts to perform work, means there is a higher

[27] See section 5A of part III below.

[28] The reason the SET applies to less than 100 percent of the IC's income is to achieve approximate parity with the effective Social Security and Medicare taxes applicable to employees, whose employers only make contributions on the employee's wage-and-salary income, and not on the worker's total compensation including the employer's Social Security and Medicare contributions. The current structure of the SET approximates parity, but does not arrive at absolute equivalence in labor costs between employees and ICs (James R. Nunns, 2014, "Costly Error in Payroll Tax Computation for the Self-Employed," Tax Policy Center, http://www.taxpolicycenter.org/publications/costly-error-payroll-tax-computation-self-employed). Half of the amount of SET paid is deducted from an IC's gross income, thus reducing the amount of income on which the IC pays income tax. After calculating this deduction, the IC pays the SET in addition to any other federal income tax owed.

likelihood of significant periods without income, thus lowering lifetime income on which Social Security benefits are based. Finally, there is substantial evidence that ICs comply with tax laws at far lower rates than employees.[29] Some of the income earned by ICs may not be reported to SSA by either the IC or the firm using the IC, leading to lower benefits than would be paid to employees earning the same total income. We address the low earnings, episodic work, and tax compliance issues of ICs each in turn below. However, since the issue of misclassified employees working as ICs hangs over all matters relating to independent contracting in the current economy, we first address employee misclassification.

Misclassified Workers

In order to improve Social Security coverage of ICs, a first step is to determine whether those categorized as independent contractors are in fact independent contractors. For reasons discussed in Part II below, IC status is a strong predictor of eventual Social Security benefits, and often results in lower coverage and benefits than similarly situated workers in traditional employment relationships.

Some portion of ICs in the economy would be classified as traditional employees if their work arrangement were closely scrutinized by government authorities. These workers are considered to be "misclassified" as ICs.[30] Estimates of the extent of misclassification vary, but multiple reports suggest that the practice is widespread, affecting millions of workers. Depending on the state, between 10 and 40 percent of employers are estimated to engage in misclassification.[31]

A number of factors lead to the misclassification of workers as ICs. First, certain macroeconomic trends affecting the labor market have the effect of obscuring the employer-employee relationship, which in the past was more transparent. The "fissuring" of the workplace, a phenomenon documented by David Weil, describes the process of firms' shedding certain components of their business that used to be controlled by one firm. These functions are outsourced to subcontracted firms, which in turn seek to achieve a pared-down structure by engaging subcontracted firms or subcontracted workers. Each firm at each layer of outsourced work must extract profit from smaller and smaller wedges of the enterprise. One method firms

[29] See full discussion below in section 2 of part III. Also see Internal Revenue Service, 2016, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010," Publication 1415 (Rev. 5-2016) https://www.irs.gov/pub/irs-soi/p1415.pdf.

[30] Françoise Carré, 2015, "(In)dependent Contractor Misclassification," Briefing Paper #403, Economic Policy Institute, https://www.epi.org/publication/independent-contractor-misclassification/.

[31] National Employment Law Project, 2015, "Independent Contractor Misclassification Imposes Huge Costs on Workers and Federal and State Treasuries," pp. 4-5, http://www.nelp.org/content/uploads/Independent-Contractor-Costs.pdf. Additional studies on the extent of misclassification are available at Chicago Regional Council of Carpenters, 2016, "Size and Cost of Payroll Fraud: Survey of National and State Studies," https://www.carpentersunion.org/news/size-and-cost-payroll-fraud-survey-national-and-state-studies. A 2000 study for the Department of Labor estimated that about 1 million workers were misclassified as ICs for the purposes of UI: Planmatics, 2000, "Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs," written for the U.S. Department of Labor, Employment and Training Administration, https://wdr.doleta.gov/owsdrr/00-5/00-5.pdf.

use to maximize profit in this fissured business model is by lowering total labor costs by engaging ICs instead of employees.

A second factor leading to workers being misclassified as ICs is the rise of online labor platforms. These companies benefit from their ambiguous relationships with the workers providing labor through their platforms. Courts and administrative agencies have ruled on both sides of the issue, some deciding that the online platform workers are employees, others ruling that they are ICs.[32] The technological advances allowing services to be provided through these platforms have generated renewed debate around what constitutes an employment relationship. Some of these workers could ultimately be determined by the courts to be properly classified as employees.

A third factor is the deliberate intention of some employers to misclassify employees as ICs in order to reduce their payroll costs. By doing so, they avoid their responsibilities to contribute to employer-provided mandatory social insurance programs such as workers' compensation, unemployment insurance, and (in some states) paid family and medical leave. They also are not required to contribute the employer's share of Social Security and Medicare contributions. The harm to social systems because of misclassification has been documented by researchers.[33] The lack of robust enforcement of worker classification laws nationwide creates a lightly regulated

[32] In 2018, a U.S. District Court ruled that a driver for GrubHub was an IC and not an employee for purposes of California's wage-and-hour laws (*Lawson v. GrubHub Inc.*, 15-cv-05128, U.S. District Court, Northern District of California). In the same year, another U.S. District Court found that drivers for Uber were properly classified as ICs and not employees for purposes of the federal Fair Labor Standards Act (*Razak v. Uber Technologies Inc*, U.S. District Court for the Eastern District of Pennsylvania, No. 2:16-cv-00573). In 2017, the Unemployment Insurance Appeals Board of New York found that an Uber driver was an employee for the purposes of unemployment insurance (State of New York Unemployment Insurance Appeal Board, ALJ Case Number 016-23858, http://www.nelp.org/content/uploads/NY-Appeals-Board-Uber.pdf). However, also in 2017, a Florida Court of Appeals found that a driver for Uber was an IC and not an employee (McGillis v. Department of Economic Opportunity, Florida Third District Court of Appeal, No. 3D15-2758 (2017), https://huntonlaborblogfullservice.huntonwilliamsblogs.com/wp-content/uploads/sites/14/2017/02/Uber-decision.pdf). In 2016, an Administrative Law Judge of the New York State Department of Labor ruled that a delivery person for Postmates was an employee for purposes of unemployment insurance (State of New York Unemployment Insurance Appeal Board, Appeal Board Number 588563, http://www.nelp.org/content/uploads/NY-Appeals-Board-Postmates.pdf). California's Employment Development Department has made similar determinations finding drivers for online platforms to be employees (Chris Roberts, 2016, "Another Uber Driver Awarded Unemployment Benefits," *SF Weekly*, March 4, 2016, https://archives.sfweekly.com/thesnitch/2016/03/04/uber-driver-awarded-unemployment-benefits-first-known-case-in-state). In 2015, Oregon's Bureau of Labor and Industries found Uber drivers to be employees for purposes of unemployment insurance, (Oregon Bureau of Labor and Industries, Advisory opinion of the Commissioner, October 14, 2015, http://www.nelp.org/content/uploads/Oregon-BOLI-order.pdf). To help reconcile some of the diverse decisions in the State of California, the Supreme Court of California in 2018 established a new definition of employee in *Dynamex Operations West, Inc. v. The Superior Court of Los Angeles County.* The case has the potential to affect the employment status of workers on online platforms in future litigation.

[33] Sarah Leberstein and Catherine Ruckelshaus, 2016, "Independent Contractor vs. Employee: Why independent contractor misclassification matters and what we can do to stop it," National Employment Law Project, http://www.nelp.org/content/uploads/Policy-Brief-Independent-Contractor-vs-Employee.pdf; Carré, 2015, "(In)dependent Contractor Misclassification."

environment that enables employers to avoid employment responsibilities and commit payroll fraud through misclassification.

The impact on the individual worker of being classified as an IC instead of an employee is profound. Misclassified workers are not insured against risks through employer-based social insurance programs and do not receive employee benefits. They lack minimum wage, overtime, and discrimination protections.[34] They also are likely to face lower Social Security benefits in retirement and disability for the reasons explained in the rest of this part of the paper.

Low Earnings

Lifetime earnings determine Social Security benefits: in general, lower lifetime earnings yield lower Social Security benefits, and higher lifetime earnings result in higher benefits. The evidence discussed below suggests that ICs on average earn less than workers as a whole. On its face, ICs' lower income implies that they will earn lower Social Security benefits than other workers. But this fact alone is merely one still frame in the larger motion picture of workers' cycling in and out of alternative work arrangements over the course of their working lives. This dynamism begs the question: low earnings compared to what? If the alternative to independent contracting is zero earnings during unemployment, earning income as an IC, even if relatively low and volatile, would produce higher income and higher Social Security benefits. Indeed, independent contracting, especially when it is performed through an online platform, does appear to be a supplement to, rather than a replacement for, traditional work.[35] We simply do not know what is in the best interests of any particular worker.[36] Given the lack of longitudinal data tracking workers' earnings trajectories over their careers, which could be used to compare the outcomes of similarly situated ICs and standard workers across the life course, we cannot conclude that independent contracting is a causal factor in lowering a worker's Social Security benefits in retirement. Independent contracting may very well increase lifetime earnings and Social Security benefits for some workers. What we can say is that people earning income as ICs receive lower incomes and earn lower Social Security benefits, on average, than people working in traditional employment arrangements at any point in time. This constrained interpretation does not detract from a central conclusion of this paper, which is that income earned through independent contracting, regardless of the amount, has a lower probability of being fully credited towards Social Security benefits than income earned in a traditional work

[34] Leberstein and Ruckelshaus, 2016.

[35] Katharine Abraham et al., 2017, "Measuring the Gig Economy: Current Knowledge and Open Issues," NBER working paper, https://aysps.gsu.edu/files/2016/09/Measuring-the-Gig-Economy-Current-Knowledge-and-Open-Issues.pdf: "One view, which the current limited evidence seems to support, is that much of the online platform/on-demand non-employee work is supplemental in nature. That is, there is not yet compelling evidence that the primary activity over the course of an individual's career is increasingly taking the form of non-employee work" (p. 31). Also see Diana Farrell and Fiona Greig, 2016, "Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility," JPMorgan Chase & Co. institute, p. 22, https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf: "Earnings from labor platforms offset dips in non-platform income" (p. 26).

[36] Again, see Abraham et al., 2017: "Longitudinal matched employer-employee data that also fully integrates non-employee work activity is needed to address these questions."

arrangement. With this is mind, we present the following evidence on earnings differentials between ICs and other workers.

According to the IRS's Office of Tax Analysis, the average total net earnings for workers who engage in independent contracting for their primary source of income is 69 percent less than the average total earnings for workers overall.[37] The earnings for workers who engage in some independent contracting to supplement their income is 35 percent less than workers overall.[38] Furthermore, according to the GAO, independent contractors as a group in 2010 were more likely to have family income below $20,000 than workers in the workforce as a whole.[39] And according to another study, the subgroup of ICs operating through an online labor platform have low incomes on average compared with the labor force as a whole.[40]

Another indication that ICs have lower earnings than employees on average is the trend in recent years towards a higher proportion of self-employed workers than workers overall having total income below the Social Security taxable maximum,[41] which could suggest a growth in the share of low-wage ICs. If a worker has earnings above the taxable maximum, it means she has very high earnings relative to most workers in the economy, above the 95th percentile of

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[37] Emilie Jackson, Adam Looney, and Shanthi Ramnath, 2017, "The Rise of Alternative Work Arrangements: Evidence and Implications for Tax Filing and Benefit Coverage," Office of Tax Analysis Working Paper 114, https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/WP-114.pdf.

[38] The average total net earnings for all tax filers was $47,396 in 2014. Average total net earnings for those identified as ICs by the IRS Office of Tax Analysis and who engaged in independent contracting for their primary source of income was $14,483. This is 69 percent less than $47,396. The average total net earnings among those who supplemented their income through independent contracting was $30,636. This is 35 percent less than $47,396 (Jackson, Looney, and Ramnath, 2017, P. 34, table 6). The Office's definition of "independent contractor" is based on the assumption that ICs are analogous to Schedule C filers with low expenses (under $5,000) because they are primarily engaged in business enterprises involving the return on labor, whereas Schedule C filers with high expenses (over $5,000) are engaged in more capital-intensive businesses that should not properly be considered contracting. As the authors note, "A contract worker (or misclassified employee or a household worker) who works at the contracting firm's establishment and uses the firm's equipment or supplies would likely have few business-related expenses," (p. 13). However, this estimate must be cautiously interpreted: there are at least two reasons the Office's definition of IC misses many workers who would otherwise be considered ICs. First, some ICs have legitimate expenses exceeding the $5,000 threshold, meaning they are not counted among the 12.8 million ICs. Delivery people and other drivers often have extensive expenses related to vehicle maintenance that exceed $5,000 in a year. Moreover, 40 percent of self-described "consultants" – widely accepted to be within the definition of independent contractor – have business expenses exceeding $5,000 and so are not counted in the Office's estimate of 12.8 million ICs. Second, sole proprietors routinely overstate their expenses; those whose overstating of expenses pushes them above the $5,000 expense threshold are also erroneously omitted from the above estimate of 12.8 million ICs. See the discussion of tax compliance among ICs in section 2 of part III of this paper.

[39] U.S. Government Accountability Office (GAO), 2015, "Contingent Workforce: Size, Characteristics, Earnings, and Benefits," GAO-15-168R, p. 18, http://www.gao.gov/assets/670/669766.pdf.

[40] Diana Farrell and Fiona Greig, 2016, "Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility," JPMorgan Chase & Co. institute, p. 22, https://www.jpmorganchase.com/corporate/institute/document/jpmc-institute-volatility-2-report.pdf.

[41] SSA, 2017, *Annual Statistical Supplement, 2016*, Table 4.B4, https://www.ssa.gov/policy/docs/statcomps/supplement/2016/4b.html#table4.b4.

earnings reported to SSA in recent years.[42] Workers with earnings below the taxable maximum may still have relatively high earnings, but many have earnings closer to the average wage reported to SSA, which is $43,000.[43] In previous decades, a higher proportion of workers overall than self-employed workers had income below the taxable maximum,[44] reflecting the fact that a higher proportion of the self-employed were highly paid doctors, lawyers, and consultants,[45] who had total earnings above the taxable maximum, while a higher proportion of wage earners were industrial laborers and lower-compensated office workers. Until 2002, a higher proportion of workers overall had total income below the taxable maximum, but since 2002, a higher proportion of the self-employed have had income below the taxable maximum.[46] Although there are many factors involved in this reversal, one cause may be the fissured workplace, which, as described above, could lead to more widespread misclassification of low-income workers as ICs. The relatively lower earnings of ICs, coupled with the tax-compliance issues described below, are likely to have a negative effect on overall Social Security benefits in retirement.

Episodic Work

Social Security benefits will generally be equal for an IC and an employee earning the same amount. But focusing on SSA's equivalent benefit computation for equal total earnings ignores the broader context of potentially higher earnings that an IC could have earned with less volatile income. The evidence tells us that ICs have more volatile incomes and face more periods of low or no earnings than employees. By some estimates, ICs are more than twice as likely to have been laid off in the previous year compared to standard full-time employees.[47] An IC with periods of no work will have lower earnings than a worker earning the same amount with a steady income stream simply by virtue of the fact that the worker had higher total earnings over the same period. ICs also are more likely to experience spikes or dips in income than households without self-employment income.[48] That said, some households use self-

[42] Income above $128,400 is in the 95th percentile of wages reported to SSA: SSA, Office of the Chief Actuary, 2018, Wage Statistics for 2013, https://www.ssa.gov/cgi-bin/netcomp.cgi?year=2013.
[43] Ibid.
[44] SSA, 2017, *Annual Statistical Supplement, 2016*, Table 4.B4.
[45] In 1994, for example, median Social Security reported earnings for the self-employed were 75 percent of the median reported earnings for wage-and-salary workers. Twenty years later, in 2014, median Social Security reported earnings for the self-employed were only 54 percent of the median reported earnings for wage-and-salary workers. SSA, 2017, *Annual Statistical Supplement, 2016*, Table 4.B3, https://www.ssa.gov/policy/docs/statcomps/supplement/2016/4b.html#table4.b3.
[46] SSA, 2017, *Annual Statistical Supplement, 2016*, Table 4.B4.
[47] GAO, 2015, "Contingent Workforce," p. 21, see Table 8. Estimates are for 2010.
[48] "Although 55 percent of adults in households without self-employment income saw no months in which household income spiked or dipped, only 29 percent of those in households with self-employment income reported the same," Elaine Maag et al., 2017, "Income Volatility: New Research Results with Implications for Income Tax Filing and Liabilities," Tax Policy Center, https://www.urban.org/sites/default/files/publication/90431/2001284-income-volatility-new-research-results-with-implications-for-income-tax-filing-and-liabilities_0.pdf.

employment to supplement their incomes and to help even out spikes and dips in monthly income.[49]

Poor Tax Compliance

An important difference between IC and employee status is that ICs are responsible for managing their own periodic income and self-employment tax obligations, whereas employers manage tax withholding for their employees. This difference in responsibilities has significant consequences for tax compliance and for Social Security benefits.

There are several reasons why tax compliance among ICs lags behind that of traditional employees.[50] Workers earning income as ICs may be unaware they are ICs for tax purposes; or even if they are aware of their IC status, they may be unaware of their tax obligations; or even if they are aware of both their IC status and their tax obligations, they may fall below income-reporting thresholds from the firm using their labor and so neglect to fully report their income; or they may be paid in cash "under the table" with no intention by the firm or the IC to report the income; or they may simply be confused or overwhelmed by the tax-filing paperwork, so they misreport their taxes; or they may fail to file quarterly taxes and, by the time they find out they owe penalties and self-employment taxes, they no longer have the money to pay their taxes. Each of these circumstances would lead to lower Social Security benefits for the worker.

Tax laws affecting traditional workers versus ICs
Employers bear much of the tax-reporting burden for traditional employees. Employers' payroll withholding services are tantamount to an employee benefit for workers. Employers are required to keep accurate records of the wages paid to their employees, and to report those wages to the IRS and to the worker. Employers also withhold the proper amount of income taxes and payroll contributions due to Social Security and Medicare, freeing workers from this tax-compliance burden.

Unless they have other sources of income or other complicating factors such as dependent children or tax deductions, many workers can file a simplified one-page tax return called the Form 1040-EZ, which is specifically designed for low-income employees who may not have access to tax assistance. Research suggests that low-income self-employed workers are more likely to make mistakes in the filing process than higher-earning self-employed people.[51] In this way, the Form 1040-EZ can be viewed as an important tax-filing tool for low-income workers. In

[49] Jonathan Morduch and Rachel Schneider, 2013, "Spikes and Dips: How Income Uncertainty Affects Households," U.S. Financial Diaries, http://www.usfinancialdiaries.org/issue1-spikes.
[50] For a full discussion of the evidence showing tax noncompliance among ICs, see section 2 of part III of this paper.
[51] Ufuk Akcigit, Philippe Aghion, Mathieu Lequien, and Stefanie Stantcheva, "Tax Simplicity and Heterogeneous Learning," NBER Working Paper 24049, https://scholar.harvard.edu/stantcheva/publications/self-employment-and-tax-incentives-evidence-french-tax-returns; Andrew Van Dam, 2017, "The one thing the self-employed want more than a tax cut," Washington Post, December 18, 2017, https://www.washingtonpost.com/news/wonk/wp/2017/12/18/the-one-thing-the-self-employed-want-more-than-a-tax-cut/?utm_term=.0fb6b900832a.

2015, 24 million tax filers used IRS Form 1040-EZ, representing almost 16 percent of all income-tax returns filed.[52] Independent contractors, however, lack access to any such simplified tax form.

In contrast to similarly situated employees, ICs face more complicated tax requirements. This is especially true for low-income workers compared to the process that they would follow were they to simply receive wages instead of alternative income. Workers with IC income are prohibited from filing Form 1040-EZ, and are required to file using the regular Form 1040.[53] In addition to navigating the complexity of the full Form 1040, ICs must accurately complete the supplementary Schedules C and SE used by business owners, and must understand and accurately claim business expense deductions. ICs are also required to file and remit quarterly estimated payments of their income taxes and self-employment taxes. Thus, simply by virtue of the fact that ICs receive income from self-employment instead of wages, these workers face a more complicated tax-filing process and are at greater risk for errors in tax filing.

These errors in tax filing may result in either overpayment or underpayment of taxes. Overpayments may occur by failing to include all employment-related expenses and deductions at tax time, which puts these workers at a disadvantage in terms of their economic security compared with traditional employees. Ten percent of sole-proprietor tax returns overreport their income.[54] Underpayment may occur as a result of incomplete or non-existent reporting from the entity for which a worker provides contract labor. Two-thirds of sole-proprietor tax returns underreport their income.[55] Underpayment can be especially costly for these workers not only because it exposes them to potential tax penalties but also because, over time, it will lower their expected Social Security benefits.

[52] IRS, 2017, SOI—2015 Individual Income Tax Returns, Line Item Estimates, https://www.irs.gov/pub/irs-soi/15inlinecount.pdf.
[53] IRS, 2017, Form 1040-EZ Instructions, p.6, https://www.irs.gov/pub/irs-dft/i1040ez--dft.pdf.
[54] GAO, 2017, "IRS Needs Specific Goals and Strategies for Improving Compliance," GAO-18-39, p. 36, https://www.gao.gov/assets/690/688067.pdf.
[55] Ibid.

Part III. Strategies for Improving Social Security Coverage and Benefits for Independent Contractors

This part of the paper discusses policy options to improve Social Security coverage and benefits for ICs. The options are divided into six categories. We will first offer strategies to ensure correct employment classification of workers in section 1. We then discuss ways to improve tax compliance among ICs in section 2. In section 3, we discuss a special subset of proposals that could improve compliance by improving reporting of IC income. Section 4 offers alternative ways to collect the employer-equivalent share of self-employment taxes owed on the income of ICs. Section 5 proposes options for equalizing the tax treatment of income earned by ICs and employees. Finally, in section 6, we offer several strategies to improve ICs' overall financial security. These last strategies may not directly increase Social Security coverage or benefits for ICs, but could help to improve their retirement security and overall financial security.

1. Improve Enforcement and Accuracy of Employment Classification of Workers

Some ICs are misclassified and should be treated as regular employees for the purposes of Social Security coverage and benefits. For the reasons given above, there are systemic features of coverage and benefits for ICs that make traditional employment classification more desirable for the purposes of improving retirement security. Therefore, this first set of options to improve coverage and benefits for ICs would ensure that as many workers as can qualify within the legal strictures of the traditional employment classification are classified as employees.

1A. Improve enforcement of existing laws regarding employment classification at the state and federal levels

Employment classification audits performed in many states have yielded estimates of millions of instances of employment misclassification over several years.[56] States and the federal government have responded in a number of ways. Twenty-seven states have adopted laws that create a presumption for employee status, unless an employer can prove that a worker is an IC by confirming three objective factors, known as the ABC test.[57] The three factors are:

> (a) that the worker is free from control and direction over performance of the work, both under the contract and in fact;
> (b) that the work provided is outside the usual course of the business for which the work is performed; and
> (c) that the worker is customarily engaged in an independently established trade, occupation or business.[58]

[56] Carré, 2015, "(In)dependent Contractor Misclassification"; Catherine Ruckelshaus, 2016, "Independent Contractor vs. Employee: Why Misclassification Matters and What We Can Do To Stop It," National Employment Law Project, http://www.nelp.org/publication/independent-contractor-vs-employee/.
[57] Ruckelshaus, 2016, "Independent Contractor vs. Employee." California's Supreme Court affirmed the use of the ABC for employee status in 2018 in *Dynamex Operations West, Inc. v. The Superior Court of Los Angeles County.*
[58] *Dynamex Operations West, Inc. v. The Superior Court of Los Angeles County*, Supreme Court of California, S222732, April, 2018.

Nineteen states have created inter-agency task forces or commissions to coordinate data-sharing and enforcement operations.[59] The federal government, for its part, has developed Memoranda of Understanding (MOU) between federal agencies – particularly the Internal Revenue Service (IRS) and the Department of Labor (DOL) – and several states to coordinate enforcement operations.[60] Legislatively, Congress has attempted to reduce the prevalence of misclassification through the Payroll Fraud Prevention Act, which, if enacted, would require employers to clearly inform their workforce about their current employment status.[61] This disclosure would lead to greater transparency between employers and workers and allow workers to question their current status.

One proposal for improving enforcement of employment classifications at the federal level would be to strengthen and fully implement existing MOUs between IRS and DOL on worker misclassification. The Treasury Inspector General for Tax Administration (TIGTA) recently found that the IRS was not fulfilling all of its agreed responsibilities identified in the MOU with DOL. In particular, IRS was not consistently referring cases of suspected misclassification to DOL, as agreed to in the MOU.[62]

Another proposal would be for the IRS to update its 1984 study on employment tax compliance.[63] That study is still widely cited and provides perhaps the only authoritative nationwide estimates of employee misclassification. The results of that study also influence some of IRS's current methodology for estimating the federal tax gap, which are based on findings from the 1984 study. Updating that study, as suggested by GAO in a recent report, could help to identify employer characteristics that could direct enforcement actions on misclassification.[64]

A third option to improve enforcement of existing laws would be to reinstate a strong interpretation of existing statutory presumptions of employee status. The Administrator of the Wage and Hour Division of DOL in 2015, David Weil, adopted an Administrator's Interpretation of the wage-and-hour laws that applied the Fair Labor Standards Act's broad "suffer or permit"

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[59] Ruckelshaus, 2016, "Independent Contractor vs. Employee."
[60] A list of current agreements between DOL and states is available at U.S. Department of Labor, Wage and Hour Division, "Misclassification of Employees as Independent Contractors," https://www.dol.gov/whd/workers/misclassification/stateinfo-nojs.htm.
[61] 114th Congress, H.R. 3527 SEE H.R. 3629 (115th Congress) at https://www.congress.gov/bill/115th-congress/house-bill/3629.
[62] IRS, Treasury Inspector General for Tax Administration, 2018, "Additional Actions Are Needed to Make the Worker Misclassification Initiative With the Department of Labor a Success," https://www.treasury.gov/tigta/iereports/2018reports/2018IER002fr.pdf.
[63] IRS, Treasury Inspector General for Tax Administration, 2013, "Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings," https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf.
[64] GAO, 2017, "Timely Use of National Research Program Results Would Help IRS Improve Compliance and Tax Gap Estimates," GAO-17-371, https://www.gao.gov/assets/690/684162.pdf.

standard to the agency's misclassification enforcement operations.[65] The adoption of the "suffer or permit" standard, which is often considered the broadest definition of employee status, thereby superseded the narrower common law control test as the Wage and Hour Division's standard of reference for identifying misclassification. This Administrator's Interpretation was withdrawn by the new Administration in 2017. One policy option is to reinstate this interpretation.

1B. Enact targeted laws to require employee status for certain workers

One way to reduce the prevalence of misclassification is to foreclose the option to classify workers as ICs in the first place. This option would establish a rule that would prohibit workers from being ICs in certain industries. The rule would mandate that workers in certain industries be employees for all purposes, not only in determining whether Social Security and Medicare contributions should be made by the employer. The industries that could be targeted by this approach would be those with high rates of misclassification as identified by state and federal audits. Precedents for such a rule can be found in state laws requiring workers to be employees in some dangerous industries for which there is a public policy interest in attributing risks to particular employers to avoid shifting the costs of insuring those risks onto public programs. An example would be the construction industry, in which there is a higher probability of workplace injury than in other industries.

1C. Expand the application of statutory employee laws

A more limited policy option than laws that outright prohibit IC status is to expand the pool of workers covered by what are called "statutory employee" laws. These laws apply only to a firm's liability for contributing the employer's portion of Social Security and Medicare contributions and for withholding and transmitting the employee's share on behalf of the worker. Statutory employees as defined in this way are not employees for any other purposes under federal law including unemployment insurance, collective bargaining, or wage-and-hour rules.

Such statutory employee laws are already in existence in certain limited instances. Workers in the following four categories are automatically considered employees for the purposes of Social Security and Medicare:[66]

- Some delivery workers
- Some life insurance sales agents
- Some home workers
- Some travelling salespeople

[65] David Weil, 2015, "The Application of the Fair Labor Standards Act's 'Suffer or Permit' Standard in the Identification of Employees Who Are Misclassified as Independent Contractors," Administrator's Interpretation No. 2015-1, https://www.blr.com/html_email/AI2015-1.pdf.

[66] IRS, 2017, "Statutory Employees," https://www.irs.gov/businesses/small-businesses-self-employed/statutory-employees.

One option would be to expand the set of ICs for whom these laws apply. For example, ICs in industries that are identified as tending to use low-income workers, such as retail, delivery services, or food service, could fall under statutory employee rules. This policy option does not address the underlying policy problem of employee misclassification, nor does it address other significant employment issues such as insuring against the risks of workplace injury or becoming involuntarily unemployed. However, this option would benefit low-income ICs by increasing compliance with Social Security and Medicare contribution laws through the statutory requirement for employers to treat ICs as employees for the limited purpose of contributing and remitting Social Security and Medicare contributions.

1D. Improve the Form SS-8 complaint process

According to the Treasury Inspector General for Tax Administration (TIGTA), the primary means by which employers' obligations to pay their share of Social Security contributions for a misclassified employee are enforced is through the active intervention of the employee herself.[67] The worker must proactively request a determination letter from the IRS officially determining whether a worker's employment tax status is that of an employee or IC.[68] Form SS-8, used to request this determination letter, requires the worker to accurately complete four pages of technical questions addressing all aspects of the nature of the work and the employment relationship, including such minutiae as describing the worker's daily routine and manner of selling products. The form assumes a high level of sophistication in matters of taxation and business processes on the part of the worker. At the end of the form, the worker must sign attesting to the accuracy of the information under the penalty of perjury. It is not easy to imagine large numbers of low-income workers successfully challenging their employment classification using this form. Indeed, taking 3.4 million as a lower bound for the number of misclassified employees,[69] it is striking that the IRS received only 6,262 Form SS-8s in 2012, representing less than 0.2 percent of the low estimate for the number of misclassified employees.[70]

A determination by the IRS that a given worker is in fact misclassified will trigger liability for the employer to pay the employer's portion of the worker's Social Security and Medicare contributions going forward. The determination could also trigger liability for the employer to pay back taxes. However, the law allows for a "safe harbor" for certain employers that prohibits the IRS from retroactively classifying some workers as employees.[71] In one audit of the SS-8

[67] IRS, Treasury Inspector General for Tax Administration, 2013, "Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings," https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf.

[68] 90 percent of Form SS-8 requests are filed by workers: GAO, 2009, "Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention," GAO-09-717, https://www.gao.gov/new.items/d09717.pdf.

[69] IRS, Treasury Inspector General for Tax Administration, 2013, "Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings," https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf.

[70] Ibid.

[71] This safe harbor provision is known as Section 530 relief. IRS, 2018, "Worker Reclassification – Section 530 Relief," https://www.irs.gov/government-entities/worker-reclassification-section-530-relief.

program conducted by TIGTA in 2013, 17.25 percent of employers who were identified as having misclassified at least one worker as an IC were eligible for this safe harbor and did not have to pay back taxes.

One option would be to simplify the Form SS-8 process to encourage more workers to use the program. Doing so could increase filings and lead to greater scrutiny of the employer's choice of employment classification.

A second option would add worker protections into the SS-8 program to prevent retaliation against workers who file the form. The 2013 TIGTA audit of the SS-8 program found that two-thirds of the employers identified as having misclassified workers as ICs did not subsequently file any tax forms for the misclassified workers, suggesting that either the workers no longer worked for the firms or were thereafter paid under the table. The high rate of nonfiling after an SS-8 misclassification determination raises the possibility that many of the workers may have been retaliated against by the employer and were fired from their jobs.

It is worth noting that disputes between worker and employer over responsibility for paying payroll taxes has no direct effect on actual Social Security benefits. The calculation of benefits is based on income earned, not taxes paid. Thus, as long as the wage record is transmitted to the Social Security Administration, the worker will be credited for benefits. The main problem arises when IC status leads to lower reported income and tax compliance, issues that will be addressed in section 2 below.

2. Improve Tax Compliance among ICs

While Social Security is designed to cover all workers' wages up to the taxable maximum, regardless of employment classification, achievement of universal wage coverage (up to the taxable maximum) depends upon tax compliance. In the real world, universal wage coverage is as difficult to attain as perfect tax compliance. In the case of independent contractors, tax compliance directly relates to retirement preparedness through the recording of earnings and collection of Social Security contributions. Generally, for independent contractors, poor tax compliance will result in lower Social Security benefits and a less secure retirement due to the lower reported income on which benefits are calculated.

One of the main advantages of the Social Security contribution system, which is reliant upon automatic payroll deductions, is that neither workers nor employers face any decision points at which they can decide whether or how much to contribute. Contributions are deducted, reported, and transmitted as a matter of course. For ICs, by contrast, the processes for reporting earnings and paying in to Social Security are not automatic. ICs can reduce their self-employment taxes owed by reducing the amount subject to the 15.3 percent SET. They can do so by overstating business expenses or underreporting income. Both strategies yield higher after-tax income now, which some may value more highly than Social Security benefits later. ICs sometimes even fail to pay their taxes altogether. The absence of an automatic SET filing

process, together with opportunities for underreporting or nonfiling of taxes owed, weakens the Social Security system and jeopardizes retirement security for some ICs.

Indeed, the data suggest widespread tax non-compliance among ICs, who face these trade-offs between income consumed today and income saved for later consumption in retirement. The United States Government Accountability Office (GAO) reports that two-thirds of "sole proprietors" (a group that encompasses ICs) underreport their income.[72] A related finding is that less than half of all self-employment taxes owed are actually paid. We calculate that whereas $129 billion in self-employment taxes are owed by U.S. taxpayers, only $60 billion of that amount is paid.[73] This leaves $69 billion in Social Security and Medicare contributions that are not flowing into the trust funds on behalf of self-employed people, due mainly to underreporting of income or overstating deductions.

Looking at the entire U.S. tax system, a third of all underreporting of taxes is due to misreporting by sole proprietors.[74] ICs operating as sole proprietors are some of the largest contributors to the tax gap, which is the difference between the amount of tax owed nationwide and the amount that is actually paid.[75] Improving tax compliance on the part of ICs would significantly shrink the size of the tax gap and significantly increase the expected Social Security benefits of these workers.

As described in Parts I and II above, the tax filing process is more complicated for ICs than the process for traditional employees. A low-income misclassified IC will face a tax filing process involving three IRS forms instead of the one-page "postcard" Form 1040-EZ. Furthermore, the automatic quality of Social Security contributions, a key strength of the program in providing

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[72] GAO, 2017, "IRS Needs Specific Goals and Strategies for Improving Compliance," GAO-18-39, p. 36, https://www.gao.gov/assets/690/688067.pdf. Sole proprietors include business owners providing goods for sale in addition to ICs providing labor. The available data do not distinguish between these groups.

[73] The estimate for the total amount of SET owed is derived by the following method. First, we observe the IRS estimate for the amount of SET not paid due to "underreporting" ($65 billion). The term "underreporting," as used by the IRS in this context, refers to taxpayers' understating the amount of the tax they owe on their tax forms by underreporting income or overreporting deductions, which results in lower calculated taxes owed. Second, to this amount is added the amount of the SET not paid due to "nonfiling" ($4 billion). The term "nonfiling" refers to taxpayers' either not filing tax forms at all, or filing their taxes late. A third contributor to lower SET receipts than legally required is due to "underpayment," which refers to taxpayers' failure to timely pay the taxes that were identified as owed on their tax forms. However, the amount of "underpayment" of the SET is not differentiated from underpayment of other types of employment taxes (FICA and UI taxes) in available data, so we do not include that amount. The IRS estimates for the amount of SET owed but not paid for all three reasons (underreporting, nonfiling, and underpayment) are annual averages for tax years 2008-2010, and are sensitive to sampling error. (IRS, 2016, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010," Publication 1415 (Rev. 5-2016) https://www.irs.gov/pub/irs-soi/p1415.pdf.) Next, the amount of SET actually paid by taxpayers ($60 billion) is added to the estimate for the amount not paid. The amount actually paid by taxpayers is from tax year 2015, the most recent year for which data are available (IRS, 2017, 2015 SOI Line Item Estimates).

[74] IRS, 2007, "Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance," p. 14, https://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

[75] IRS, 2016, "Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2008–2010," Publication 1415 (Rev. 5-2016), https://www.irs.gov/pub/irs-soi/p1415.pdf.

retirement security, is compromised. Automatic deductions are an essential part of virtually all major retirement security proposals, the necessity of which is borne out by the findings of behavioral economics, which show much higher rates of retirement savings when the process is easy and automatic.[76] Contrary to these lessons, the SET filing process places the burden of complying with one's tax obligations (and thus providing for one's retirement security) squarely on the shoulders of the ideal prudent and forward-looking independent worker.

All workers face competing economic priorities, one of which is the choice to consume income now or save for later. For most workers, saving for retirement is hard, and public policy can help to structure retirement programs and shift incentives to increase their retirement security. Social Security generally does a good job in helping workers provide for their future during their working years through its mandatory, automatic, and universal contribution structure. But Social Security's strong system for ensuring greater retirement security among workers is undermined when it comes to ICs.

2A. Improve ICs' knowledge about their tax responsibilities

Much of the underreporting of taxes by ICs may be the result of lack of awareness about the full extent of their tax obligations rather than deliberate attempts to evade tax liability. The IRS acknowledges that many ICs "may fail to comply fully because they are overwhelmed by the cost and complexity of meeting their tax obligations and their business requirements."[77] Discouraged ICs may simply "walk away" and fail to file.[78] According to one survey of ICs working with an on-demand platform, "36% of respondents didn't understand what kind of records they needed to keep for tax purposes."[79] A range of simple, low-cost options could have a high impact on tax compliance simply by improving awareness of tax requirements.

App-based companies such as Uber and TaskRabbit are well-situated to provide such information. For example, the home-sharing service Airbnb has published a 27-page booklet containing "general guidance on the taxation of rental income."[80] The booklet makes clear that the guide is provided merely for informational purposes, and encourages users to seek tax guidance from a professional. The clear need for such information on the part of workers (or, in the case of Airbnb, "hosts") should outweigh the reluctance of the platforms to appear involved in the affairs of the workers providing their service. While Airbnb's operations are largely outside the scope of this paper because income generated for its hosts is rental income, not

[76] John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, 2007, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," NBER Working Paper No. 12009, http://www.nber.org/papers/w12009.

[77] IRS, 2007, "Reducing the Federal Tax Gap," p. 15.

[78] Caroline Bruckner, 2016, "Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy," American University Kogod School of Business, p. 11, http://www.american.edu/kogod/news/Shortchanged.cfm.

[79] Ibid.

[80] Airbnb, 2017, "General guidance on the taxation of rental income," https://assets.airbnb.com/eyguidance/us.pdf.

labor income, and thus subject to different tax requirements,[81] the platform's provision of tax guidance stands as an example of a good business practice for online platforms of providing proactive tax education to workers.

Another opportunity for tax education is guidance offered directly by the IRS. The IRS already provides guides for self-employed individuals[82] and "sharing economy" workers.[83] Although hundreds of pages of information, guidance, and instructions already exist for sole proprietors and the self-employed,[84] not all workers realize that they are considered sole proprietors for tax purposes in the first place, or would use that word to describe themselves. There is a need for resources that can help workers not only find the tax forms they need, but also to simply identify their tax status based on yes-no questions about the structure of their work arrangement. A guide such as this should help workers identify their tax status with a reasonable probability of accuracy (short of the certainty that would come from consulting a tax accountant) and be used to identify their tax status and locate appropriate tax forms.

2B. Require automatic payment of taxes by ICs

The surest way to ensure tax compliance is to automatically withhold taxes due, as is done for employees. According to the IRS, when income is subject to tax withholding, only about 1 percent of income is misreported.[85] But when income is not subject to either withholding or reporting, i.e. when tax forms such as a W-2 or Form 1099 are not required to be sent to the IRS, about 63 percent of such income is misreported. As a general rule, the U.S. has a pay-as-you-earn tax system. Most workers are required to pay taxes throughout the year, with a reconciliation of taxes owed at tax time, around April 15th of the following year. Workers who receive wages automatically comply with this pay-as-you-earn requirement through the income- and payroll-tax withholding services of their employers. This withholding process automatically remits taxes, including Social Security contributions. Workers earning income as ICs, however, must comply with a separate, do-it-yourself, pay-as-you-earn process. All ICs with more than about $6,500 in income[86] are required to pay taxes in quarterly installments, known

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[81] An exception to this rule pertains to individuals who are considered to be in the business of renting out properties, and thus are operating as a business owner subject to self-employment taxes. Most Airbnb hosts, however, consider their use of the online platform to generate ancillary rental income, which is reported on Schedule E rather than Schedule C. Rental income reported on Schedule E is not subject to the SET.

[82] IRS, 2017, Self-Employed Individuals Tax Center, https://www.irs.gov/businesses/small-businesses-self-employed/self-employed-individuals-tax-center.

[83] IRS, 2018, Sharing Economy Tax Center, https://www.irs.gov/businesses/small-businesses-self-employed/sharing-economy-tax-center.

[84] IRS, 2017, "Are You Self-employed?" IRS Tax Map, https://taxmap.irs.gov/taxmap/ts0/soleproprietor_o_41f7a137.htm.

[85] IRS, 2016, "Tax Gap Estimates for Tax Years 2008–2010," https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf.

[86] The rule is that quarterly tax payments are required if the taxpayer is expected to owe at least $1,000 in taxes for that year, including both income and self-employment taxes. IRS, 2018, "Estimated Taxes," https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes. Considering just self-employment taxes, which are assessed on all income up to a cap at a flat rate of 15.3 percent, about $1,000 would be owed on income of $6,500.

as estimated tax payments.[87] Given that the average yearly earnings for workers providing labor through online labor platforms is about $6,400,[88] a significant share of these workers are already likely required to file quarterly tax payments. Yet a third of them report not knowing whether they have to file quarterly taxes.[89]

In addition to providing clearer information to ICs about tax reporting requirements, as addressed in proposal 2A, this option would require automatic withholding of tax payments, rather than leaving it up to the IC to proactively file estimated payments. One option would be to create requirements for withholding of self-employment taxes by the entity that uses the IC's labor (though not requiring the entities to actually contribute the employer's portion of the contributions). This proposal would apply to all businesses that directly engage ICs to perform work, whether online or not. The statutory test to trigger these mandatory withholdings by the entity using the contract labor could be designed to cast a far wider net than the existing statutory tests requiring automatic Social Security and Medicare withholding. Statutory employee laws already exist for the purposes of Social Security and Medicare taxes under certain circumstances.[90] However, the rules could be amended to broaden their scope and apply to more types of workers. For instance, one of the requirements to trigger statutorily required withholding of taxes for ICs is that the services be "performed on a continuing basis for the same payer."[91] This requirement may limit the types of workers for whom the taxes must be withheld, particularly transient workers who perform services for multiple businesses. But it would cover regular Uber and Lyft drivers, for example. Adding in an explicit threshold for duration of work at a low level, for example a total of four or eight hours per year, or a low threshold for the number of discrete payments (such as two or three per year), would expand the scope of these requirements and facilitate Social Security contributions for more workers.

Another way to design withholding of Social Security contributions for ICs is to require withholding on the part of the entity that coordinates the labor of the IC. Such a proposal would have to account for the IC's expenses before withholding contributions. This could be accomplished simply by requiring 15.3% withholding from payments made to ICs, with a reconciliation of excess contributions at tax time. Or it could be accomplished by ICs' declaring estimated expenses on the Form W-9 they provide to firms before engaging in contract work, just as employees declare expected exemptions on Form W-4 when entering into employment with a firm.

In whatever ways these questions are resolved, since these policy options merely require firms to withhold the amount owed by ICs, rather than requiring firms to actually contribute to Social

[87] IRS, 2018, "Estimated Taxes."
[88] JP Morgan Chase reports that the average monthly income of workers using online labor platforms who participated in the platform for that month was $533, which is $6,396 on a yearly basis. Farrell and Greig, 2016, "Paychecks, Paydays, and the Online Platform Economy," p. 24.
[89] Bruckner, 2016, "Shortchanged," p. 11.
[90] See sections 1A, B, and C of this paper, and IRS, 2017, "Statutory Employees," https://www.irs.gov/businesses/small-businesses-self-employed/statutory-employees.
[91] IRS, 2017, "Statutory Employees."

Security and Medicare on behalf of the workers, the group of workers for whom this requirement applies could be made much broader. Furthermore, requirements for automatic contributions do not increase ICs' or employers' tax obligations; they merely execute payment for ICs' preexisting tax obligations.

2C. Ensure access to tax-preparation assistance for ICs

Free tax assistance is generally available from two sources: nonprofits and the government. Options for paid tax assistance exist, but present problems for many ICs, particularly ones with limited resources. For-profit tax-assistance services operate in all states, but serious concerns have been raised about the benefit of these services due to evidence of fraud and unreasonably high fees.[92] And tax advice from private accountants is often beyond the means of many ICs.

Free, qualified tax assistance is available to people who make less than $54,000 through a network of Volunteer Income Tax Assistance (VITA) sites.[93] This assistance is usually coordinated by a local nonprofit or faith-based organization.[94]

Funding for VITA sites is essential to ensuring access to tax assistance for low-income ICs. This funding comes from cost-sharing agreements between the IRS and private philanthropy and fundraising operations. The IRS offers matching funds to organizations that offer free tax assistance as a VITA site.[95] Consequently, ensuring adequate funding for VITA sites through both government appropriations and nonprofit solvency is a key strategy for improving tax-compliance by ICs, thereby increasing Social Security coverage and benefits for these workers.

Other nonprofit services exist for low-income taxpayers, often tailored to specific demographic groups. One example is AARP's Tax-Aide program,[96] which provides free tax assistance and preparation for low- and moderate-income filers, and is intended mainly for people age 60 and over.[97] Supporting such programs, and expanding the scope of some free tax assistance services to include moderate-income tax filers above the $54,000 threshold, are also strategies for improving IC tax compliance.

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[92] https://waysandmeans.house.gov/UploadedFiles/National_Community_Tax_Coalition728.pdf

[93] Jackie Lynn Coleman, 2011, Written Comments on Tax Preparation & Paid Preparer Regulation Submitted by the National Community Tax Coalition to the U.S. House Ways & Means Subcommittee on Oversight, https://www.irs.gov/individuals/free-tax-return-preparation-for-you-by-volunteers.

[94] An example is the Maryland CASH Campaign (http://mdcash.org). VITA sites were previously organized by a now-defunct organization called the National Community Tax Coalition, which disseminated best-practices and advocated for access to qualified tax assistance at the national level. The functions of this organization have been largely assumed by Prosperity Now's Taxpayer Opportunity Network, https://prosperitynow.org/get-involved/taxpayer-opportunity-network.

[95] IRS, 2017, "Applying for a VITA Grant," https://www.irs.gov/individuals/applying-for-a-vita-grant.

[96] AARP, 2018, "AARP Foundation Tax-Aide Program," https://www.aarp.org/money/taxes/aarp_taxaide/.

[97] Eileen Ambrose, 2014, "How to Get Free Help With Your Taxes: AARP Foundation Tax-Aide program assists millions in preparing their returns, https://www.aarp.org/money/taxes/info-2014/get-free-help-filing-your-taxes.html.

2D. Ensure adequate resources for tax enforcement

The U.S. tax collection system largely relies upon voluntary compliance. The vast majority of taxpayers honestly file their taxes to the best of their abilities and proceed on with their lives. The IRS estimates that 82 percent of all taxes owed are paid accurately and on time.[98] Other people with earned income do not fully comply with tax laws. Some may file tax returns with errors, either made by mistake or committed with intent to deceive, others may fail to file a required tax return, and still others may fail to actually pay the taxes they owe. Workers and businesses that fall into one of these three categories account for the other 18 percent of tax liability that remains uncollected, known as the "tax gap." Some of this gap is eventually collected through enforced payments, but even considering these late payments, the gap is still left at about 16 percent.

Despite this relatively high figure of one-sixth of all tax liability being left uncollected, only 0.6 percent of all tax returns are subject to audits by the IRS.[99] Among independent contractors with income between $25,000 and $100,000, 1.7 percent are identified for audit. The IRS's ability to conduct enforcement audits has diminished in recent years due to budget cuts. Since 2010, the IRS's budget has declined 17 percent in real terms, leading to a 14 percent cut in staff.[100] These cuts have severely curtailed the IRS's audit capabilities and, according to former IRS Commissioner John Koskinen, has led to a 30 percent reduction in revenue generated from audits.[101] From a budget perspective, this is unfortunate because it is estimated that every $1 invested in the IRS produces $4 in revenue.[102] From the perspective of tax compliance by ICs, it is also unfortunate because higher rates of audits are likely to identify more income on which taxes are owed, and therefore to generate higher Social Security benefits for the ICs who owe the taxes.

Among all individual tax return filers, ICs are some of the likeliest filers to be identified for audits.[103] The only groups among individual filers (i.e. non-corporate filers) that are more likely to experience an audit than sole proprietors are those with very high incomes (over $1 million) and international filers. Of the ICs who experience an audit, 95 percent are identified as having filed incorrectly.[104] Given the declining rates of audit enforcement and the high rates at which targeted ICs are identified as incorrectly filing their taxes, increased funding for the IRS's enforcement operations could have a positive impact on IC tax compliance and consequently Social Security coverage and benefits for these workers.

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[98] IRS, 2016, "Tax Gap Estimates for Tax Years 2008–2010."
[99] IRS, 2016, Internal Revenue Service Data Book, p. 21: https://www.irs.gov/pub/irs-soi/16databk.pdf.
[100] Chuck Marr and Cecile Murray, 2016, "IRS Funding Cuts Compromise Taxpayer Service and Weaken Enforcement," Center on Budget and Policy Priorities, https://www.cbpp.org/research/federal-tax/irs-funding-cuts-compromise-taxpayer-service-and-weaken-enforcement.
[101] IRS, 2015, "Prepared Remarks of Commissioner Koskinen before the AICPA," https://www.irs.gov/newsroom/prepared-remarks-of-commissioner-koskinen-before-the-aicpa.
[102] Ibid.
[103] IRS, 2016, Data Book, p. 21.
[104] This applies to the ICs with income between $25,000 and $100,000: ibid., p. 24.

3. Strengthen Requirements for Reporting IC Income

While directly withholding taxes owed is the surest way to achieve high rates of tax compliance, even a requirement for certain parties to report amounts paid without withholding can significantly reduce misreporting. When income is subject to little or no reporting requirements, the IRS estimates that 63 percent of that income is misreported. But when income is subject to reporting, as on the Form 1099 that many ICs may receive, misreporting decreases to 7 percent.[105]

3A. Require stronger reporting requirements from firms using IC labor

Under current law, businesses must report payments made for services if the total payments made to an individual during the year exceed $600.[106] The $600 threshold is calculated separately for each individual paid by the business. Most businesses required to report payments to ICs must use Form 1099-MISC.[107] Copies of the completed form stating the total amount of the payments are sent to the IRS and to the individual.

One way to improve tax compliance among workers with contract income would be to lower the dollar-amount threshold to trigger the requirement for payment reporting. ICs may perform work for many different firms throughout the year, each under different contracts, and each for relatively small amounts under $600. Firms using the labor of such ICs are not subject to any income reporting requirements for the workers who perform services for them.[108] Given that current computer technology allows companies to keep track of payments and to automatically generate income reports for contractors efficiently and inexpensively, the marginal added burden of requiring firms to report payments to ICs totaling less than $600 may be very low. This could be an especially relevant option for workers providing labor through the growing phenomenon of online piecework (or "crowd labor") such as Mechanical Turk. The benefit of this option could be substantially more robust income reporting for many ICs, especially those performing work on many relatively small-dollar contracts for many different firms throughout the year.

3B. Allow a standard business deduction for low-income ICs

Many ICs overreport their expenses, and many low-income ICs—unable to afford professional tax-filing assistance—are susceptible to making errors in complying with the complex tax-filing procedures for independent contractors. According to GAO, 73 percent of sole proprietors

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[105] IRS, 2016, "Tax Gap Estimates for Tax Years 2008–2010," p. 5. According to IRS Commissioner Koskinen, the types of income reporting included in the 7 percent figure include income reported on Form 1099. Quoted in Bruckner, 2016, "Shortchanged," p. 16.

[106] Individuals who use contract labor outside of a trade or business to perform services such as, for example, making repairs to their personal residence, are not required to report the payments.

[107] IRS, 2018, "About Form 1099-MISC, Miscellaneous Income," https://www.irs.gov/forms-pubs/about-form-1099-misc-miscellaneous-income.

[108] ICs accepting payment via credit card would be subject to different reporting requirements (though not from the contracting business itself). This procedure is described in detail below in section 3C.

misreport their expenses, mostly due to overreporting them.[109] By overstating expenses, ICs can reduce their taxes by lowering the amount of income subject to tax. One possible solution to this would be to allow low-income ICs to claim a standard business deduction in lieu of deducting itemized expenses.[110] Given that many ICs, particularly those working through online labor platforms, are confused about allowable deductions,[111] this option would simplify the process and cut down on the overstating of expenses. The standard business deduction could be structured as either a flat dollar amount or a percentage of gross receipts.[112] Such a system would inevitably have winners and losers, with some ICs receiving a larger deduction than they would have if they had itemized their expenses, and some ICs receiving a smaller deduction. The standard business deduction would have to be structured in such a way as to minimize these disparities. It could also be structured to apply only to workers with low incomes as a way to lower the cost of the deduction to government receipts, and to offer the highest benefit to low-income workers. The main advantage of this option for Social Security benefits would be to cut down on the extent of overreporting of expenses. To the extent that this option could achieve the goal of limiting the deductions for illegitimate expenses, the standard business deduction would increase Social Security benefits for ICs.

3C. Close or narrow the reporting gap for payments from online labor platforms

Current law requires businesses to report to the IRS using Form 1099-MISC the total annual payments made to an IC if the total annual payments are over $600. However, companies paying workers through an online labor platform are not subject to this reporting requirement. In fact, because of an unintended consequence of legislative drafting, the vast majority of them are not subject to any reporting requirements whatsoever on the income paid through online platforms.[113]

The Housing and Economic Recovery Act of 2008 created a new requirement for credit card companies and third-party payment processors (TPPPs) that was intended to increase reporting of electronic payments, thereby increasing tax compliance.[114] As a result, payments made using a credit card or TPPP are subject to reporting using Form 1099-K.[115] Examples of third-party

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[109] GAO, 2007, "Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance," GAO-07-1014, https://www.gao.gov/assets/270/265399.pdf.

[110] This option is a variation of a proposal made in Kathleen Delaney Thomas, 2017, "Taxing the Gig Economy," paper delivered at the 2017 New York University School of Law Tax Policy Colloquium, April 3, 2017, http://www.law.nyu.edu/sites/default/files/upload_documents/Taxing%20the%20Gig%20Economy_%20Thomas.pdf.

[111] Bruckner, 2016, "Shortchanged."

[111] Ibid.

[112] Ibid.

[113] The unintentionality of this "reporting hole" is described in Kelly Phillips Erb, 2014, "Credit Cards, The IRS, Form 1099-K And The $19,399 Reporting Hole," Forbes, August 29, 2014, https://www.forbes.com/sites/kellyphillipserb/2014/08/29/credit-cards-the-irs-form-1099-k-and-the-19399-reporting-hole/#5dc651661ae8.

[114] Public Law No. 110–289, Sec. 3091, codified at 26 U.S.C. §6050W.

[115] IRS, 2018, "Form 1099 K Reporting Requirements for Payment Settlement Entities," https://www.irs.gov/businesses/new-1099-k-reporting-requirements-for-payment-settlement-entities.

payment processors, officially referred to as "third party settlement organizations" in the authorizing legislation and the tax code,[116] are PayPal, Venmo, and Amazon (to the extent it facilitates sales on behalf of third-party sellers). Credit card companies are required to report all transactions made to a vendor or service provider, but TPPPs are subject to a *de minimis* reporting threshold.[117] A TPPP must report payments to a vendor or a service provider only when both of the following conditions are met: the total payments made in a year to a vendor or service provider exceed $20,000, and the total number of transactions to that vendor or service provider exceeds 200.[118]

During the process of adopting regulations to implement these new requirements pursuant to the 2008 law, the IRS received comments cautioning against requiring double reporting of payments using both Forms 1099-MISC and 1099-K.[119] In its proposed regulations for implementing the Form 1099-K reporting requirements, the IRS proposed that payments made through TPPPs be reportable on both Forms 1099-MISC and 1099-K in order to avoid the reporting gap for payments using a TPPP under $20,000 and 200 transactions. However, in the final regulations, the IRS decided to exempt payments using a TPPP from Form 1099-MISC reporting, and instead to allow the Form 1099-K reporting requirements to entirely supersede the Form 1099-MISC reporting requirements. As a result, the final regulations state that all transactions that are potentially reportable using Form 1099-K, including payments using a credit card and using a TPPP, are never reportable using Form 1099-MISC, even when payments using a TPPP fall below the *de minimis* threshold.[120]

The consequence of the final regulations is that any business that pays an IC less than $20,000 using a credit card or a TPPP such as Venmo or PayPal does not have to report the transaction. If a business paid the IC using cash or a banking check, the business would have to report payments totaling over $600 to the IC using Form 1099-MISC. Simply choosing to use a certain payment method instead of another absolves businesses of all reporting requirements below a high threshold. In theory, responsibility for reporting the payments should be taken up by the credit card company or TPPP. Indeed, if the IC accepts a direct credit card payment from the business, the credit card company is required to report all transactions, with no *de minimis* threshold.[121] But if the IC accepts payment using a TPPP, the TPPP only has to report the

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[116] 26 U.S.C. §6050W(b)(3).
[117] IRS, 2018, "General Instructions for Certain Information Returns," p. 24: https://www.irs.gov/pub/irs-pdf/i1099gi.pdf.
[118] 26 U.S.C. §6050W(e).
[119] See section on "Duplicate Reporting of the Same Transaction" in 75 FR 49821-49836, "Information Reporting for Payments Made in Settlement of Payment Card and Third Party Network Transactions," August 16, 2010, https://www.federalregister.gov/documents/2010/08/16/2010-20200/information-reporting-for-payments-made-in-settlement-of-payment-card-and-third-party-network. The requirement for payments to be reported on Form 1099-MISC is codified at 26 U.S.C. §6041. The requirement for payments to be reported on Form 1099-K is codified at 26 U.S.C. §6050W. The regulations refer to §§6041 and 6050W, but in this paper we refer to the form numbers rather than the code sections for simplicity and to maintain consistent usage throughout the rest of the paper.
[120] 26 C.F.R. §1.6041–1(a)(1)(iv). [https://www.gpo.gov/fdsys/pkg/CFR-2017-title26-vol15/pdf/CFR-2017-title26-vol15-sec1-6041-1.pdf]
[121] IRS, 2018, "General Instructions for Certain Information Returns," p. 24.

payment if the total payments exceed $20,000 and the number of discrete payments exceeds 200.

Uber and Lyft, the ride-sharing companies, have decided to use Form 1099-K to report payments to drivers instead of 1099-MISC.[122] A tacit implication of this decision is that the firms are setting themselves up as payment processors rather than transportation companies. The companies have vigorously defended against assertions that the drivers using their apps are employees.[123] By using Form 1099-K, the companies are further implying that they are not even engaging drivers as independent contractors to provide transportation services. Instead, the companies' use of Form 1099-K implies that the companies are merely serving as third-party payment processors, akin to Venmo or PayPal, accepting payments from one party and remitting a portion of those payments (after deducting a commission) to the drivers. By asserting this role as TPPPs, the companies have no obligation to report payments to a particular driver if the driver did not earn over $20,000 through the app and did not accept over 200 rides. Average yearly earnings from an online labor platform are about $6,400, meaning a significant portion of these workers are subject to no reporting requirements.[124] Lyft has chosen to adopt the $20,000/200 threshold and to not send tax forms to drivers under the threshold. Uber has chosen to voluntarily send Form 1099-K to all drivers regardless of their earnings or the number of rides they accepted.[125]

The reporting gap leads to problems. As discussed earlier, when income is subject to little or no reporting requirements, as are earnings below the $20,000/200 transaction threshold for TPPPs, the IRS estimates that, on an aggregate basis, 63 percent of that income is misreported. But when income is subject to reporting requirements, as is IC income over $600 reported on Form 1099-MISC, misreporting decreases to 7 percent.[126] One option would be to lower the $20,000/200 threshold for Form 1099-K reporting, or remove the threshold entirely as with Form 1099-K-reportable credit card transactions. This approach could increase tax compliance among ICs and increase Social Security coverage and benefits for these workers.

Another option would be to maintain the threshold as-is for bona-fide TPPPs such as PayPal and Venmo, but change the rules to disallow online labor platforms from using Form 1099-K.

[122] See the list of firms and the reporting tax forms they have chosen to use at the end of Kathleen Pender, 2015, "Here's Why Uber and Lyft Send Drivers Such Confusing Tax Forms," *SF Gate*, February 20, 2015, http://www.sfgate.com/business/networth/article/Here-s-why-Uber-and-Lyft-send-drivers-such-6092403.php.
[123] See, ex., *Bishop vs. Uber Technologies Inc* No. 37-2014-00037935-CU-PACTL (Cal. Super. Ct. Nov. 5, 2014).
[124] Farrell and Greig, 2016, "Paychecks, Paydays, and the Online Platform Economy."
[125] Pender, 2015, "Here's Why Uber and Lyft Send Drivers Such Confusing Tax Forms."
[126] IRS, 2016, "Tax Gap Estimates for Tax Years 2008–2010," p. 5.

4. Require Entities other than IC to Pay an Employer-Equivalent Share of Self-Employment Taxes

In order to mitigate some of the disparity in treatment between employees and ICs, and to lessen some of the pressures ICs face to underreport their income due to the high effective tax rate on labor from the self-employment tax, this set of proposals contains ways to facilitate the automatic collection of the employer's share of payroll taxes from entities other than the IC. These proposals differ from those that would merely facilitate automatic withholding because these would require companies, consumers, or the government to actually contribute the employer's share of Social Security contributions. Proposals for automatic withholding merely make it easier for IC's to remit their combined employee/employer contributions. But these proposals go further by actually assessing the employer-equivalent share of Social Security contributions on entities other than the IC.

4A. Require Social Security contributions by companies that use ICs

One option would be to require the hiring entity to contribute the same percentage of income to Social Security and Medicare on behalf of a worker regardless of the type of hiring arrangement utilized. In other words, if a hiring entity chose to engage a worker as an IC rather than an employee, it would still contribute the employer-equivalent share of self-employment taxes. A system such as this could be designed to levy a 7.65 percent surtax on contract payments for labor, and consequently to reduce the 15.3 percent Self Employment Tax imposed on workers with IC income to half of its current rate. While this appears to be a simple fix, it is easier said than done. Defining the circumstances under which the tax would be imposed and what constitutes labor for the purposes of the tax would be challenging. How would gross amounts paid to a contractor be bifurcated into payments for labor and for the costs of materials? Would the firm using the contract labor be allowed to deduct the worker's expenses (as the worker would do for her own half of the SET) before calculating the tax? Could the worker present an itemized bill differentiating between materials and labor?

While these are difficult questions, their complexity does not surpass that of many knotty distinctions already within the tax code. A requirement for U.S. companies that use contract labor to pay one-half of the worker's SET would equalize the cost of labor and help ensure the proper amount of Social Security contributions are made on behalf of the worker.

This option differs from the ones directly below because it would require only firms that are directly using the labor of ICs to make the contributions, whereas the proposals in the following sections 4B and C require other entities to make the contributions. 4B, for example, requires labor intermediaries to make Social Security contributions, but not "traditional" firms directly using the labor of ICs. Whether there is a meaningful difference between these entities (traditional firms and online platforms) is a contentious issue. However, we maintain the distinction here in order to broaden the scope of the policy options discussed in this paper. If online platforms are considered to be firms directly using the labor of ICs, then this option 4A would apply. If they are some other category passing through payments from consumers, then 4B would apply.

4B. Require entities that profit from the deployment of ICs' labor to contribute an employer-equivalent share of payroll taxes

This option would require companies that deploy ICs to provide labor to consumers to pay the employer share of Social Security contributions for those workers.

This proposal is structured to apply to app-based labor platforms, but could also apply to other firms that connect consumers directly to service providers such as home-care agencies. One likely consequence of this proposal, which would assess a 7.65 percent tax on the payments these platforms make to service providers, is that the platforms would pass on this cost to consumers in the form of higher service costs. From the perspective of classical economics, this cost should already be incorporated into the cost of the services. The reason is that the perfectly rational service provider would anticipate the tax liability due on labor and take that into account when deciding whether it is in his best interests to accept the offered contract for work. The independent decisions of thousands of other rational market actors would increase the cost of the service that would be required to entice an optimal number of workers to perform the service. The resulting service cost at the market equilibrium would provide an adequate payment amount for workers to cover the 15.3 percent SET that they owe on their income.

In reality, many ICs do not fully take into account the relatively high tax rate imposed on their labor during the working year, leading to financial hardship, tax avoidance, or tax debt.[127] While most independent workers have some sense that they will owe at least some tax at the end of the year, many are unaware of how much they will owe, or even fully understand the tax filing process.[128] As such, this proposal would likely increase the cost of app-based services by about 7.65 percent, representing the companies' passing on the cost to consumers.

A problem with this proposal, also addressed in the discussion of proposal 4A, is that the determination of the amount of the payroll tax to be paid will not be a straightforward calculation. Online platforms make payments to providers, whom the companies treat as independent contractors. As such, from the perspective of service providers (i.e., ICs), the payments made from the online platforms are gross receipts intended to cover all operating costs and taxes, plus profit in the form of their take-home pay. As a general rule of U.S. taxation, business expenses are not taxed, which means that, to maintain parity with labor from employment, expense deductions would have to be made from the amount paid to contractors before the 7.65 percent payroll tax is assessed on the company.

One way the correct amount of Social Security and Medicare contributions due from the entity facilitating payment to the IC could be determined is by requiring quarterly expense filings by the IC to the firm before the due date on which the firm must make the contributions. Another way would be to allow the IC to "bill" the firm for the correct amount of contributions at the

[127] Bruckner, 2016, "Shortchanged."
[128] Ibid. Also see section 2.

end of the year through some automatic process triggered by the filing of the worker's Schedule SC. A third way would be to require the firm to pay the contributions on the gross amount, but then allow for reimbursement to the firm after the IC's expense reconciliation at tax time. The goal would be to choose the option that minimizes administrative hassles for the firm while ensuring accurate contributions. Estimating these expense deductions could require extensive three-way reporting between the online platform, the service provider, and the IRS to ensure that expenses are legitimate, and that payments are made on the correct amount from the intermediary.

4C. Require end-users/consumers of services to contribute an employer-equivalent share of payroll taxes

Another policy option would be to pass on the employer-equivalent share of payroll taxes to the end-user or consumer of the service. This would be easiest to administer in cases where there is an intervening third party such as an online labor platform. When it is clear that a certain work arrangement involves a clear transaction occurring between a single firm and a single IC, as in option 4A, this option would not apply. This option differs from option 4A in that the employer's share of Social Security contributions was then assessed on a firm, whereas here the contributions are assessed on consumers. For-profit firms are often treated differently from consumers in the tax law in terms of their responsibilities towards ICs. For example, income reporting requirements such as those that use Form 1099 apply to firms that use ICs, but not to consumers who use ICs to perform tasks such as remodeling their homes.

One variation of this option would be to require only a portion of the contributions from the end-user or consumer of the service, while requiring the pass-through entity such as an online labor platform to contribute the remainder. In any case, the cost of the contributions paid by the end-user of the service (whether the full cost or shared with the pass-through entity) should be transparently displayed to users of the service in order to allow for proper remitting of the funds to Social Security and Medicare. The transparent allocation of these funds to Social Security and Medicare would also serve to remind consumers and workers of the contributory nature of these programs and the fact that they are benefits earned through work. In this way, the clear assessment of the contributions on consumers would function similar to FICA deductions on a worker's paycheck, which serves to remind the worker of her contributions to the program.

One example of such a system is the Black Car Fund in use in New York State. The Black Car Fund provides protection against the risk of work-related injury to ride-sharing drivers in the state. The system is akin to state-based workers' compensation systems. The mechanism that is used to impose the cost of the Black Car Fund on consumers (a small surcharge) could be adapted to assess the employer's share of the SET on consumers of services.

As discussed in option 4B, the cost of these contributions should already be incorporated into the cost of the services. But in fact many ICs do not fully take into account the relatively high tax rate imposed on their labor during the working year, which includes mandatory Social Security contributions. Requiring these costs to be transparently assessed on the amounts paid

to ICs by the users of that labor would ensure more robust Social Security coverage and benefits for ICs.

4D. Facilitate government subsidization of an employer-equivalent share of payroll taxes
A final option for funding the cost of the employer-equivalent share of payroll contributions for ICs would be for the government to subsidize the amount owed by ICs. For cost reasons, any realistic proposal in this regard would likely be targeted towards low-income ICs. Funds could be contributed from the General Fund of the federal government in the amount of the employer's share of the 15.3 percent SET, and these amounts transferred to the Social Security and Hospital Insurance Trust Funds. This option could also be combined with one or both of the options above. That is, the employer-equivalent share of the IC's SET could be funded by one or more of the following: the firm that profits from the deployment of the IC's labor, the individual or firm who is the end user of the IC's labor, and subsidies from the general fund.

There are policy rationales for proposals for government subsidization of IC Social Security contributions through transfers from the general fund.[129] The proposal would be targeted at low-income ICs, those least able to pay the regressive flat-rate payroll tax. One way the tax system currently helps ICs pay the tax is by allowing them to deduct the employer's share of the tax from their income for the purposes of calculating federal income tax liability. However, in a progressive tax system such as in the United States, the value of this tax deduction increases along with overall income, making the deduction more valuable for higher-income workers than for lower-income workers. For many low-income ICs, the deduction may have no effective value because they already face zero income-tax liability.[130] This proposal would be a way to make tax incentives between high- and low-income ICs more equal by zeroing out the flat 7.65 percent SET for very low-income ICs (all of whom with over $400 in income owe this tax), while retaining the deductibility of this tax for higher-income ICs. The employer's portion of the SET would be phased-in for ICs as income rises, and the taxpayer would be able to deduct the amount paid. For ICs in the part of the phase-out of the 7.65 percent SET, an equivalent amount to the amount not paid by the worker would be transferred from the general fund.

An international precedent for a general fund subsidy of public pensions for low-income self-employed can be found in Germany's artists and writers social insurance law. In this system, self-employed workers in the creative sector pay the employee half of contributions, firms

[129] The Earned Income Tax Credit already supplements the income of low-income workers, both ICs and traditional employees. This proposal would function on top of this existing support.
[130] Approximately 44 percent of tax filers have zero or negative income tax liability (Tax Policy Center, 2016, "Tax Units with Zero or Negative Income Tax Under Current Law, 2011-2026," T16-0121, http://www.taxpolicycenter.org/model-estimates/tax-units-zero-or-negative-income-tax-july-2016/t16-0121-tax-units-zero-or-negative). Part of the reason some of these filer have zero income tax liability could be because they are in fact already claiming the deduction of the employer's portion of the self-employment tax, though this single deduction is unlikely to be the deciding factor in bringing tax liability to zero for many taxpayers. Not all of the filers with zero income-tax liability have low income (Tax Policy Center, 2016, "Distribution of Tax Units That Pay No Individual Income Tax, By Expanded Cash Income Level, 2016," T16-0209, http://www.taxpolicycenter.org/model-estimates/tax-units-zero-or-negative-income-tax-liability-oct-2016/t16-0209-distribution-tax).

using their services pay roughly 30 percent of contributions on behalf of the worker, and the general fund pays the remaining 20 percent.[131]

One factor to consider is the extent to which this proposal shifts costs from firms using low-income ICs to other taxpayers. The allowance of government subsidization of Social Security contributions would further incentivize the use of ICs instead of employees, and low-income workers would have less reason to resist IC status as opposed to employee status. These are not insignificant concerns with these policy options, and must be weighed against their advantages.

5. Reduce the Disparity in the Cost of Employee versus Contract Labor

This set of policy options seeks to address the disparity in the cost of hiring employees versus ICs. Option 5A discusses the disparity from the perspective of workers, for whom contract labor receives favorable tax treatment compared with traditional employment as a result of legislation passed in 2017. 5B discusses the disparity in labor costs from the perspective of employers, who face lower costs when using the labor of workers as ICs rather than employees. Reducing the disparity in the cost of labor through employment and through contract jobs could reduce the incentive for firms to use ICs instead of employees and thereby limit the prevalence of independent contracting relative to employment.

5A. Equalize the tax treatment of worker income from employment and contract jobs
The tax reform legislation passed in 2017 known as the Tax Cuts and Jobs Act widened the disparity in the treatment of income from employment and from sole proprietorships.[132] Similar workers earning the same amount of income, one as an employee and one as an IC, will face different tax liabilities on that income. By creating a deduction for pass-through business income, the law allows ICs to deduct from taxable income 20 percent of their profit (after expenses) from contract work. The deduction is phased out for higher-income workers (those earning more than $157,500 in 2018) who work in fields such as health, accounting, law, and finance.[133]

Howard Gleckman of the Urban-Brookings Tax Policy Center considers this disparate treatment of the incomes of two similarly situated workers to be a violation of a central tenet of good tax

[131] Andri Juergensen, 2016, *Praxishandbuch Kuenstlersozialabgabe*, Kiel: Kunst Medien Recht.
[132] The formal title of the legislation was "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018" and was enrolled as Public Law No. 115-97.
[133] The full list of professions subject to the phase out are listed at 26 U.S.C. §1202(e)(3)(A). To illustrate the disparity the law creates between similarly situated ICs and employees, consider two unmarried workers who both earn a living in 2018 repairing roofs of residential buildings. One is an IC who receives $60,000 a year gross in contract income, and the other is an employee who is paid a $60,000 annual salary with no benefits. Assume for simplicity that the IC has no expenses, meaning that his net income from his contract work is $60,000. The IC will be able to deduct $12,000 from his income in determining his taxes owed, reducing his tax bill compared to the amount owed by the employee, who is not eligible for the deduction.

policy, "that taxpayers with similar situations should be treated similarly."[134] This disparate treatment of equal income may serve as an incentive for workers to accept IC status rather than employment status in order to take advantage of the short-term benefit of a lower tax liability. In return, however, these workers will trade off the many rights and benefits of employment status, including social insurance protections and other benefits that help them build a more secure retirement. Accepting IC status is also likely to lead to higher rates of tax non-compliance, which, as was discussed above in section 2, leads to lower Social Security coverage and benefits.

5B. Enact tax incentives for companies to use labor through employment rather than contracts
Because it costs less to hire workers as ICs than as employees, firms face an incentive to engage ICs. The rationale for implementing tax incentives for employment is that employment provides greater economic security for workers, which is in the public interest. It follows that mitigating the competitive disadvantage faced by firms engaging employees (rather than contractors) is in the public interest as well. The cost in terms of reduced government receipts of the tax incentives discussed here would be borne by taxpayers overall under the theory that employment offers benefits to workers that rise to the level of a public good worthy of being subsidized by the public, whereas the lack of benefits afforded to ICs amount to a shared public cost that should be offset by relatively higher taxes paid by firms that use the labor of ICs without employment benefits.

One way these incentives could be structured is by offering a tax credit worth a certain percentage of the amount paid to employees. Businesses already exclude wages from their taxable income as part of normal operating expenses, but this credit would reduce overall taxes owed on that profit in the form of a credit. The amount of the credit could be calculated as a percent of wages paid to an individual employee up to a cap, and be available on a per-employee basis up to a maximum number of employees. For example, the proposal could be designed to offer a credit worth 2 percent of a worker's annual wages up to a cap on the value of the credit of $300 and available for a maximum of 24 full-time or full-time equivalent (FTE) employees. Low-wage workers are often the ones most at risk of being involuntarily classified as ICs, and have the most to lose from such a classification.[135] Thus, the credit would be most valuable to employers using low-wage work and therefore incentivize those firms to hire employees rather than to use the labor of ICs. This structure would also target the credit to the smallest employers (those with fewer than 25 employees[136]), for which it would have the

[134] The article comments upon the Senate version of the legislation, which was subsequently amended before final passage. The Senate version provided for a 23 percent deduction of pass-through income compared to the 20 percent deduction in the final bill. The underlying point about good tax policy still stands (Howard Gleckman, 2017, "The Senate's Tax Bill Would Cut Taxes Three Times More For Business Owners Than Workers," tax Policy Center, http://www.taxpolicycenter.org/taxvox/senates-tax-bill-would-cut-taxes-three-times-more-business-owners-workers).
[135] National Employment Law Project, 2010, "1099'd: Misclassification of Employees as 'Independent Contractors,'" http://www.nelp.org/content/uploads/2015/03/1099edFactSheet2010.pdf.
[136] A precedent for defining small businesses as those with fewer than 25 full-time equivalent employees can be found in the Small Business Health Care Tax Credit, which is available to businesses with fewer than 25 full-time equivalent employees (IRS, 2018, "Small Business Health Care Tax Credit and the SHOP Marketplace,"

greatest relative value. Larger employers could claim the credit, but only up to 24 FTE employees. The credit would not be available on the amount paid for contract labor, thereby offsetting part of the cost of Social Security contributions for firms that use employees, and serving as an incentive to hire employees.

Another structure for tax incentives for hiring employees rather than using ICs could take the form of allowing firms to deduct only a portion of the cost of amounts paid to ICs, but to allow the continued deduction as a business expense of the entire amount paid to employees and for employee benefits. For example, the tax code could be amended to allow businesses to deduct only 50 percent of the amount paid to ICs as a business expense, instead of the 100 percent deductibility of employees' wages. Nearly all costs of doing business are deductible, but there are exceptions. For example, year-end gifts to build good will with entities with which a firm conducts business are subject to strict monetary limits, even though the gifts may make good business sense.[137] Fines and penalties paid to governments as a result of business activity are also not deductible.[138] In addition, there is precedent for limiting the deductibility of certain legitimate business expenses. The most famous example are meals with clients, which may indeed be legitimate expenses to further one's business, but only half of the costs of which are deductible. An example of a limit on deductions to further a policy goal, as would be the case with the option discussed here, was a 2016 congressional proposal to prohibit U.S. firms from deducting the cost of imported goods, while continuing to allow the deductibility of domestic goods.[139] The proposal was an effort to encourage firms to buy American goods, thereby in theory spurring domestic economic activity. While the proposal was not ultimately passed in legislation, it does represent a serious proposal for limiting business expenses to further a policy goal. Similarly, this policy option of limiting deductibility of payments to ICs at, for example, 50 percent of the cost of the labor, would encourage the use of labor performed by employees rather than ICs, and mitigate the competitive disadvantage currently experienced by high-road employers.

6. Improve IC's Overall Financial Security

This final set of proposals contains two options for improving the financial security of ICs through mechanisms relevant to the topic of this paper. While the focus of the paper is on Social Security, it is worth mentioning the larger context of financial and retirement security of

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https://www.irs.gov/affordable-care-act/employers/small-business-health-care-tax-credit-and-the-shop-marketplace.)

[137] IRS, 2017, "Travel, Entertainment, Gift, and Car Expenses," Publication 463, https://www.irs.gov/publications/p463.

[138] IRS, 2017, "Business Expenses," Publication 535, https://www.irs.gov/publications/p535#en_US_2016_publink1000209207.

[139] This proposal was known as the "border-adjusted tax" and was part of a tax reform blueprint submitted in the House of Representatives (Mark J. Mazur, 2017, "What Is a Border-Adjusted Tax?" http://www.taxpolicycenter.org/publications/what-border-adjusted-tax/full). The proposal received serious discussion, but was not part of the tax reform bill known as the Tax Cuts and Jobs Act that was ultimately signed into law in 2017 (formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", Public Law No. 115-97).

ICs. Portable benefits for workers are widely discussed and could be one way to help ICs achieve greater financial security in addition to Social Security. As such, we briefly discuss this policy option in 6A. Second, given that many of the proposals above have involved the restoration of ICs' full tax responsibilities, thereby increasing their taxes relative to the understated amount they are currently paying, it is reasonable to also consider proposals that may loosen certain tax requirements for ICs in ways that could improve their financial security while still not lowering Social Security contributions. As such, we discuss options to reform the system of quarterly tax payments for ICs to better take into account ICs' current ability to pay.

6A. Require firms to contribute to portable benefits for ICs

A number of such portable-benefit proposals have been made,[140] and do offer a certain level of economic security to the beneficiaries of them, at least compared to nothing at all.[141] Yet portable benefits are not a substitute for social insurance programs. The costs of experiencing a work-limiting disability or a spell of unemployment are likely to exceed to funds an individual worker could have accumulated in an individual account. Portable benefit programs may best be employed in supplementing social insurance protections for ICs rather than filling the gaps of social insurance coverage.

One proposal would be to require companies to contribute to a new system of prorated portable retirement (and other employment) benefits for ICs. This option would go beyond merely enabling workers to contribute to a portable benefits fund and instead requires firms to make contributions to these accounts. In addition to the benefit of providing limited employment benefits to ICs, this option would confer the added benefit of reducing the disparity in the cost of labor between employees and ICs.

6B. Allow ICs to participate in state-facilitated retirement savings plans

Ten states have passed legislation to establish state-facilitated retirement savings programs. Five of these structured their plans to require employers to auto-enroll their employees into a payroll-deduction IRA.[142] These auto-enrolled IRA programs prohibit employer contributions.[143] In addition, New York chose to adopt an auto-enrolled IRA that is voluntary as to employer participation. Two states established marketplaces for retirement savings vehicles (New Jersey and Washington) to facilitate employers' establishment of their own plans. And two set up state-run Multiple Employer Plans (MEPs; Massachusetts and Vermont), which have the

[140] The Aspen Institute, 2018, "Portable Benefits," https://www.aspeninstitute.org/programs/future-of-work/portable-benefits/; Nick Hanauer and David Rolf, 2017, "Portable Benefits for an Insecure Workforce," *The American Prospect*, February 23, 2017, http://prospect.org/article/portable-benefits-insecure-workforce.

[141] Shayna Strom and Mark Schmitt, 2016, "Protecting Workers in a Patchwork Economy," The Century Foundation, https://tcf.org/content/report/protecting-workers-patchwork-economy/.

[142] The states are California, Connecticut, Illinois, Maryland, and Oregon (Georgetown Center for Retirement Initiatives, "State Initiatives 2018: New Programs Begin Implementation While Others Consider Action," https://cri.georgetown.edu/states/).

[143] These state programs do not permit employer contributions in order to avoid being treated as employee pension plans covered by the Employee Retirement Income Security Act of 1974 (ERISA).

advantage of permitting employer contributions. Some of these design options permit ICs to opt in to the program, while others exclude them. Ensuring that ICs are permitted to participate in these programs and plans, either on an auto-enrollment or an opt-in basis, would provide a starting place for greater retirement security.[144]

6C. Reform the system of quarterly tax payments for ICs

The requirement to make quarterly tax payments is perhaps the most misunderstood aspect of taxes among ICs.[145] This misunderstanding can lead to underpayments and tax penalties. There is evidence that penalties for failing to file quarterly taxes discourage some workers from filing any taxes at all. One attorney in the IRS's Office of Chief Counsel has stated that, upon discovering the extent of their tax liability including penalties for the previous year's missed quarterly tax payments and the next year's first quarterly tax payment (due at tax time for the previous tax year in April), some people "just walk away and don't file."[146] Reforming the system of quarterly tax payments could help ICs by reducing potential tax penalties and by increasing overall compliance among some discouraged taxpayers.

One option would be to shield low-income IC's from penalties relating to quarterly tax payments. ICs with income over about $6,500[147] are required to pay taxes in quarterly installments, known as estimated tax payments.[148] Failure to make required quarterly payments may result in tax penalties. Penalties are assessed for missed estimated quarterly payments, late payments, or underpayments. Depending on how late a payment is, a penalty for a missed quarterly tax payment could be as high as 4 percent of the amount owed.[149] This means that an IC with $30,000 in net income and who does not make any quarterly tax payments in a year could owe about $152 in tax penalties at tax time, on top of the $6,771 owed in taxes.[150] This may not seem like a substantial sum, but for a low-income worker making

[144] The Obama Administration proposed expanding the availability of MEPs in a manner in which "certain nonprofits and other intermediaries [would] be able to create plans for contractors and other self-employed individuals who don't have access to a plan at work" (The White House, Office of the Press Secretary, 2016, "Fact Sheet: Building a 21st Century Retirement System," January 26, 2016, https://obamawhitehouse.archives.gov/the-press-office/2016/01/26/fact-sheet-building-21st-century-retirement-system-0).

[145] A third of respondents to one survey of ICs using an online labor platform did not know whether they were subject to quarterly tax payments or not. Some had never heard of quarterly tax payments (Bruckner, 2016, "Shortchanged).

[146] Bruckner, 2016, "Shortchanged, p. 11.

[147] The rule is that quarterly tax payments are required if the taxpayer is expected to owe at least $1,000 in taxes for that year (IRS, 2018, "Estimated Taxes," https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes). Considering just self-employment taxes, which are assessed on all income up to a cap at a flat rate of 15.3 percent, about $1,000 would be owed on income of $6,500.

[148] IRS, 2018, "Estimated Taxes."

[149] IRS, 2017, "Instructions for Form 2210," https://www.irs.gov/pub/irs-pdf/i2210.pdf.

[150] The $6,771 includes $4,590 in self-employment taxes. Quarterly tax payments would be $1,524 (to equal the required 90 percent of total tax due at the end of the year). The tax penalty for the first quarter's missed payment would be 4 percent of that quarter's tax payment ($61), and for simplicity the penalties for the rest of the missed quarterly payments are calculated as declining by a fourth of this amount and added together ($61+$46+30+$15). See IRS, 2017, "Tax Withholding and Estimated Tax," Publication 505, https://www.irs.gov/pub/irs-pdf/p505.pdf; and IRS, 2017, Form 2210, https://www.irs.gov/pub/irs-pdf/f2210.pdf.

ends meet, a shock expense of $152 could be financially distressing. About half of households do not have $400 for an emergency expense to support their family, suggesting that a sum about a third this much in penalties alone would further reduce these households' abilities to provide for other needs.[151]

While quarterly tax payments are an important way to improve tax compliance by requiring equal payments throughout the year, they may be a hardship for some workers with volatile income. Large dips in income from month to month, which have been documented for many workers,[152] may reduce a household's ability to make required tax payments in a particular quarter, triggering tax penalties. Ensuring tax compliance among low-income ICs without imposing penalties could be a way to improve the overall financial health of many households. Coupling reduced or eliminated penalties relating to quarterly tax payments for low-income taxpayers with efforts to improve tax compliance among these workers (as discussed in section 2) is one option.

A second option would be to shield ICs with low and volatile incomes from the quarterly payment requirement. Current rules base the requirement to make quarterly tax payments on income alone. ICs with income over about $6,500 in income are required to make the payments.[153] This relatively low threshold captures many low-income taxpayers who may be less able to make the payments on time due to low or volatile incomes. One alternative to the current system based entirely on income would be to base the requirement for quarterly tax payments on a combination of income and volatility of income. The intention would be to target more highly-compensated and higher-skilled ICs, and those with more consistent incomes throughout the year. These are workers who would be better able to pay quarterly taxes, and also be more sophisticated in tax matters. Requiring such workers to make quarterly tax payments could ensure higher tax compliance throughout the year by maintaining engagement with the tax system. Lower-income workers with more volatile incomes could be exempt from the requirement to file quarterly taxes if their gross receipts from IC work in a particular quarter falls below a threshold, such as $10,000. This option would work best in conjunction with efforts to improve tax compliance among lower-income workers, particularly through automatic withholding, as discussed in section 2.

The advantages of proposals to reduce or eliminate quarterly tax-filing requirements for low-income ICs, in terms of reduced expense shocks and avoidance of volatility-induced inability to pay, must be weighed against concerns about the reduced tax compliance that could result.

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[151] Board of Governors of the Federal Reserve System, 2016, "Report on the Economic Well-Being of U.S. Households in 2015," https://www.federalreserve.gov/2015-report-economic-well-being-us-households-201605.pdf.

[152] Anthony Hannagan and Jonathan Morduch, 2015, "Income Gains and Month-to-Month Income Volatility: Household evidence from the US Financial Diaries," The U.S. Financial Diaries Project, http://www.usfinancialdiaries.org/paper-1/.

[153] The rule is that quarterly tax payments are required if the taxpayer is expected to owe at least $1,000 in taxes for that year (IRS, 2018, "Estimated Taxes"). Considering just self-employment taxes, which are assessed on all income up to a cap at a flat rate of 15.3 percent, about $1,000 would be owed on income of $6,500.

Conclusion

Independent contractors have long made up a significant share of the workforce. In recent decades, however, macroeconomic and technological dynamics such as the fissured workplace and the development of online intermediaries have given rise to a bourgeoning of heterogeneous independent contracting arrangements, many of which are disproportionately performed by workers earning low incomes. Moreover, the long-term trend has been towards a higher portion of the workforce earning income as ICs. Traditional methods of allocating, reporting, and paying self-employment taxes are in dire need of reform to accommodate IC work arrangements. The employer-equivalent share of self-employment taxes is a particular area of concern in light of the proliferation of pseudo-self-employment. For Social Security to more fully cover the total earnings of all ICs, reforms are needed. Such reforms could improve the accuracy and enforcement of worker classification, strengthen the tax compliance of ICs, broaden income reporting requirements, equalize incentives for firms to deploy labor as ICs versus employees, or find more creative ways to fund the employer-equivalent share of self-employment taxes.

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