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INDIVIDUALS AS "EMPLOYEES" OR "CONTRACTORS": WHY IT MATTERS WHAT YOU ARE CALLED WHEN IT COMES TO FEDERAL TAXES

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ABSTRACT

When we file federal taxes, our individual tax burdens are affected by whether our employers and the IRS classify us as "employees" or "contractors." Today, that distinction is not a neat one. Classifying workers as "employees" or "contractors" belies increasing similarities—like the ability to work remotely during the COVID-19 pandemic—between those classifications. With those increasing similarities in mind, this Note makes two arguments about the employee / contractor distinction in federal tax law. First, federal tax law draws an increasingly arbitrary and unfair line between employees and contractors given the modern substantive convergence of work done as an "employee" or a "contractor." And second, updating how this distinction is drawn and applied within federal tax law can better serve the purposes of the provisions that treat employees and contractors differently. While federal tax law is not alone in promulgating inequities surrounding this distinction, this Note chose to focus on federal tax law's application of the distinction for two reasons. Federal tax law already has tools it can use to shift workers toward one classification or another, so there is less need for a large legislative overhaul, which means it will not take as much to effect change. Also, shifting worker classification could help remedy problems currently facing federal tax law. As a result, federal tax law should be motivated by self-interest to acknowledge the similarities between employees and contractors today. With that motivation and the tools to effect change, federal tax law is the perfect area of law to start championing an updated application of the employee / contractor distinction which reflects the modern workforce. The law just needs a nudge in the right direction.

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I. INTRODUCTION

Federal tax law holds there is a difference between individual workers who are called employees and individual workers who are called contractors. Provisions of the Internal Revenue Code apply differently depending on which classification a worker receives. But today there is an increasingly dim line dividing workers that employers and the Internal Revenue Service consider to be "employees" or "contractors." Terms like "gig economy" and "freelancers" swirl in the national discourse, cases are litigated over the appropriate classification of workers like Uber drivers,[1] and the COVID-19 pandemic has forced a significant portion of the U.S. workforce to work from home—blurring a traditional difference in *where* employees and contractors typically work compared to one another. Other differences are dissipating, too. Today, there is an increasing substantive convergence between "employees" and "contractors" in terms of (1) flexibility of schedule and autonomy over completing work,[2] (2) number of payors,[3] and (3) the increasing legal uncertainty regarding accurately classifying a worker as one or the other.[4] In light of that convergence, this Note will consider

1. *E.g.*, *James v. Uber Techs. Inc.*, NO.19-cv-06462-EMC, 2021 WL 254303 (N.D. Cal. Jan. 26, 2021).

2. Katherine Lim et al., *Independent Contractors in the U.S.: New Trends from 15 Years of Administrative Tax Data*, 2-3 (I.R.S., Working Paper, 2019), https://www.irs.gov/pub/irs-soi/19rpindcontractorinus.pdf (also noting that "individuals who are contractors might incorrectly identify themselves as employees due to the often similar nature of their relationship with a firm").

3. Brett Collins et al., *Is Gig Work Replacing Traditional Employment? Evidence from Two Decades of Tax Returns* 14 (I.R.S., Working Paper, 2019), https://www.irs.gov/pub/irs-soi/19rpgigworkreplacingtraditionalemployment.pdf (noting that "it is no more common for wage earners to be tied to a single employer than it is for contractors to be tied to a single payer firm").

4. *See* Lim et al., *supra* note 2, at 3 n.2-4.

whether it is desirable for the federal tax provisions that treat employees and contractors differently to continue to do so given indicia of the purposes for which those sections were enacted.[5] This Note's two main arguments are that (1) federal tax law draws an increasingly arbitrary and unfair line between employees and contractors given the modern substantive convergence of work done as an "employee" or a "contractor"; and (2) updating how the distinction is drawn and applied can better serve the purposes of the federal tax provisions that treat employees and contractors differently.

Before this Note dives into that analysis, it believes that comparing the ordinary definitions of "employee" and "contractor" with the way federal tax law defines those terms will help provide some general context for understanding why federal tax law may have decided to treat employees and contractors differently.

In terms of ordinary meaning, "employee" means "one employed by another usually for wages or salary and in a position below the executive level."[6] And "contractor" means "one that contracts to perform work . . . ."[7] The difference between the ordinary definitions of the terms focuses on the regularity of payment rather than the method of agreement to provide services or the structure of the work relationship.[8] Federal tax law also cares about the regularity of payments, but bases its distinction more so on the relationship structure between an employer and a worker.[9]

For federal tax purposes, a worker is considered an "employee" if they have "the status of an employee under the usual common law rules applicable in determining the employer-employee relationship."[10] The usual common law rules applicable for that determination in the context of federal tax law yield an aptly named multifactor balancing test that focuses on the amount of control an

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5. This Note will refer to such purposes as *the* purposes for which the provisions were enacted. However, this Note wanted to use the phrase "indicia of purposes" at the beginning here to acknowledge all the inherent difficulties in discerning legislative purpose. Namely, difficulties regarding aggregation (whether we can say there was a legislative consensus on the reason for passing these provisions) and attribution (whether we can attribute the statement of one legislator to the majority that enacted the provision). Despite those difficulties, this Note believes the sources it relies on in search of the purposes for enacting these provisions are sufficiently reliable to support this Note's argument that such indicia of purposes do indeed reveal *the* purposes for which the provisions were enacted.

6. *Employee*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/employee (last visited Feb. 11, 2021).

7. *Contractor*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/contractor (last visited Feb. 11, 2021).

8. For while all "employees" are "contractors" in the ordinary sense given that employees execute a contract with their employer to gain employment, "contractors" contracting to perform work (i.e., specific projects) do not receive wages or salary, which have a connotation of payment at regular intervals. *See Wage*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/wage (last visited Feb. 11, 2021); *see Salary*, MERRIAM-WEBSTER, https://www.merriam-webster.com/dictionary/salary (last visited Feb. 11, 2011).

9. *See* Shu-Yi Oei & Diane M. Ring, *Tax Law's Workplace Shift*, 100 B.U. L. REV. 651, 683-84 (2020).

10. Rev. Rul. 87-41, 1987-1 C.B. 296.

employer has over a worker: the "common law control test."[11] Specifically, federal tax law employs a non-exhaustive list of twenty factors to distinguish employees from contractors.[12] The general gist of the factors is that if a worker is subject to an employer's control in both (1) what gets done and (2) *how* that gets done, they will typically be considered an employee for federal tax purposes.[13]

That said, given the vastness of the multifactor balancing test for this distinction, there is, perhaps predictably, leeway surrounding which classification a worker will receive. This Note believes such leeway is worth highlighting because it shows that federal tax law already has tools that can help it bring more workers into one classification or the other if doing so would better serve the purposes of the provisions that currently treat the two classifications differently. Among the most prominent contributors for such leeway are (1) Section 530 of the Revenue Act of 1978, which is a safe harbor provision that permits an employer to classify a worker as a contractor as long as they have treated the worker as such, and a "reasonable basis" exists for such treatment;[14] and (2) the IRS training materials regarding this distinction acknowledging that "the relative importance and weight of the twenty common law factors can vary significantly."[15] But to determine whether federal tax law may want to employ those tools to treat workers more as employees or contractors under certain

11. Oei & Ring, *supra* note 9, at 684 (noting that in embracing the common law control test, the federal income tax rejected the "economic realities test," which is another test recognized in the context of federal regulation for distinguishing employees from contractors).

12. Rev. Rul. 87-41, *supra* note 10 (identifying the twenty factors as (1) instructions; (2) training; (3) integration; (4) services rendered personally; (5) hiring, supervising, and paying assistants; (6) continuing relationship; (7) set hours of work; (8) full time required; (9) doing work on employer's premises; (10) order or sequence set; (11) oral or written reports; (12) payment by hour, week, month; (13) payment of business and/or traveling expenses; (14) furnishing of tools or materials; (15) significant investment; (16) realization of profit or loss; (17) working for more than one firm at a time; (18) making service available to the general public; (19) right to discharge; and (20) right to terminate); WILLIAM HAYS WEISSMAN, SECTION 530: ITS HISTORY AND APPLICATION IN LIGHT OF THE FEDERAL DEFINITION OF THE EMPLOYER-EMPLOYEE RELATIONSHIP FOR FEDERAL TAX PURPOSES 4 (National Ass'n of Tax Reporting and Professional Management Feb. 28, 2009).

13. Oei & Ring, *supra* note 9, at 684. For example, if worker A is told by employer B to create a report by calling persons C, D, and E, substantiating those interviews with research from a certain database, formatting the report in accordance with training worker A received from the employer, and to have it on a boss' desk by Monday morning, worker A would probably be considered an employee for federal tax purposes. Conversely, if worker A was merely told to have a report on a boss' desk by Monday morning, worker A would probably be considered a contractor for federal tax purposes. This example intends to show that if the employer controls the *results* but not the *way* in which the work gets done, the worker will typically be considered a contractor for federal tax purposes.

14. *See* Weissman, *supra* note 12, at 6.

15. IRS, *Independent Contractor or Employee? Training Materials*, DEP'T OF THE TREASURY, at 2-4 (Oct. 30, 1996), https://www.irs.gov/pub/irs-utl/emporind.pdf. That said, the training materials do clarify that evidence that can be most persuasive can be categorized within three categories: (1) behavioral control, (2) financial control, and (3) relationship of the parties. However, only the "presence or absence of instructions and training on how work is to be done" is signaled among all the factors as ones that are especially relevant. *Id.* at 2-32.

provisions of the I.R.C., we first need to understand *how* exactly federal taxes treat employees and contractors differently.

Part II of this Note will do so, identifying five prominent ways in which the federal taxes treat employees differently than contractors. Specifically, it will highlight differences regarding (1) Social Security, Medicare, and unemployment payroll taxes; (2) federal income tax withholding, (3) contractors being considered businesses and business deductions; (4) the exclusion of certain work benefits from taxable income; and (5) section 199A, introduced by the 2017 Tax Cuts and Jobs Act (TCJA), which provides a 20 percent deduction for qualified business income eligible to contractors but not employees. Part II will conclude with a summary of the differences, purposes, recommendations regarding this distinct treatment, and statements about whether it is more advantageous to be classified as one type of worker or the other for each subpart. Part III will apply Part II's takeaways by briefly analyzing scholarly proposed tax reform regarding the disparate treatment of employees and contractors; namely Kathleen DeLaney Thomas' proposed (1) "non-employee withholding" on earnings paid out by online platform companies like Uber; and (2) "standard business deduction" for gig workers.[16] Part IV concludes.

II. FEDERAL TAX DIFFERENCES FOR EMPLOYEES AND CONTRACTORS

Each subsection in this Part will adhere to a uniform order of analysis. First, this Note will present how each aspect of federal tax law currently treats employees and contractors differently. To help illustrate the difference in each subsection, this Note will use two characters who will remain with us throughout the analysis: "Employee" and "Contractor," who are single taxpayers who both generated $100,000 of value as a result of their work in the 2020 taxable year. Second, this Note will investigate the purposes Congress sought to pursue by enacting these provisions. Lastly, this Note will analyze whether such purposes would be better served today if (1) all workers were treated like employees; or (2) all workers were treated like contractors. In doing so, this Note will identify problems arising with such potential changes and propose a desirable shift toward one classification or the other, if appropriate.

A. *Social Security, Medicare, and Unemployment Taxes*

Both employees and contractors must pay payroll taxes that support Social Security and Medicare. For employees, these taxes are collectively referred to as Federal Insurance Contributions Act (FICA) taxes.[17] For contractors, these taxes are called Self-Employment Contribution Act of 1954 (SECA) taxes.[18] The

16. Kathleen DeLaney Thomas, *Taxing the Gig Economy*, 166 U. PA. L. REV. 1415, 1418 (2018).

17. Oei & Ring, *supra* note 9, at 670.

18. *Id.*

difference in the way these payroll taxes apply to employees and contractors is seen in *who pays* these taxes, and *how much each classification of worker pays*. Both employees and contractors incur a total tax of 12.4% of their pay to support Social Security and a total tax of 2.9% of their pay to fund Medicare.[19] However, employees nominally split these taxes with their employers, where both the employee and employer are responsible for paying half of the total amount owed for these taxes.[20] Additionally, employers handle all the reporting and payment obligations of these taxes for their employees.[21] Contractors, on the other hand, are responsible for paying the entirety of these taxes by themselves and for reporting that amount to the IRS[22] So, these taxes impose different substantive and procedural obligations for a worker depending on if they are classified as an employee or a contractor. The last wrinkle is that employers who hire employees are subject to an additional payroll tax—the Federal Unemployment Tax Act (FUTA) tax[23]—which imposes a "payroll tax equal to 6% of the first $7,000 in wages."[24] However, employers can decrease their FUTA tax liability to 0.6% by paying a sufficient amount into state unemployment funds.[25] Conversely, employers that hire contractors are not subject to paying FUTA taxes for that worker. Therefore, employees subject their employers to greater tax liability than contractors do just by the nature of the worker classification.

The additional tax liability incurred by employers who hire employees rather than hiring contractors should, in theory, factor into how much each worker is paid given the value their work generates. For the purposes of this Note, we will assume market forces only contemplate (1) the value of the work that our characters (Employee and Contractor) generate; and (2) the additional FICA and FUTA tax liability imposed on employers who hire an employee. Therefore, while Contractor will be paid $100,000 for the $100,000 of value their work

19. *See* I.R.C. § 3101(a), (b) (establishing a 6.2% tax on an employee's wages under (a) to help fund Social Security and a 1.45% tax on an employee's wages under (b) to help fund Medicare); *see also* I.R.C. § 3111(a), (b) (establishing another 6.2% and 1.45% tax, respectively, on an employee's wages that must be paid by the employer, bringing the total to 12.4% for Social Security taxes and 2.9% for Medicare taxes); *see also* I.R.C. § 1401 (establishing the same total taxes on self-employment income, which is how contractors pay these taxes); *but see Contribution and Benefit Base*, SOC. SEC. ADMIN., (https://www.ssa.gov/oact/COLA/cbb.html) (limiting the 12.4% for Social Security tax to the first $137,700 of wages in 2020). There is no such comparable limit for the 2.9% for Medicare taxes.

20. *Compare* I.R.C. § 3101, *with* I.R.C. § 3111.

21. *See* Oei & Ring, *supra* note 9, at 670.

22. I.R.C. § 1401; *see also* Oei & Ring, *supra* note 9, at 670-71.

23. I.R.C. § 3301.

24. Oei & Ring, *supra* note 9, at 671.

25. *Id.* ("The unemployment insurance system is a unified federal-state system and unemployment taxes are paid at the state and federal levels. Employers can claim a credit of up to 5.4% against their federal FUTA tax liability for amounts paid to state unemployment funds ('SUTA' taxes), thereby reducing their federal FUTA tax to 0.6%.").

generates, Employee will only be paid about $92,380[26] by their employer for the same $100,000 value as a result of their employer having to cover $5,728 in Social Security tax,[27] $1,340 in Medicare tax,[28] and $554 in FUTA tax (assuming they reduce their FUTA tax liability as low as they can).[29] Going forward in this Note, we will thus operate with the understanding that Employee has $92,380 of income while Contractor has $100,000 of income, despite both producing the same value for their work.

Employee would owe the same amount as their employer for Social Security and Medicare taxes.[30] That sum of $7,068 for Employee's FICA taxes would be withheld and paid by Employee's employer on behalf of Employee while the employer would also pay that *same* amount again to cover *its* share of FICA tax liability.[31] Contractor, on the other hand, would owe $12,400 in Social Security tax[32] and $2,900 in Medicare tax.[33] Contractor would see what they owe in total for SECA taxes ($15,300) come into their pocket as they collect their $100,000 of income, but would have to report and pay in full their SECA tax liability when they file their tax return.

Despite generating the same value from their work ($100,000) and incurring the same tax liability in terms of percentages for their FICA and SECA taxes, respectively, the *way* these payroll taxes treat employees and contractors differently results in Contractor paying $1,164 *more* in SECA taxes than Employee and Employee's employer end up paying in total FICA taxes.[34] Now, if we also take into account the additional $554 in tax liability to which Employee will subject their employer due to FUTA tax, then the overall difference for these payroll taxes collected based on worker classification drops to about $610. While that amount (1) may seem insignificant given the overall income of the two

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26. Employee generates $100,000 of value, but only gets paid about $92,392 because the employer will be required to pay 7.65% in payroll taxes and 0.6% for FUTA tax (assuming employer is able to take the maximum tax credit for payment into state unemployment programs). The math, where X is Employee's salary, is: X + (0.0765+0.006)X = $100,000, which then results in X amounting to about $92,380.

27. I.R.C. § 3111(a) (multiplying $92,380 by 0.062, which results in $5,727.56).

28. I.R.C. § 3111(b) (multiplying $92,380 by 0.0145, which results in $1,339.51).

29. *See* Oei & Ring, *supra* note 9, at 671 (explaining that employers can reduce their net FUTA tax liability to 0.6% if they pay enough into a state unemployment fund and claim up to a 5.4% credit against their FUTA tax liability, which, in this hypothetical, yields $554 as a result of multiplying $92,380 by 0.006).

30. I.R.C. § 3101(a), (b).

31. Oei & Ring, *supra* note 9, at 670; I.R.C. § 3111(a), (b).

32. I.R.C. § 1401(a) (imposing a 12.4% tax on Contractor's income. $100,000 multiplied by 12.4% = $12,400).

33. I.R.C. § 1401(b) (imposing a 2.9% tax on Contractor's income. $100,000 multiplied by 2.9% = $2,900).

34. Using the calculations above, this Note reaches the amount of $1,164 because Contractor's $15,300 in total SECA taxes exceeds the sum of (1) the $7,068 Employee ends up owing for their half of FICA taxes, and (2) that same amount ($7,068) Employee's employer ends up owing for its half of FICA taxes.

characters; and (2) may be slightly less or more depending on the exact economic forces exerted by the market in reality (the analysis of which is beyond the scope of this Note), the takeaway is that *there is a difference* regarding tax liability for these payroll taxes depending on *which classification* a worker receives. In terms of how much money ends up in Employee's and Contractor's pockets solely as a result of this difference, Employee will take home $85,312 (never seeing the $7,068 in FICA taxes they owe because that will be withheld by their Employer throughout their paychecks for that year) while Contractor will take home $84,700—a difference of $612 (with the $2 difference between this amount and the "about $610" referenced above explained by the rounding of numbers through these calculations). Whether that difference is significant enough to warrant a change in the way these payroll taxes currently apply to employees and contractors must be evaluated in light of the purpose for the distinct treatment.

The Federal Insurance Contributions Act was enacted to fund the Social Security program.[35] The Self-Employment Contributions Act of 1954 was enacted as an equitable measure to acquire a portion of self-employed income to fund that program just as the income of employees was doing because some self-employed workers had begun to receive Social Security benefits starting in 1950.[36] And when Medicare was established in 1965, FICA and SECA taxes were expanded to cover funding that program as well.[37]

These purposes reveal an attempt to make these taxes apply the *same* for each worker, regardless of whether that worker was considered an employee or a contractor. But as the analysis above shows, there is at least *some* difference in the amount employees and contractors end up paying for these payroll taxes. And given that there is a difference, there is at least a question of whether a shift in the Internal Revenue Code to treating all workers like employees or contractors for FICA or SECA tax purposes could better serve the aim of funding the Social Security and Medicare programs.

The Social Security and Medicare Boards of Trustees, in their summary of the 2020 annual reports on the status of the programs, acknowledged that "both face long-term financing shortfalls under currently scheduled benefits and financing."[38] More pointedly, the Trustees estimated that the reserves used to fund Social Security will be unable to pay scheduled benefits on a timely basis

35. *Compare, e.g.*, Social Security Amendments of 1958, Pub. L. No. 85-840, 72 Stat. 1013, 1041 (1958) (describing one "rate of tax" as 3.5% for the years 1963-65), *with* Social Security Amendments of 1958, Pub. L. No. 87-64, 75 Stat. 131, 139 (1961) (describing those same years as now have a rate of 3.675%).

36. PAUL BURNHAM, CONG. BUDGET OFF., PUB. NO. 4168, THE TAXATION OF CAPITAL AND LABOR THROUGH THE SELF-EMPLOYMENT TAX 1 (2012), https://www.cbo.gov/sites/default/files/cbofiles/attachments/09-27-SECA.pdf.

37. *See id.*

38. SOCIAL SECURITY AND MEDICARE BOARDS OF TRUSTEES, STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS, A SUMMARY OF THE 2020 ANNUAL REPORTS III (2020), https://www.ssa.gov/oact/TRSUM/tr20summary.pdf.

starting in 2035.[39] And the Trustees' estimates regarding Medicare triggered a "Medicare funding warning" for the third year in a row, noting that the "Hospital Insurance (HI) Trust Fund, which pays Medicare Part A inpatient hospital expenses, will be able to pay scheduled benefits until 2026," after which the reserves will be "depleted and continuing program income will be sufficient to pay [only] 90 percent of total scheduled benefits."[40] One way to potentially address these financing shortfalls could be to change the way in which these payroll taxes are collected from workers.

If all workers were treated like employees for Social Security and Medicare tax purposes, then any payor would be responsible for paying half of that worker's payroll taxes.[41] In theory, payors knowing that would then factor such tax liability into how much they would be willing to pay workers for a certain amount of value generated from that worker's work. We can see this at play in the context of this Note's hypothetical characters and its conception of the effect of market forces, where Employee's employer knew that they would (1) have to pay half of Employee's FICA taxes and (2) incur FUTA tax liability, leading the employer to pay Employee less overall. Employee got paid less than the value of the work they generated as a result. And getting paid fewer wages, in turn, *decreased* the amount of payroll taxes collected by Employee and their employer, all because of the way the Internal Revenue Code splits the method of payment of these taxes for employees. Given this conclusion, there might be a way to better serve the funding purpose of these payroll taxes: treat all workers like contractors.

If all workers were treated like contractors for Social Security and Medicare tax purposes, each worker would be on the hook for paying the full amount of these payroll taxes themselves.[42] In the analysis at the beginning of this section, we saw that Contractor was paid the full $100,000 of value their work generated, and as a result owed $15,300 in SECA taxes. This amount ended up being $1,164 *more* than what Employee and their employer paid in total. Now, this Note admits that market forces not considered in this Note will affect how much workers actually get paid for the value of their work, and that individual workers will have expenses which lower the wage base against which these payroll taxes are calculated (see subsection 3 in this Part). That means that outside of this sterile scholarly analysis, contractors that generate the same value of work as their employee counterparts will not *always* pay more in Social Security and Medicare taxes. But this analysis shows that, as a starting point, contractors are theoretically paying more in these payroll taxes than their employee counterparts are simply because of *how* the IRS collects these taxes.[43] And because of that, if

39. *Id.*

40. *Id.* at IV.

41. *See* I.R.C. § 3111(a).

42. I.R.C. § 1401(a), (b).

43. There are a whole host of other considerations here that are simply beyond the scope of this Note that affect this analysis. For instance, this difference will increase or decrease as the value

these payroll taxes were collected from workers as if they were contractors (i.e., the payors would not be responsible for paying half), then this change could help further the goal of these taxes: funding Social Security and Medicare.

However, there is one significant counterargument that likely would cut harshly against this treatment actually increasing funding for the Social Security and Medicare programs. The tax gap for contractors is significantly larger than it is for employers.[44] Given that, asking all workers to (1) make sure they save enough money to pay these taxes each year, and (2) keep track of how much they owe in these taxes could end up mitigating any gain toward funding these programs that could result from treating all workers as contractors for Social Security and Medicare tax purposes. The difference in the amount collected from each classification of worker in the analysis above is, admittedly, relatively negligible, and certainly subject to more market forces that are not considered in this Note. That means that while *theoretically* payroll taxes could pull in more revenue just by making all workers pay it all, like contractors already do, the revenue gap shows us that the *reality* of this change might end up exacerbating the funding worries for these programs.

Because of that counterargument, this Note argues that such a drastic shift to treating all workers like contractors for payroll tax purposes is unwarranted. That does not mean, however, that *any* change is unwarranted. Perhaps there is room for the Internal Revenue Code to treat *more* employees like contractors regarding payroll taxes for the purposes of getting more funding for the Social Security and Medicare programs—maybe focusing on workers with histories of sterling tax compliance. This would serve as a boon for those workers pulled in by this change because they would start seeing more money come into their pockets each paycheck (despite being earmarked to pay payroll taxes come tax filing season), thus giving them the time-value of that "extra" money. But that line-drawing is difficult, and the same worries about the revenue gap and compliance remain. This Note's aim is not to find the exact sweet spot regarding worker classification for payroll tax purposes, but to point out that the *way* in which these taxes are collected affects the *amount* that is collected, and because of that, there is a possibility change could beneficially serve the purpose of these provisions.

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of the worker increases or decreases, respectively (though in 2020, Social Security taxes are only calculated against the first $137,700 of wages; Medicare taxes don't have a cap). And this Note does not analyze whether employees or contractors get paid more, on average, which could also sway this section's analysis and recommendation. The point of the section is to just show that there is *some* difference, and that these sections of the I.R.C. could be altered to help address Social Security and Medicare's anticipated funding shortfalls.

44. INTERNAL REVENUE SERV., PUB. 1415, FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2011-2013, at 8 fig.1 (2019) [hereinafter *Tax Gap Estimates*] (https://www.irs.gov/pub/irs-pdf/p1415.pdf) (underreporting of SECA taxes was estimated to have contributed $45 billion to the tax gap while underreporting of FICA and unemployment taxes was estimated to have contributed only $24 billion to the tax gap).

B. *Federal Income Tax Withholding*

Employees have some of their wages withheld by their employer to cover what the employee will owe in federal income tax for a certain pay period.[45] The amount withheld depends on (1) the employee's wages; (2) their Form W-4, on which an employee identifies the withholding allowances to which they are entitled; and (3) tables promulgated each year by the Secretary of the Treasury.[46] Contractors, on the other hand, do not have any of their compensation withheld by their payors. Instead, contractors must make quarterly estimated income tax payments,[47] which comprise a rough approximation of the withholding scheme to which employees are subject. If contractors underpay their quarterly estimated income tax payments (which could happen by simply failing to make the payment at all), an additional tax is imposed on them.[48] To illustrate the effect of this distinct treatment, let us look at how federal income tax withholding affects (or does not affect) Employee and Contractor.

Employee, who is paid $92,380 in wages for the $100,000 of value their work generates would have $15,243 withheld by their employer over the course of the 2020 taxable year.[49] Contractor, who is not subject to federal income tax withholding, would have none withheld over the course of the 2020 taxable year. If Employee and Contractor both took the standard deduction and Contractor also took the deduction for half of their SECA tax liability[50] as the only ways of reducing their gross income,[51] Employee would owe $20,440,[52] and Contractor would owe $20,431[53] in federal income tax. Here, Employee's employer would

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45. I.R.C. § 3402(a).

46. I.R.C. § 3402(a)(1).

47. *See* I.R.C. § 6654(c).

48. I.R.C. § 6654(a); *but see* I.R.C. § 6654(e)(1) (exempting a contractor from this additional underpayment tax if the contractor owes less than $1,000 in federal income tax for that taxable year).

49. *See* Internal Revenue Serv., Pub. 15-T, Federal Income Tax Withholding Methods 6 (2020), https://www.irs.gov/pub/irs-pdf/p15t.pdf (using the tables for automated payroll systems and considering that $92,380 falls within the $90,325-$168,865 range, this amount is calculated as the sum of (1) the $14,750 to be withheld as an initial measure for an adjusted annual wage in that range; and (2) 24% of the amount Employee's adjusted annual wage ($92,380 here) exceeds $90,325, which here is $493.20).

50. *See* I.R.C. § 164(f)(1).

51. *See generally* I.R.C. § 63(c)(7)(A)(ii) (noting that there are special rules in place for taxable years 2018 through 2025 which increase the standard deduction for all taxpayers other than heads of households from the original amount of $3,000 as identified in (c)(2)(C) to $12,000). Contractor would also likely take the qualified business income deduction under I.R.C. § 199A, giving them a deduction for 20% of their net business income. But for simplicity's sake in this section, Contractor will only take the standard deduction and deduction for half of their SECA tax liability.

52. *See* I.R.C. § 1(c) (being applied to the $92,380 in wages minus the $12,000 standard deduction, which equals $80,380, and requires $20,439.80 of federal income tax, which is the result of (1) the $12,107 initially required for an adjusted taxable income in that range; plus (2) 31% of the amount by which $80,380 exceeds $53,500 (which is $26,880, 31% of which is $8,332.80)).

53. *See id.* (being applied to $100,000 of income minus the $12,000 standard deduction and $7,650 (half of Contractor's SECA tax liability), which equals $80,350 and requires $20,430.50 of federal income tax, which is the result of (1) the $12,107 initially required for an adjusted taxable

already have withheld $15,243 of that amount, leaving Employee on the hook for $5,197 when they file their 2020 tax return. If Contractor paid their estimated quarterly taxes, Contractor would owe somewhere between nothing and $2,043 to satisfy their federal income tax obligation for the 2020 taxable year.[54]

The current regime of federal income tax withholding was introduced by the Current Tax Payment Act of 1943.[55] The withholding was described as a "main feature" of the Act and focused primarily on increasing compliance in paying the federal income tax.[56] Compliance remains a big issue particularly affected by the employee / contractor distinction. The tax gap (the difference between the IRS' estimated total true tax liability and tax paid voluntarily and timely[57]) displays the practical effect of this distinction in action when it comes to compliance. Within the tax gap, the underreporting of individual income tax for business income—i.e., the classification for income of individuals working as contractors[58]—is the single largest category of noncompliance.[59] And for a direct comparison between contractors and employees, while not explicitly income tax withholding, underreporting of SECA tax is almost *double* what underreporting

income in that range; plus (2) 31% of the amount by which $80,350 exceeds $53,500 (which is $26,850, 31% of which is $8,323.50)).

54. *See* I.R.C. § 6654(d) (requiring that each estimated quarterly payment be 25 percent of the required annual payment, with (B) defining "required annual payment" as the lesser of 90 percent of the tax shown on the return for the taxable year or 100 percent of the tax shown on the return for the preceding taxable year. For the purposes of this Note, that means Contractor would have either paid 90% of what they owe in federal income tax already, leaving them with only $2,043.10 to pay, or, assuming that Contractor earned $100,000 last year as well, nothing to pay using the latter definition of "required annual payment").

55. Current Tax Payment Act of 1943, Pub. L. No. 78-68, § 1622, 57 Stat. 126, 128 (1943) (current version at I.R.C. § 3402).

56. RANDOLPH E. PAUL, *Taxation in the United States*, 330 (1954) (evincing that the Secretary of the Treasury at the time, Henry Morgenthau, Jr., stated that withholding was the "'best available expedient' to achieve a more convenient method for the payment of income taxes" and that such a system of "collection-at-the-source [was] necessary to the very existence of the income tax."). Additionally, Randolph E. Paul, who worked for the Treasury Department and played a large role in convincing Congress to enact withholding, championed such a regime's benefits in terms of ease, combatting inflation, and compliance. *See id.* at 331; *see also* INTERNAL REVENUE SERV., *The Tax Gap*, https://www.irs.gov/newsroom/the-tax-gap (Oct. 21, 2020) ("All initiatives by the IRS to improve tax collection are intended to narrow the tax gap and increase compliance.").

57. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1.

58. Collins et al., *supra* note 3, at 8 (noting that "self-employment income . . . is considered active business income by the IRS").

59. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1. While this 2019 report only addressed estimates of the tax gap for the 2011-2013 taxable years, the underreporting of individual income tax from business income has been the single largest category of noncompliance for decades. *See, e.g.*, INTERNAL REVENUE SERV., *Individual Income Tax Gap Estimates for 1985, 1988, and 1992*, at 8, tbl.3 (Apr. 1996).

of FICA and unemployment tax is,[60] which strongly suggests that withholding has a significant effect on increasing federal income tax compliance.

In light of the compliance purposes for federal income tax withholding, this Note will analyze whether treating all workers as employees or treating all workers as contractors would increase compliance. If all workers were treated like employees, then every employer would have to withhold a certain amount of what they pay each worker.[61] On its face, requiring employers to withhold a portion of a paycheck any time they pay a worker would increase compliance.[62] And increasing compliance is the exact purpose for which the federal income tax withholding provision was introduced.[63] Therefore, this treatment has significant advantages for federal income tax compliance. But there are disadvantages as well. Withholding a portion of what employers pay each worker requires employers to know *how much* to withhold because the correct amount to withhold changes based on that worker's gross income from *all* sources of income, not *just* what they are getting paid by *that* employer.[64] Therefore, treating all workers like employees for federal income tax withholding purposes raises issues concerning (1) estimation, (2) disclosure, and (3) increased administrative costs.

First, the worker will have to try to accurately estimate how much taxable income they will have in a current year and report that to each employer, even if they only work with that employer for one discrete project in the taxable year. This raises problems about over-withholding for estimates that are too high (privileging the government to the detriment of the taxpayer because the taxpayer loses the time-value of that money), or under-withholding for estimates that are too low (which undermines compliance, cutting against the very purpose for which Congress enacted the federal income tax withholding provision). Second, the worker will have to disclose the total amount of taxable income to every employer, which could raise issues related to the confidentiality of business strategy if that worker only does a certain amount of work for a limited number of employers, where comparison between each employer could become inevitable, leading to a certain employer gleaning insight about a competitor's business strategy. And third, each employer will have increased administrative costs because they would be required to (1) store, (2) analyze, and (3) maintain the confidentiality of a greater amount of information about each worker they pay, which could result in each employer paying each worker less for each project because funds that would otherwise go to the worker would be spent elsewhere.

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60. *Tax Gap Estimates*, *supra* note 44, at 8, fig.1 (Underreporting of SECA taxes was estimated to have contributed $45 billion to the tax gap while underreporting of FICA and unemployment taxes was estimated to have contributed only $24 billion to the tax gap).

61. I.R.C. § 3402(a).

62. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1 (depicting FICA and unemployment tax reporting, which applies to employees, as nearly twice as compliant as SECA tax reporting, which contractors pay).

63. *See* PAUL, *supra* note 56, at 330-31.

64. *See* I.R.C. § 3402(a)(1).

That said, there are counterarguments to each of these three disadvantages that should be addressed.

For estimation concerns, the federal income tax already requires contractors to file estimated quarterly taxes,[65] and understands that estimation will not always be perfect.[66] The argument would then run something like this: if the Internal Revenue Code deems inaccurate estimates acceptable for tax purposes, why would workers incorrectly estimating what they think their total taxable income will be raise a concern? To that counterargument, this Note has two responses. First, the amount of workers estimating their taxes would increase drastically, and the tax gap indicates that contractors are significantly less compliant in reporting the total tax they owe when compared to employees.[67] And second, while tax collection may be an imprecise science, the IRS would really like to collect what they are owed. Such an influx of taxpayers having to estimate total taxable income leading to withholding problems and subsequent compliance issues would likely pose an unmanageable mess for the Treasury to handle. The concerns relating to estimation are extreme—so much so that they on their own are arguably sufficiently prohibitive of treating all workers as employees for withholding purposes.

For disclosure concerns, the counterargument would be that the information disclosed to each employer would not allow each employer to glean insight into a competitor's business strategy because an estimation regarding taxable income on its own does not tell that employer how many other employers the worker has, and therefore the chances each employer could allocate a certain amount of the taxable income to a competitor are slim. This Note finds this counterargument persuasive for two reasons. First, it shows the concerns related to disclosure are not anywhere near the magnitude of the concerns relating to estimation. And second, chances are that if one employer is hiring a worker to do a project that a competitor would also hire that worker to do (as is the nature of contractor-type work), market forces would likely lead each employer to pay a similar amount. So, even to the extent that an employer could discern how much their competitors paid each worker, that information is likely available already. Therefore, this concern arguably is a minimal one that won't affect this Note's recommendation significantly.

Finally, for administrative cost concerns, the counterargument would be that, to the IRS, *where* it collects its tax revenue matters less than *whether* such revenue is collected, and because the companies would have to pay other companies for the increased data storage, analysis, and protection costs, those other companies

65. I.R.C. § 6654(c).

66. *See* I.R.C. § 6654(d)(1) (allowing each quarterly payment that ends up being 25% of only 90% of the tax shown on the return for the taxable year to still be considered the "required annual payment" for the purposes of estimated income tax payments).

67. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1 (pertinently pointing to (1) individual income tax for business income—i.e., the income of individuals working as contractors—as the largest category of noncompliance; and (2) SECA tax underreporting (owed by contractors) being nearly *double* that of FICA and unemployment tax reporting (owed by employees)).

will have more income as a result, leading to them paying more federal income tax and mitigating any decrease in income tax resulting from the actual workers being paid less. This Note finds this counterargument somewhat persuasive, but would note that, as of the 2017 Tax Cuts and Jobs Act, there is a *significant* difference in the tax rate for corporations compared to tax rates for individuals.[68] The corporate tax rate is a flat 21%,[69] whereas the individual tax rate is progressive, with a series of rates between 10% and 37%.[70] This means that if the administrative costs of treating all workers as employees for withholding purposes causes employers to pay corporations some money they would otherwise use to pay individual workers, then the amount of revenue collected could (1) increase if the workers were subject to a tax rate less than 21%, or (2) decrease if the workers were subject to a tax rate greater than 21%. Specific statistical analysis of just what that potential increase or decrease would be is beyond the scope of this Note. But it is enough for this Note's purposes to note that the increased administrative costs employers would incur if all workers were treated like employees for withholding purposes *could* result in an increase or decrease in total tax revenue collected. If it results in an increase, then not only is the compliance purpose of withholding served, but the government also gains more revenue based on employers changing *who* they pay. But if this results in a decrease of revenue, that decrease could effectively cancel out any additional revenue collected as a result of the higher level of compliance brought about by imposing withholding on payments to all workers.

To summarize, treating all workers like *employees* for withholding purposes results in the following. All employers would withhold a portion of what they pay a worker.[71] That would increase compliance.[72] Increasing compliance was the primary purpose for enacting the withholding provision.[73] Therefore, treating all workers like employees for withholding purposes would seem to serve purposes for which withholding was enacted, which suggests the income tax *should* change tax withholding treatment in this way. But there are drawbacks. Namely, (1) grave concerns resulting from workers having to estimate their total taxable income for each year and report that estimate to each of their employers; as well as (2) a lesser concern about disclosure requirements revealing private business strategies; and (3) moderate concerns about changes in the amount of revenue collected given increased administrative costs. On the whole, it is unclear whether treating all workers as employees for withholding purposes

68. *Compare* I.R.C. § 11(b) (establishing the corporate tax rate at 21%), *with* I.R.C. § 1(j)(2) (outlining a series of tax rates with 10% as the minimum and 37% as the maximum).

69. I.R.C. § 11(b).

70. I.R.C. § 1(j)(2).

71. I.R.C. § 3402(a).

72. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1 (depicting FICA and unemployment tax reporting, which applies to employees, as nearly twice as compliant as SECA tax reporting, which contractors pay).

73. *See* PAUL, *supra* note 56, at 330-31.

would serve the compliance purpose for which withholding was enacted any more than the current regime already serves such purpose. Therefore, we need to look at the converse: what does federal income tax withholding look like if we treat all workers as *contractors* for withholding purposes?

If all workers were treated like contractors, then every employer would not have to withhold the portion of that worker's federal income tax liability from each paycheck for that worker. On its face, failing to require employers to withhold a portion of a paycheck any time they pay a worker will decrease compliance.[74] And decreasing compliance directly contravenes the exact purpose for which the federal income tax withholding provision was introduced.[75] Therefore, this treatment cuts against federal income tax compliance. And unlike the nuance surrounding serving the compliance purpose if we treated all workers like employees, treating all workers as contractors for withholding purposes lacks any readily apparent advantages. The biggest piece of evidence supporting that assertion is the tax gap regarding income tax collected from employees being significantly less than the revenue gap collected from contractors.[76] That basically means that the IRS has higher levels of income tax compliance collecting from employees rather than contractors.[77] Given that, it is difficult to justify changing the withholding treatment in a way that directly opposes the purpose of the withholding provision without seeing any compliance advantages in such a change. Therefore, this Note concludes that treating all workers as contractors is *not* advisable in light of the withholding provision's purpose.

In conclusion, federal income tax withholding was implemented to increase compliance.[78] Treating all workers as employees for withholding purposes, while seemingly a good move for tax compliance on its face, has sufficient concerns that lead this Note to conclude that it is quite unclear whether such a change would advance the compliance purpose of withholding. And treating all workers as contractors for withholding purposes would decrease compliance, directly opposing the purpose of the withholding provision while offering no apparent compliance advantages. Therefore, this Note does not recommend either proposed change when it comes to the compliance purpose driving federal income tax withholding. That said, the compliance advantages on its face of treating *more, but not all* workers like employees for withholding purposes may be more desirable than the Internal Revenue Code's current treatment. But that depends on the effects of the concerns discussed above, and also raises issues regarding line-drawing in an attempt to treat *more* workers like employees for

74. *See Tax Gap Estimates*, *supra* note 44, at 8, fig.1 (pertinently pointing to (1) individual income tax for business income—i.e., the income of individuals working as contractors—as the largest category of noncompliance; and (2) SECA tax underreporting (owed by contractors) being nearly *double* that of FICA and unemployment tax reporting (owed by employees)).

75. *See* PAUL, *supra* note 56, at 330-31.

76. *Tax Gap Estimates*, *supra* note 44, at 8 (highlighting that SECA tax underreporting (owed by contractors) is nearly *double* that of FICA and unemployment tax reporting (owed by employees)).

77. *See id.* at 8 n. 3.

78. *See* PAUL, *supra* note 56, at 330–31.

withholding purposes, but not *all* workers. Such discussion is beyond the scope of this Note, but it warrants further inquiry.

C. *Contractors as Businesses and Business Deductions*

Perhaps the biggest tax distinction when it comes to employees and contractors is that contractors are considered businesses for tax purposes,[79] and are therefore eligible for deductions available to businesses while employees are not.[80] This difference initially can be seen regarding the deduction of trade or business expenses[81] in the fact that contractors can always take qualifying trade or business expenses as deductions to reduce their taxable income,[82] while employees are limited on that front because of the nature of their worker classification. For section 162, which governs deductions for trade or business expenses, the first hurdle for either classification to clear is proving that such expense is ordinary and necessary and in the pursuit of business. "Ordinary" and "necessary" are terms of art when it comes to tax law. A business expense is "necessary" if it is "appropriate and helpful."[83] And as for whether a business expense is "ordinary," "[l]ife in all its fullness must supply the answer to the riddle."[84] Luckily for us, the Treasury lent the fullness of life a hand by laying out some examples of ordinary and necessary business expenses—things like supplies, advertising, and "rental for the use of business property."[85] For contractors, we can stop there. If they have a trade or business expense that qualifies as ordinary and necessary, they can take it. But employees have another hurdle to clear—as of the writing of this Note, they must get that expense reimbursed by their employer to take that expense as a deduction.

If the employee gets their ordinary and necessary trade or business expense reimbursed, then it is deducted "above-the-line" and factors in to calculating the taxpayer's adjusted gross income, just as this expense would do for a contractor.[86] Any of these expenses that are unreimbursed for employees, however, will be considered miscellaneous itemized deductions.[87] And that classification is particularly important currently because the 2017 Tax Cuts and Jobs Act

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79. Collins et al., *supra* note 3, at 8 ("From the perspective of the tax code, 1099 independent contractors—those with either 1099-MISC non-employee compensation or an OPE 1099-K—are self-employed. Formally, this 1099 income, like all self-employment income, is considered active business income by the IRS. Accordingly, unless individuals become incorporated, this income should be reported to tax authorities as proceeds from a wholly-owned business on Schedule C").

80. Lim et al., *supra* note 2, at 5 ("[Contractors] are treated as sole proprietors and are entitled to claim "above the line" business expense deductions.").

81. I.R.C. § 162.

82. *Id.*

83. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

84. *Id.* at 115.

85. Treas. Reg. § 1.162-1(a).

86. *See* I.R.C. § 62(a)(2)(A).

87. I.R.C. § 67(b).

expressly disallows taxpayers from taking any miscellaneous itemized deductions between 2018 and 2025.[88] That means that if an otherwise-qualifying trade or business expense is unreimbursed, an employee cannot claim a deduction for it in 2020.[89]

However, the eligibility and ease with which each classification of worker can take these ordinary and necessary business deductions are just the tip of the iceberg when it comes to how federal taxes treat employees and contractors differently regarding business deductions. There are also a whole host of deductions available to businesses that contractors can take advantage of that employees simply cannot. For example: immediate expensing of up to $1 million dollars of business assets that constitute qualified property,[90] deducting business losses against business income,[91] and the ability to carry forward a net operating loss as a deduction if a contractor cannot take advantage of the whole loss in a certain year.[92]

The ability to take business deductions also has ramifications for the previous sections of the note. Business deductions are deducted from gross income, reducing taxable income.[93] As such, contractors that generate the same value from their work as an employee counterpart may end up paying less income tax because they've been able to deduct more expenses throughout the taxable year. And further for contractors, SECA taxes are calculated against "self-employment income," which is also reduced by these deductions,[94] so contractors may end up paying less than employees in payroll taxes too. The access to business deductions is a huge boon for contractors when it comes to federal taxes as compared to employees.

Our hypothetical situation with Employee and Contractor has no business expenses to deduct (for the sake of keeping the math as simple as possible). But as shown above, Contractor would have (1) a much easier time deducting a business expense and would have (2) the ability to deduct more costs in general as business expenses than Employee would. Just to throw out a very simple example of these concepts in action, if Contractor bought a nice three-hole punch to use in their work, they would be able to deduct that under section 162. But if Employee bought the same three-hole punch to use at their job, they would need their employer to reimburse that expense before Employee could take that as a deduction.

The purpose for which the Internal Revenue Code distinguishes employees from contractors regarding business deductions likely just reflects reality. If you

88. I.R.C. § 67(g).

89. *See id.*

90. I.R.C. § 179(a), (b)(1).

91. I.R.C. § 165(c)(1).

92. I.R.C. §§ 172(a), (b)(1)(A), (b)(2).

93. *See* I.R.C. § 62.

94. I.R.C. § 1401.

are a contractor, *you are your own business*.[95] But if you are an employee, you work *for* a business. Therefore, the purposes for which this distinction was drawn seem to be Congress exercising its policymaking discretion in accurately classifying which role a worker occupies, and then allowing or forbidding workers to take certain business deductions based on their classification. For the purposes of this Note, that will force this section to wrap up quickly, because there simply is little analysis to be done.

If we treat all workers like employees, then the distinction falls away and all contractors, simply because they are an individual, would lose the ability to deduct many of the expenses Congress deemed them to be able to rightfully take given that Congress considers contractors businesses. That would not align with how Congress exercised its discretion regarding worker classification, nor would that serve the purpose of allowing business deductions for *all* businesses, even if that business is only one person. And if we treat all workers like contractors regarding business deductions, then the distinction falls away and employees gain the ability to take far more deductions than Congress intended them to be able to take. That also cuts against Congress' exercise of discretion and thwarts the purpose of making sure that, in Congress' view, business deductions are taken only by those eligible to take them.

In both instances, the ramifications result in inequities. The government would get more revenue if it began to deny contractors the business deductions to which they are rightfully entitled because the contractors would end up with greater taxable income. While that could help address the tax gap for contractors, that simply isn't where Congress has decided to draw the line regarding which workers are considered businesses and are therefore eligible to take these business deductions. And the government would get less revenue if it began to give any employee access to the full-fledged array of business deductions for any "business" expense because more deductions would likely be taken, resulting in less income tax collected from employees overall.

This Note's argument then in this section is to point out that the Internal Revenue Code does not *need* to change (1) the classification of contractors as businesses, nor (2) the resulting different eligibility of workers to take business deductions because this current distinction is a result of line-drawing, and line-drawing always involves an element of discretion in the end. That said, given the substantive convergence of employees and contractors in terms of (1) flexibility of schedule and autonomy over completing work,[96] (2) number of payors,[97] and (3) increasing legal uncertainty regarding accurately classifying a worker as one

95. Collins et al., *supra* note 3, at 8.

96. Lim et al., *supra* note 2, at 3 ("On average, workers classified as ICs should have more control over their work process than employees; however, in practice, there will be overlap between the two groups as many employees have flexible schedules and a large amount of autonomy in completing their work.").

97. Collins et al., *supra* note 3, at 14 (noting that "it is no more common for wage earners to be tied to a single employer than it is for contractors to be tied to a single payer firm").

or the other,[98] the Internal Revenue Code might want to take a look at allowing employees more latitude when it comes to taking the business deductions contractors can. Or, at the very least, Congress could repeal the way the 2017 Tax Cuts and Jobs Act started denying employees a business deduction for an ordinary and necessary trade or business expense simply because that expense was unreimbursed.[99] But until then, defining contractors as businesses and employees as employees reflects reality, and the deductions to which each classification is eligible is a result of line-drawing which Congress has already done.

D. *Work Benefits*

Another way federal taxes treat employees and contractors differently relates to a worker's eligibility to exclude certain work benefits from gross income. Gross income includes "all income from whatever source derived."[100] If the Internal Revenue Code stopped there, that would mean that any time an employer provided a work benefit—like buying lunch for a worker—the value of that lunch would be included in the gross income of the worker.[101] However, the Internal Revenue Code specifies certain benefits related to the workplace that a worker can exclude from income. Here, this Note will focus on three such benefits: (1) meals and lodging furnished for the convenience of the employer,[102] (2) health insurance,[103] and (3) fringe benefits.[104] A worker's eligibility to exclude certain work benefits from income often depends on whether that worker is classified an employee or a contractor.

I.R.C. section 119 allows *employees* to exclude from gross include the value of meals or lodging provided by, or on behalf of, their employer if those are provided (1) to the employee for the convenience of the employer, and (2) on the business premises of the employer (and for lodging to be excludable, the employee must also be required to accept such lodging as a condition of employment).[105] That section does not mention contractors at all, leaving it to apply only to employees. The only expenses for meals and lodging contractors are able to deduct are those incurred while away from home solely in the pursuit of business,[106] but employees can also take such deductions. Therefore, there is

98. *See* Lim et al., *supra* note 2, at 3–4.

99. *See* I.R.C. § 67(g).

100. I.R.C. § 61(a).

101. *See id.*

102. I.R.C. § 119(a).

103. *Compare* I.R.C. § 106 (explaining employer-provided health insurance tax ramifications for employees), *with* I.R.C. § 162(l)(1) (laying out a potential deduction for health insurance costs of self-employed individuals).

104. I.R.C. § 132.

105. I.R.C. § 119(a); Treas. Reg. 1.119-1(a)–(b) (2020).

106. *See* Treas. Reg. 1.162-1–2 (2020).

a tax advantage to being an employee regarding meals and lodging provided by an employer.

How workers get health insurance also has different tax effects for employees and contractors. For employees, health insurance provided by their employer is excluded from their gross income.[107] In contrast, contractors can only take deductions for health insurance premiums to the extent that they have net earnings from self-employment in a taxable year.[108] And further, even if a contractor deducts such health insurance premiums, that deduction does not factor into the amount of earnings against which SECA taxes are calculated.[109] Therefore, not only do contractors have to turn a profit in the taxable year from their self-employment income in order to get any sort of health insurance premium deduction at all, even if they do, they will still have to pay SECA taxes on their total earnings. Compared to employees who have their health insurance automatically excluded from gross income as long as it is provided by their employer, and who therefore have less income against which to calculate their FICA taxes, federal taxes privilege being an employee instead of a contractor regarding health insurance as well.

Eligibility to take fringe benefits also varies between employees and contractors. Fringe benefits include things like a parking spot which an employer pays for a worker to use, employee discounts, or simply doughnuts and coffee in the break room.[110] Employees can take all of those things and more, but contractors are only eligible to take some.[111] Specifically, contractors are eligible to exclude working condition fringe benefits and de minimis fringe benefits, but are ineligible to exclude the hypothetical parking spot and employee discount above, among other fringe benefits.[112] Therefore, employees are favored by federal taxes here as well because they are able to exclude more perks of working for an employer than contractors are. That said, it is comforting to know that both employees and contractors can have a cup of coffee without worrying about including its value in their taxable income for that year.

Our hypothetical with Employee and Contractor does not include any work benefits like meals, lodging, health insurance premiums, or fringe benefits (for simplicity's sake). But if it did, Employee would be able to deduct anything in those categories which Contractor could, and then some. The effect, assuming that Employee and Contractor had the same income from the value of those work

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107. I.R.C. § 106.

108. I.R.C. § 162(l)(2)(A); I.R.S., *Topic No. 502 Medical and Dental Benefits*, https://www.irs.gov/taxtopics/tc502 (last updated Jan. 20, 2021).

109. I.R.C. § 162(l)(4).

110. *See* I.R.C. § 132; *see also* Treas. Reg. § 1.132-1 (2020).

111. *See* I.R.C. § 132 (using the word "employee" and never utilizing the word "contractor" in the section when defining the various fringe benefits); *see also* Treas. Reg. § 1.132-1(b) (2020) (describing that, for the purpose of I.R.C. § 132, the term "employee" might cover more people than just employees).

112. *See* Oei & Ring, *supra* note 9, at 673 (explaining the differences between fringe benefits available to employees v. contractors); Treas. Reg. § 1.132-1(2)(iv), (4) (2020).

benefits identified above,[113] would be that Employee would ultimately have less taxable income than Contractor, and Employee would therefore pay less in federal income tax and FICA taxes.[114] Contractor, on the other hand, would have to run through a confusing analysis of (1) which benefits they could exclude (2) under which circumstances, and (3) how those exclusions affect Contractor's calculations regarding federal income tax and SECA taxes differently.

Turning now to the purposes of the provisions in this subpart, meals and lodging for the convenience of the employer were first excluded from gross income in the Internal Revenue Code of 1954.[115] A clear purpose for that section can be found from the 1978 amendment to that provision, where members of both the House and the Senate believed that the IRS had overstepped its bounds in promulgating regulations regarding that section,[116] with one senator, after noting that the Senate approved the House's amendments, saying that the "action taken by the Senate today is one to restore the decision making process to Congress."[117] The very purpose of cementing the general excludability of these meals and lodgings was for Congress to draw clear lines on the issue given the "lack of uniform treatment of taxpayers who receive different types of benefits, even though the benefits may have approximately the same economic value . . . ."[118]

The provision excluding employer-provided health was introduced in the Internal Revenue Code of 1954.[119] Compared to the previous Internal Revenue Code (of 1939), which only allowed excluding amounts *received as compensation* through health insurance (and specifically *not* what employers paid as premiums for health insurance to cover their employees), this expansion of section 106 suggests a purpose to encourage employers to provide health insurance for those who worked for them.[120]

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113. *See* I.R.C. § 132(a); *see generally* I.R.C. § 61 (noting that gross income is "all income from whatever source derived[,] which would include these fringe benefits as income before they are excluded by another section—here, that would be I.R.C. § 132).

114. *See* Oei & Ring, *supra* note 9, at 675 (noting that the health insurance premiums and medical benefits under I.R.C. § 105(b) aren't included in the wage base of employees used to calculated FICA taxes); *see also* 124 CONG. REC. 23884 (daily ed. Aug. 2, 1978) (Statement of Sen. Russel Long) (clarifying meals and lodging provided for the convenience of the employer are excluded from the wage base used to calculate FICA and FUTA taxes).

115. I.R.C. § 119 (1954).

116. *See* 124 CONG. REC. Part 18, page 23883-84 (Aug. 2, 1978) (referencing the IRS regulation that automatically disqualified meals even if provided for the convenience of the employee if that employee had to pay even a portion for the meal and declaring such regulation as "inconsistent with the correct reading of the law").

117. 124 CONG. REC. part 18, page 23883 (Aug. 2, 1978) (likely holding special significance regarding statutory purpose given that this quote came from a section with the heading "Major Issue").

118. *Id.*

119. I.R.C. § 106 (1954).

120. *Compare* Treas. Reg. § 1.162-10(a) (2020) (permitting employers an ordinary and necessary business deduction under I.R.C. § 162 for the payment of their employees' health insurance premiums), *with* I.R.C. § 106 (permitting *employees* to exclude such payments on their behalf from gross income).

And finally, the fringe benefits in section 132 were introduced in the Deficit Reduction Act of 1984.[121] Similarly to meals and lodging, Congress' goal in specifying which fringe benefits would be excluded from taxable income was to (1) "reaffirm the general rule of taxability of all forms of compensation in the absence of a specific statutory exception," (2) address the "dramatic use of the noncash forms of compensation," and (3) to prevent the "further erosion of our tax base through the future growth of noncash compensation . . . ."[122] In essence, Congress' purpose in enacting the meals, lodging, and fringe benefits provisions amounted to it seeking to exercise its line-drawing discretionary power.

In summary, these work benefits were motivated by (1) the desire to provide clarity regarding which work benefits were excludable and which were not, and (2) to encourage employers to provide health insurance for their employees.

If we treated all workers like employees regarding taxing work benefits, all contractors would suddenly be eligible to exclude (1) meals and lodging provided for the convenience of their employer, (2) every fringe benefit that was previously only available to employees, and (3) any health insurance premiums paid to cover that worker by the respective employer. That could further the purpose that motivated excluding employer-provided health insurance from gross income because employers would be able to provide health insurance for every worker that worked for them. The counterargument here would be one based on reality. Employers can, technically, *already* buy health insurance for anyone who works for them. Therefore, even though this potential change would allow employers to take a deduction for health insurance premiums paid for anyone who works for them (employee or not), that doesn't mean they *would.* Perhaps employers would reserve paying for health insurance as an employee-only perk to incentivize workers to try to get hired as employees (thus being subject to more employer control) rather than working as contractors.

The line-drawing purposes behind excluding meals and lodging furnished for the convenience of the employer and other fringe benefits, however, is exciting and leaves room for real change here. Since the reason Congress enacted these provisions and made them apply to employees was, at its core, a desire to exercise discretion in policymaking, Congress could once again be faithful to that line-drawing purpose by (1) acknowledging that employees and contractors are converging in many aspects of the classifications,[123] and then (2) expanding to contractors the ability to exclude such work benefits from their income. This Note argues here that the purposes that originally motivated specifying these work benefits were to be excluded from income would be better served by amending the provisions to allow contractors to exclude these work benefits just

121. Deficit Reduction Act of 1984, Pub. L. No. 98–369, 98 Stat. 494 (1984).

122. 130 CONG. REC. 19,022, (1984) (discussing the reasons for the conference committee adopting substantially the "House version of the bill providing uniform rules for the tax treatment of various non-statutory fringe benefits").

123. *See* Lim et al., *supra* note 2, at 3.

like employees given the substantive convergence between the two classifications of workers.[124]

On the flip side, if we treated all workers like contractors regarding the exclusion of work benefits for tax purposes, employees would lose the ability to exclude the work benefits (employer-provided health insurance, meals and lodging provided for the convenience of the employer, certain fringe benefits) that Congress decided they should be *able* to exclude. Not only would that cut against the line-drawing purposes motivating the meals and lodging and fringe benefit exclusion provisions, but that could also decrease the amount of health insurance provided by employers. For if this were the case, employees might be able to choose more cost-effective plans than the ones offered to them by employers, the premiums of which would suddenly be deductible only to the limited extent contractors can currently deduct such health insurance premiums. The counterargument would be that employers would still be able *themselves* to deduct the premiums they pay for health insurance for their workers,[125] so perhaps they would continue to provide health insurance for their employees, and therefore this shift wouldn't damage the purpose for which section 106 was originally enacted. However, given that treating all workers like contractors would directly oppose the policy decisions of Congress regarding the other work benefits covered in this section, this Note does not recommend such a change.

In summary, this Note argues that given the fact that many of the traditional distinctions between employees and contractors are dissipating, Congress could faithfully and better serve the purposes that motivated the exclusion of certain work benefits from income if it expanded the eligibility to exclude such benefits to contractors just like it already does for employees. But this Note does not recommend any change regarding the current eligibility of employees to exclude employer-provided health insurance despite contractors not being able to do so.

E. *Section 199A of the 2017 Tax Cuts and Jobs Act*

The last aspect this Note will analyze regarding how federal taxes treat employees and contractors differently is a recent development. Section 199A of the 2017 Tax Cuts and Jobs Act created a qualified business income deduction allowing pass-through businesses (including individuals who are contractors—thus considered sole proprietors of their own businesses)[126] to deduct 20% of qualified business income.[127] "Qualified business income" is the net of income, gain, deduction, and loss from any qualified trade or business,[128] which again,

124. *Id.*

125. *See* Treas. Reg. § 1.162-10(a) (2020).

126. Lim et al., *supra* note 2, at 5 (explaining that contractors "are treated as sole proprietors and are entitled to claim 'above the line' business expense deductions").

127. I.R.C. § 199A(a).

128. INTERNAL REVENUE SERV., *Tax Cuts and Jobs Act, Provisions 11011 Section 199A – Qualified Business Income Deductions – FAQs*, https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs (Mar. 26, 2021).

includes business operated as sole proprietorships, which is how individual contractors can—and often do—run their business. The trade or business of performing services as an employee is specifically disqualified for this deduction.[129] That means that contractors who run their businesses as pass-through businesses can take a deduction of 20% of their net business income,[130] while employees cannot. That's a staggering inequity that turns on whether an individual is classified as an employee or a contractor.

Going back to our characters, we can recall that Employee had $92,380 of income while Contractor had $100,000 of income. Contractor would be eligible for this qualified business income deduction, and therefore, assuming for the purposes of this Note that the $100,000 is the net of Contractor's business income, could exclude $20,000 of income simply because they are classified as a pass-through business eligible for the deduction while Employee is specifically barred from taking this deduction. That's a *significant* boon to a worker being considered a contractor rather than an employee. The question then becomes: does this distinction that results from the classification of an individual worker serve the purpose for which this provision was enacted?

Section 199A's qualified business income deduction for pass-through businesses was enacted to "treat corporate and non-corporate business income more similarly under the income tax" given the House Ways and Means Committee's belief that the "reduction in the corporate income tax to 20 percent provided by the bill does not completely address the income tax rate on business income . . . [namely] the income of businesses conducted in pass-through form or in sole proprietorship form . . . ."[131] Given that the focus of the provision was meant to be an equitable solution addressing different forms of business income in light of the reduction of the corporate tax rate to 21%,[132] it seems no official consideration was given to the effects this would have regarding the taxation of income of individual workers depending on whether they were classified as an employee or a contractor. Proponents of the section believed it was needed to bring pass-through businesses to the same level of taxation as corporations, while opponents contended it created an "arbitrary preference for pass-through business income over other sources of income . . . ."[133] What was lost in the effort to achieve equity for different forms of business income (at least as indicated by what was not discussed in the Ways and Means Committee report) is that this created a *significant* tax advantage for individuals classified as contractors rather than employees. Nevertheless, this Note will still analyze whether treating all

129. I.R.C. § 199A(d)(1)(B).

130. *See* Thomas, *supra* note 16, at 1424.

131. H.R. REP. No. 115-409, at 129 (2017).

132. I.R.C. § 11(b).

133. Scott Greenberg & Nicole Kaeding, *Reforming the Pass-Through Deduction*, TAX FOUNDATION, at 2 (June 21, 2018), https://taxfoundation.org/reforming-pass-through-deduction-199a/.

workers as one classification or the other serves the business income equity purposes of the section.

If all workers were treated like employees under this section, then contractors who would have previously been eligible for this deduction would lose that eligibility because employees are specifically barred from taking this deduction.[134] That would directly oppose the purpose of this section—which was, in essence, to acknowledge that business income came in all different forms, and pass-through business (like contractors) should receive a deduction aimed at achieving equity with the reduction in corporate tax rate implemented by the TCJA. Treating all workers like employees for the purpose of section 199A would bar certain pass-through business (here, contractors) from taking the deduction, which has literally the opposite effect for which the section was enacted. This Note would not recommend treating all workers like employees under this section.

If all workers were treated like contractors, on the other hand, this Note argues that wouldn't make a difference within the statutory provisions of this section. This is because even if we wanted to make employees eligible to receive this deduction like contractors are, the "trade or business of performing services as an employee"[135] is still statutorily disqualified as a form of business income that qualifies for this deduction. Therefore, this change could not be enacted without Congress deleting one of the *two* categories of trades or businesses that specifically *don't* qualify for this deduction,[136] which would defeat the purpose behind that provision. And even if we did away with that limitation, there suddenly would be an *enormous* amount of the U.S. workforce receiving about a 20% income deduction across the board—corporations, pass-through business (like contractors), and now employees. If that were the case, the effect of this proposed change would essentially amount to a 20% reduction in taxable income for most taxpayers, and while the TCJA's overall stated purpose was in part to "reduce tax burdens on families and individuals,"[137] this Note believes that if Congress had wanted to reduce the tax burden by the amount effectuated by this proposed change, Congress would have just done so in the first place given that the Act passed in a straight party-line vote through budget reconciliation.

Therefore, this Note argues that neither treating all workers as employees nor treating all workers as contractors is desirable given the purposes for which section 199A was enacted. But this Note wanted to analyze section 199A nonetheless because it is an enormous difference that now exists for individual workers' taxes depending *solely* on whether they are classified as an employee or a contractor. And this Note would like to encourage deeper thinking on the effects of this section because in striving to *achieve* equity across taxation of

134. *See* I.R.C. § 199A(d)(1)(B).

135. *Id.*

136. *See* I.R.C. § 199A(d)(1).

137. *See* H.R. REP. No. 115-409, supra *note* 131, at 112.

business income, Congress decimated equity between the income of individual workers based on which classification that worker receives.

F. *Summary of Differences, Purposes, and Note Recommendations*

A general summary of this Note's analysis for this Part is below.

1. Social Security, Medicare, and Unemployment Taxes:
   - Employees split their payroll tax liability with their employer. Contractors pay their payroll tax liability all themselves. This is not just a procedural difference. It affects the amount of payroll taxes collected from each worker depending on whether they're classified as an employee or a contractor.
   - The purpose of these taxes was to fund their respective programs.
   - With Social Security and Medicare facing funding shortfalls, this Note does not recommend treating workers all as either employees or contractors. The payroll taxes collected from employees and their employers combined is, on a starting level, less than those collected from contractors. But there are serious compliance concerns if no payroll taxes were withheld. That said, this Note concludes that treating *more* employees as contractors for payroll tax purposes could potentially better serve the funding purposes for which these taxes were enacted. But that change involves difficult line-drawing concerns and the compliance issues remain.
   - It is more advantageous to be an employee for the purposes of Social Security, Medicare, and unemployment payroll taxes.
2. Federal Income Tax Withholding:
   - Employees have a portion of their income tax withheld by employers. Contractors do not.
   - The purpose of federal income tax withholding was to increase tax compliance.
   - This Note does not recommend treating all workers as either employees or contractors. While treating every worker as an employee on its face would seem to increase compliance, there are significant concerns regarding estimation, disclosure, and administrative costs that deter this Note from advocating that change. And treating every worker as a contractor would decrease compliance. While there may be a way to attain more compliance by treating *more* contractors like employees for withholding purposes, that line-drawing is difficult and finding that exact right balance is not the aim of this Note.
   - It is unclear whether it is more advantageous to be an employee or a contractor for federal income tax withholding purposes. While employees have a portion of their income tax withheld and therefore face less risk of underpayment and IRS penalties, contractors receive

more money in their pockets given that none is withheld, conferring on them the time-value of that "extra" money yet exposing them to greater risk of underpayment and IRS penalties.

3. Contractors as Businesses and Business Deductions:

- Contractors can take more deductions related to business expenses than employees can. Contractors also have an easier time qualifying for such deductions.
- The purpose of these provisions was to effectuate Congressional discretion regarding which workers were businesses and which were not, and then resulting eligibility to take certain deductions.
- This Note recommends that, as these sections were enacted as a display of Congressional discretion regarding which taxpayers qualify as businesses and eligibility for deductions as such, Congress can faithfully serve that purpose by (1) acknowledging the dissipation of the traditional differences between employees and contractors, and (2) easing the requirements to take certain business deductions as an employee (namely the 2017 TCJA's prohibition on deductions for unreimbursed ordinary and necessary business expenses).
- It is far more advantageous to be a contractor for tax purposes when it comes to business deductions.

4. Work Benefits:

- Employees are able to exclude more work benefits—like meals and lodging provided for the convenience of the employer, employer-provided healthcare, and other fringe benefits from their taxable income—than contractors can.
- The purposes for enacting these provisions allowing exclusion of such benefits were (1) for Congress to exercise its decision-making authority to specify which fringe benefits were and were not excludable from income given the rise in noncash forms of compensation, and (2) seemingly to encourage employers to provide employees with health insurance.
- This Note recommends that, as these sections were enacted specifically so that Congress could exercise its discretion (in part due to a perception that IRS regulations overstepped the law), Congress could faithfully and better serve these discretionary purposes by (1) acknowledging the increasing substantive convergence of employees and contractors, and (2) expanding the current eligibility employees have in excluding certain work benefits to contractors as well.
- It is more advantageous to be an employee for tax purposes when it comes to excluding work benefits.

5. Section 199A of the 2017 Tax Cuts and Jobs Act

- Individuals who are contractors can deduct 20% of their net business income while individuals who are employees are specifically barred from this deduction.
- The purpose of this section was to create more equity among forms of business income given that the TCJA capped the corporate tax rate at 21%, yet pass-through businesses were still being taxed at rates that applied to individual taxpayers.
- This Note argues that treating all workers either as employees or contractors is not desirable given the purposes of this section. However, this Note would implore Congress to realize that in pursuing equity regarding different forms of business income, it has created significant inequity for individual taxpayers depending on whether they are classified as an employee or a contractor.
- It is far more advantageous to be a contractor for tax purposes when it comes to section 199A and its qualified business income deduction.

In conclusion, federal taxes have quite a few different effects for individual workers depending on whether that worker is classified as an employee or a contractor. For some provisions, like employer-provided work benefits and some business deductions, Congress could both (1) update the Internal Revenue Code to accurately reflect today's realities regarding the similarity of work that employees and contractors do by extending eligibility for those tax benefits to the group currently ineligible; and (2) faithfully serve the initial purpose for which Congress enacted those provisions—an exercise of Congressional decision-making power regarding eligibility for tax exclusions and deductions reflecting the realities of the workforce. For other provisions of federal taxes, like payroll taxes and federal income tax withholding, there is at least an open question whether a little tinkering in treating more workers like contractors or employees, respectively, might better serve the purposes for which those provisions were enacted. And for section 199A introduced by the 2017 TCJA, even though Congress was pursuing equity for different forms of business income, it ended up creating significant inequity for individual workers that turns on whether a worker is classified as an employee or a contractor. This Note argues that it would be beneficial to explore how Congress balanced the equity pursued by 199A against the inequity it created—if it did that balancing at all.

It is also unclear whether being an employee or a contractor is preferable when it comes to federal taxes overall, but this Note would argue that it is more advantageous to be a contractor. On the one hand, employees get to exclude lots of employer-provided work benefits and end up paying slightly less in payroll taxes. But contractors will likely pay far less in income tax given that they can take a wide array of business deductions (including traditional ones as well as the recent qualified business income deduction from section 199A of the TCJA) and can deduct half of what they pay in SECA taxes[138] from their gross income in calculating taxable income. The eligibility to take these business deductions and

138. I.R.C. § 164(f).

the amount these deductions can shave off a contractor's gross income likely make it more advantageous to be a contractor. But a complete analysis of whether that is the case is beyond the scope of this Note, which set out to identify the ramifications for federal tax purposes, then to scrutinize whether that distinct treatment served the purposes for which the sections were enacted.

III. BRIEF ANALYSIS OF SCHOLARLY PROPOSED TAX REFORM

With those takeaways from Part II in mind, this Note will now apply them by considering tax reform proposals from a prominent tax scholar. In Kathleen DeLaney Thomas' 2018 article, *Taxing the Gig Economy*, Thomas proposes (1) a "non-employee withholding regime" and (2) a "standard business deduction" for gig workers.[139] These two proposed tax reforms are pertinent to this Note because they address distinctions in federal tax law affecting contractors. Thomas' stated goals for the reforms are reducing "tax compliance burdens for [millions of American workers who earn income through 'gig' work and are considered business owners (i.e., contractors) for tax purposes], while simultaneously enhancing the government's ability to collect tax revenue."[140] Given that the analysis of this Note has focused on (1) the difference in compliance for employees and contractors; (2) concerns that arise when proposing that payors withhold, for tax purposes, some of what they would otherwise pay contractors; and (3) the numerous business deductions already available to contractors (specifically, "gig workers" in Thomas' article), this Note wanted to explore these proposals. This Note believes both proposals present a potential beneficial step toward reconciling the distinct treatment of employees and contractors within the context of federal tax law to reflect the economic realities of the workforce today more accurately. But they each present some wrinkles that are worth analyzing.

A. *Thomas' Proposed "Non-Employee Withholding"*

Thomas' proposal for a "non-employee withholding" regime aims to have payors withhold a portion of what they pay an individual contractor to cover that worker's income and self-employment tax obligations arising from that payment.[141] This proposal would create equity with that way employers currently withhold some of what they pay their employees to cover those workers' income and FICA tax obligations.[142] In general, Thomas' proposed "non-employee withholding" outlines a scope where payors (1) only begin to withhold once beyond the $600 1099-MISC reporting threshold,[143] (2) are subject to it only

139. Thomas, *supra* note 16, at 1415.

140. *Id.*

141. *See id.* at 1447.

142. *See id.* at 1443.

143. *See* I.R.C. § 6041(a).

when the payor hires the contractor in the course of the payor's business, and (3) attempt to withhold only for individual contractors (and not other businesses that have their own withholding requirements).[144] There are many meritorious reasons for this proposal bearing on the proposed scope that Thomas identifies. Among them are the fact that aiming this withholding at smaller contractors will help them navigate compliance requirements,[145] leading to less penalties for missed estimated payments and more revenue for the IRS overall.[146] Additionally, limiting this requirement to whenever payors hire contractors in the course of business would seem a logical extension of the systems these payors likely have in place for withholding regarding their full-time employees.[147]

However, there are also issues that arise relating to this proposed scope. The first is that triggering this requirement only if such payment exceeds $600 could leave a substantial part of a contractor's income un-withheld, especially those doing small projects for many different payors throughout the taxable year. The gross income of such a contractor includes "all income from whatever source derived,"[148] not just income that exceeds $600. Therefore, if the non-employee withholding starts only beyond that threshold, many of the same compliance issues remain.[149] In fact, it may end up being even more confusing for the contractors at which this proposal is aimed to figure out which payors have withheld some money and which paychecks require the contractor to tuck some money away for their estimated quarterly payments.

The second issue is that deciding whether a contractor was or was not hired in the course of the payor's business could require inquiries into what the payor's business *is* and whether the contractor's work was done in the course of it. This issue would be especially present for contractors that work for smaller or newer businesses, which are increasingly hiring contractors instead of employees.[150] And given the world's collective experience with the COVID-19 pandemic, a plumber called to someone's home is likely conferring a personal benefit as well as a business-related benefit since the pandemic has forced many workers to work from home. Those issues aside, this Note wholeheartedly supports Thomas' focusing the scope of this proposal so it does not apply to other businesses with their own withholding requirements, because that focus is sensible and would

144. *See* Thomas, *supra* note 16, at 1443–45.

145. *Id.* at 1437.

146. *See id.* at 1438–39.

147. *See id.* at 1440.

148. I.R.C. § 61(a).

149. While Thomas suggests on page 1444 that "[p]ayers that anticipated an ongoing relationship with a service provider or seller of goods could begin withholding with the first payment even if it was under the threshold, though there would be no penalty for failing to do so," mitigating this concern somewhat, there would be no requirement to do so, and the compliance worries therefore remain.

150. Lim et al., *supra* note 2, at 3 ("Our firm level analysis shows that growth in the use of [independent contractor] labor, as measured by multiple metrics, is concentrated among small firms, which we define as those with few employees").

reduce confusion regarding withholding since it would avoid companies withholding each other's tax liability in a weird tax catch-22.

In the part of her article where Thomas proposes that this withholding cover SECA taxes for the contractors, Thomas states that economically, "it probably doesn't matter who is nominally responsible for payroll taxes; if the platform company (or other payer) were responsible for half of those taxes, they would likely reduce gross payments to workers to compensate."[151] However, the analysis in this Note evinces that there *is* an economic difference regarding who pays these Social Security and Medicare taxes, especially if the payor and contractor share the cost like employees and employers currently do. And this Note points out that this difference is the very *result* of reducing gross payments to workers to compensate. Therefore, this Note believes that the purposes for which SECA taxes were imposed (funding Social Security and Medicare) would probably be better served if the contractor remained on the hook for all of it because that would theoretically generate more revenue. Further, this proposal would likely create an administrative nightmare for the IRS, as it would be trying to keep up with different payors attempting to pay different amounts of an individual's SECA tax liability while still trying to get the remaining half from the contractor themselves. While the compliance concerns that accompany a decision to leave a contractor to their own devises are significant, this Note believes this proposal would do harm to the purpose for which SECA taxes were imposed.

The rest of Thomas' proposal aligns with this Note as it explores the difficulties in trying to determine the correct amount to withhold—which was the main reason this Note did not recommend treating all workers like employees for income tax withholding purposes—including all the complexities surrounding determining the net income of a contractor, which this Note believes is extremely difficult.[152] It concludes by granting the contractor the right to opt-out of this non-employee withholding proposal for one reason or another, such as the withholding creating liquidity issues or a contractor simply preferring to deal with their own tax burdens.[153] While this Note believes granting the ability to opt-out is an equitable one, it has concerns about what that means for the practical effect of this proposal. Specifically, if contractors can opt out on a whim, (1) do compliance and revenue benefits gained by withholding some compensation of those contractors who don't opt-out outweigh (2) the headache that would accompany payors trying to remember for whom they have to withhold money and for whom they do not, or the IRS trying to figure out which payors it needs to go after if a contractor mistakenly believes they did not opt-out and therefore only paid a portion of the federal taxes they owe? The counterargument to this Note's concerns would be that this proposal, even though it leaves in place some old issues regarding contractor compliance, would at least increase compliance

151. Thomas, *supra* note 16, at 1445.

152. *See id.* at 1445-53.

153. *Id.* at 1453.

and revenue to *some degree.* To that extent, this Note agrees that the proposal has significant merit, but there are concerns that it raises specifically relating to this Note's analysis regarding the reasons for which the withholding and payroll tax provisions were enacted that are worth exploring.

In sum, the balancing to be done regarding this proposal is (1) how Congress would value the potential benefit to tax compliance this withholding would engender versus (2) concerns about (a) the practical administration of this proposal and (b) concerns this Note set out in the previous part. As relevant here, those concerns are grave concerns about estimation and more moderate concerns about disclosure and administrative costs for the payors.

B. *Thomas' Proposed "Standard Business Deduction" for Gig Workers*

Thomas also proposes a "standard business deduction" for gig workers, which would allow such contractors to take a deduction of "a fixed amount—based on a percentage of gross receipts—that could be deducted in lieu of actual business expenses."[154] According to Thomas, this "would, therefore, eliminate the need to track and report those expenses."[155] Noting current qualities of federal taxes, such as (1) the confusing nature of tax rules, (2) that expenses are reported "on an honor system," and that (3) "expense tracking and reporting is time-consuming and burdensome, even for taxpayers who are familiar with the rules," Thomas aims this proposal at mitigating those issues, "reducing evasion and unintentional noncompliance and virtually eliminating tax recordkeeping requirements for many small businesses."[156] This Note interprets that last goal as an attempt to help contractors take more of the business deductions for which they are eligible (some of which are discussed in Part II(3) of this Note). But this Note believes the goals of the proposal therefore seem at odds with each other, especially given that the deduction is permissive.

Starting with the goal of eliminating tax recordkeeping requirements, Thomas writes that the standard business deduction should be targeted "at truly 'small' business owners."[157] But this Note believes that these smaller business (like contractors) may be the ones who, as Thomas says, "have no idea what sorts of costs are deductible from their business receipts or how to properly record their expenses."[158] Thomas elaborates that given such uncertainty regarding eligibility for business deductions, taxpayers "will inevitably file inaccurate returns, which may [either] [1] deprive them of deductions that they are entitled to or [2] shortchange the government of tax revenue."[159] The general idea is that if taxpayers underreport their business expenses, that is unfair to them because they

154. *Id.* at 1454.

155. *Id.*

156. Thomas, *supra* note 16, at 1454.

157. *Id.* at 1459.

158. *Id.* at 1454.

159. *Id.* at 1455.

are eligible to take business deductions for more, whereas if they overreport, the government loses revenue because taxpayers will be claiming more business deductions.

This permissive quality of this proposal therefore makes it a windfall to those smaller business who cannot keep track of which business expenses qualify as a deduction. Those who traditionally underreport (and give the government more revenue than it is entitled to as a result) will likely always opt to take the standard business deduction if it gives them a greater deduction than what they think they are otherwise entitled to. While that would be an honorable way to make sure such businesses (including contractors) receive the deductions to which Congress believes they are entitled (which this Note identified as the purpose for treating employees and contractors differently regarding eligibility to take many business deductions), this standard business deduction would likely *undermine* the other aim of this proposal. That is because federal tax law worries about evasion and noncompliance *because* the government is worried it may not be collecting all the taxes it is owed. Therefore, while the standard business deduction would help reduce evasion and unintentional noncompliance for businesses by eliminating burdensome recordkeeping requirements, that same reduction will also likely reduce the revenue the government collects, which brings the aims of this proposal in conflict with each other. Further, because the standard business deduction is permissive, all the concerns that Thomas focuses on in this section regarding unintentional and intentional *overreporting*[160] would likely remain. This is because those taxpayers and businesses intent on overreporting their business expenses would likely still try to do so, intentional or not, because they would believe that they could get away with claiming more in total deductions than the standard business deduction would otherwise allow them. Therefore, the proposal ends up giving traditionally underreporting businesses a greater deduction while allowing traditionally overreporting businesses to still try to get away with overreporting because this proposal is permissive.

This Note loves that this proposal would help contractors claim the business deductions to which they are entitled, as that was Congress' purpose for enacting all the tax provisions granting deductions for business expenses to contractors. However, this Note is concerned whether this proposal can reconcile its stated purposes given the brief analysis above. If the standard business deduction is meant to deliver the business deductions Congress believed businesses—even individual contractors—were entitled to when it enacted those provisions, then that serves the purpose of the legislation but raises greater concerns about a decrease in revenue the government would be able to collect from contractors—an already difficult group to wrangle.[161] And if, on the other hand, the standard business deduction is meant to reduce evasion, noncompliance, and tax

160. *Id.*

161. *See* Tax Gap Estimates, *supra* note 44, at 8, fig.1 (pointing to individual income tax for business income—i.e., the income of individuals working as contractors—as the largest category of noncompliance).

recordkeeping requirements for small businesses,[162] then this Note believes an analysis is needed regarding how many contractors *do not* take as many business deductions as they are entitled to, and as a result end up giving the government more money than it would otherwise collect from them. This Note believes such analysis is needed because the reasons underlying compliance and evasion concerns—namely, the government not getting enough revenue—would be defeated by such underreporting contractors suddenly having the ability to take the standard business deduction as it would likely grant them a greater deduction than what they were planning on claiming without it.

Overall, both of Thomas' proposals serve the purposes for which the withholding and eligibility regarding business deductions provisions were established, and this Note believes they have much merit, especially in a day and age where the substantive differences between contractors and employees are dissipating.[163] But this Note has enough concerns about the practical effects each proposal would bring to caution it against endorsing them wholeheartedly without further analysis focused on projections of their impact. While these proposals are aimed at helping contractors given (1) that many U.S. workers occupy that role these days and (2) the ease with which one can be a contractor while working remotely from home (an experience many taxpayers have likely come to know intimately), they also raise questions related to implementation and effect. And because of that, while this Note believes the proposals could be beneficial in addressing the different treatment of employees and contractors within federal tax law, this Note would like to see further statistical research on them before endorsing either proposal as a way to address the different ways federal taxes apply to employees and contractors.

IV. CONCLUSION

Federal tax law can breathe a sigh of relief, however, in knowing it is not alone in experiencing difficulties and promulgating inequities surrounding the employee / contractor distinction. Statutes and other areas of law employ a whole bunch of different tests to draw this distinction,[164] suggesting there is a lack of clarity regarding the best way to determine whether a worker is an employee or a contractor. And even when an area of law makes a conclusion about the classification of a worker, that conclusion may not be binding between different jurisdictions.[165] Further, even when there is general consensus that a certain test applies to a certain situation, courts and administrative agencies can disagree about *what, exactly,* the test requires.[166] The ramifications of the employee /

162. Thomas, *supra* note 16, at 1454.

163. *See* Lim et al., *supra* note 2, at 3.

164. Oei & Ring, *supra* note 9, at 680–82 (noting that different statutes and areas of law use the common law agency test, economic realities test, or ABC tests).

165. *Id.* at 670–80

166. *Id.* at 681 (noting that there is general acknowledgement "that the common law test applies for [National Labor Relations Act] purposes, [but] exactly what the test requires is

contractor distinction extend beyond the world of federal tax as well. For example, the distinction determines whether and to what extent a worker has a right to "minimum-wage, collective bargaining, workplace benefits, [and] health and safety."[167] But just because there is confusion surrounding the distinction and the stakes regarding the classification are high does not mean that federal tax law should not try to champion change.

Congress can alter parts of the Internal Revenue Code to better reflect the realities of today's workforce. In fact, this Note argues that there are ways for it to do so regarding certain provisions discussed in this Note that would also more faithfully serve the purposes for which those provisions were enacted. Specifically, Congress can further the line-drawing purposes motivating eligibility for business deductions and exclusion of work benefits from taxable income by allowing employees and contractors the ability to utilize more of those provisions, respectively. For other provisions, while a change may on its face acknowledge the substantive convergence of the qualities of an "employee" and a "contractor" and seemingly serve the purpose for which they were enacted, there are countervailing considerations that lead this Note to conclude that further analysis beyond the scope of this Note is warranted before potentially advocating for such a change. In particular, the provisions discussed regarding payroll taxes and federal income tax withholding might be better served if all workers were treated like contractors and employees, respectively, but there are practical concerns surrounding such a change that may end up opposing the program-funding and compliance purposes for which those sections were enacted. And for section 199A of the TCJA, this Note would advocate for Congress to consider and issue a statement on how it weighs the equity it sought to pursue for different forms of business income against the enormous inequity it created for individual workers depending on whether they are classified as an employee or contractor.

All in all, this Note hoped to provide some takeaways surrounding the employer / contractor distinction in federal tax law. These takeaways are meant to support this Note's two main arguments: that (1) federal tax law draws an increasingly arbitrary and unfair line between employees and contractors given the modern substantive convergence of work done as an "employee" or a "contractor"; and (2) updating how the distinction is drawn and applied can better serve the purposes of the federal tax provisions that treat employees and contractors differently.

First among the takeaways, federal tax law has the means to effectuate any desired change in how certain provisions apply to different classifications of workers primarily because of the vast multifactor test it employs to make that distinction. Second, in general, it seems being a contractor is more advantageous than being an employee for federal tax purposes primarily because of the

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contested . . . . [C]ourts and the National Labor Relations Board ('NLRB') have sparred [for example] over how important it is that the worker has 'significant entrepreneurial opportunity for gain or loss' (which suggests independent contractor status)").

167. *See, e.g.*, *id.* at 654.

availability of various business deductions. Third, if Congress wanted, it could statutorily update the provisions discussed above to more accurately reflect the dissipation of the traditional differences between employees and contractors, which would better serve the purposes for which those provisions were enacted. Fourth, scholarly-proposed tax reform addresses some of the inequities promulgated by the I.R.C. in its distinct treatment of employees and contractors that is promising, but merits further consideration. And finally, federal tax law is not alone in struggling with the effects of this distinction. But despite that struggle and the inconsistencies surrounding the distinction, one fact remains quite clear: regardless of whether *we think* we work as "employees" or "contractors", it matters what we are *called* when it comes to federal taxes.