



The Uber Effect:

How Tech Companies Jumped on the Independent Contractor Track But Now Find It Going In Another Direction – Part 2

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In the previous issue of the *Bar Bulletin*, we discussed the recent changes in the legal tests used in California to determine whether an individual is an independent contractor or an employee. The evolution of the law has created some confusion. In this article, we continue to explore the significance of recent developments in the independent contractor versus employee designation arena in the context of Congress' 2017 tax reform.

The Odd Intersection of Changes in Independent Contractor Test With the 2017 Tax Reform

The Tax Cut and Jobs Act (TCJA) of 2017 created many benefits for sole proprietors and pass-through entities who work as independent contractors. The tax reform doubled the standard deduction and lowered the individual tax rates for most tax brackets. In addition, higher thresholds are now needed to bump taxpayers into higher tax brackets. These reforms, however, in general will lower the tax amounts that most sole proprietors and pass-through entities pay.

The TCJA also eliminated the deduction for unreimbursed business expenses for employees

a deduction if they reimburse employees and the reimbursements are excluded from the employee's taxable income. Employees are thus advised to request that their employers reimburse them and claim the deduction.

Another, perhaps more difficult solution, is for the employee to seek a pay raise to compensate for the lack of a previously allowed deduction. On the other hand, if these employees can change their status to qualify as independent contractors, then they may be able to take deductions for many business-related expenses. Therefore, the TCJA favors independent contractor status.

Confusion Surrounding the Tax Obligations of the Gig Economy

The average person's confusion about their tax obligations in the rising gig economy may be one of the reasons lawmakers have been hostile to companies like Uber. Many of the individuals working in the gig economy do not understand how much in taxes they need to pay. This confusion is seen in recent IRS data showing that underpayment of estimated

record-keeping requirements.¹ Moreover, 43 percent did not know how much they would owe in taxes and did not set aside money to pay any tax liabilities. Furthermore, almost one-half did not know about any tax deductions, expenses or credits to offset their tax liability. Finally, almost 70 percent did not receive any tax guidance from the platform they worked with in 2015.

Many of the clients who seek the assistance of the Cal Poly Low Income Taxpayer Clinic are very surprised and confused when they learn that the odd jobs they have picked up to make ends meet come with tax reporting and recordkeeping obligation. It is apparent that many workers in the new gig economy need more guidance from the IRS or other sources regarding their taxes.

Steps Taken to Address the Confusion

Some progress has been made toward clarifying the confusion around taxation of the gig economy. In 2016, the IRS launched the Sharing Economy Tax Center webpage on the IRS website (<https://www.irs.gov/businesses/small-businesses-self-employed/sharing-economy-tax-center>) that provides more instructions to gig economy workers and addresses common issues they often face.

In 2017, Nina Olson, the National Taxpayer Advocate, in her annual report to congress elevated the lack of tax guidance

reportable payment transactions. These actions have improved the situation, but there is still more to do to reduce the confusion in the gig economy.

Tips for Taxpayers

To make the filing process easier, taxpayers should separate their personal and business expenses throughout the year. It is important to document business expenses and note the purpose of each expense. Having separate credit cards and bank accounts for business expenses is key in this process. In addition, taxpayers should keep track of the miles they are driving for business purposes by using apps designed for this purpose or even an old-fashioned pen and paper. Taxpayers can also use accounting software systems to manage sales and expenses. They should update their system daily or at least weekly to stay on top of their documentation.

Requirements for Form 1099-K

The 2018 Intuit Tax Survey of self-employed found that while 32 percent of self-employed taxpayers properly reported their earnings, 32 percent underreported their earnings, and the remaining 36 percent did not report.

It is important to note that Form 1099-MISC is required on amounts paid by non-employers to service providers that exceed \$600. However, if a payment is made via a credit or debit card, as is the case for most gig economy jobs, non-employers must

year, most of them do not receive a Form 1099-K. Thus, while the self-employed individual is required to report all earnings over \$400, most will not receive any type of corroboration—and failure to receive a 1099 is not an excuse for failure to file.

What Both Workers and Employers Should Know

Of course, some contractors will meet the new ABC test, but most will not. If you want to avoid the risk, the best approach is to only hire independent contractors if they are the type you would look up in the “yellow pages” in the old days. The plumber, the electrician, the landscaper, or some other type of trade that typically comes in for a one-time job will be fine. After *Dynamex*, these are the only types of contractors you can hire with confidence that they will be viewed as independent contractors.

If you venture into the grey area, the penalties you might face for misclassification of independent contractors are significant. For the misclassified worker, some deductions may be disallowed and back taxes may be owed, which will also trigger penalties for failure to pay and interest dating back to the original due date.

For the employer who fails to withhold federal income tax, the IRS imposes a penalty of 1.5 percent of wages paid, and for failing to withhold the employ-

have been paid. Furthermore, the employer cannot recover any part of the penalty from the employee.

The California Franchise Tax Board (FTB) also has its own set of penalties for misclassification of employees. The FTB imposes penalties to employers ranging from \$5,000 to \$15,000 per violation or between \$10,000 and \$25,000 if the misclassification is deemed a pattern or practice of willful misclassification. Failure to withhold and pay payroll taxes can also result in a misdemeanor charge of \$1,000 per misclassified worker and one year in prison. The employer also must post this violation on their company website with an explanation of the violation. The FTB also protects these misclassified workers by allowing them to seek up to three years' worth of unpaid wages (i.e. overtime and meal/rest break violations) and penalties from their employer.

It is highly unlikely the law in this area will take another detour, especially in California, so if you have independent contractors now that do not meet the ABC test and are going along for the ride, hoping for a carve out for your business, be sure you buckle your seatbelt. It looks like it is going to be a bumpy ride. ■

¹ Bruckner C. (2016, May 23). *Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy*. Retrieved from <https://www.american.edu/kogod/news/Shortchanged.cfm>