

**WRITTEN STATEMENT OF**

**NINA E. OLSON**

**NATIONAL TAXPAYER ADVOCATE**

**HEARING ON**

**“THE SHARING ECONOMY:**

**A TAXING EXPERIENCE FOR NEW ENTREPRENEURS”**

**BEFORE THE**

**COMMITTEE ON SMALL BUSINESS**

**U.S. HOUSE OF REPRESENTATIVES**

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Chairman Chabot, Ranking Member Velázquez, and distinguished Members of this Committee:

Thank you for holding today's hearing on the sharing economy and inviting me to speak on this important and emerging topic.<sup>1</sup> In my testimony today, I will focus mainly on two aspects of taxation in relation to the sharing economy: the IRS presence in the sharing economy and ways to increase tax compliance among participants in the sharing economy.

The IRS has an opportunity to be at the forefront of tax compliance in the emerging and growing area of the sharing economy. Estimates show that over 2.5 million Americans are earning income through the sharing economy<sup>2</sup> and that number is expected to continue its upward trajectory.<sup>3</sup> Establishing the tax compliance norms for this emerging industry in its infancy will assist the IRS as this segment of taxpayers grows.

At my Public Forum in Washington, DC on May 17, 2016, one of our panelists provided written testimony on the results of a survey of members of the National Association of the Self-Employed (NASE).<sup>4</sup> The survey revealed that:

- 34 percent of those who reported earning income in the sharing economy did not know they needed to file quarterly estimated tax payments;
- 36 percent did not understand what records they would need to maintain as a small business for tax purposes;
- 43 percent did not set aside money to meet their tax obligations or know how much they owed; and

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<sup>1</sup> The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

<sup>2</sup> JPMorgan Chase & Co. Institute, *Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility* (Feb. 2016), <https://www.jpmorganchase.com/corporate/institute/report-paychecks-paydays-and-the-online-platform-economy.htm>. This estimate is for one month and is an estimate of the number of people earning income in the sharing economy.

<sup>3</sup> JPMorgan Chase & Co. Institute, *The Online Platform Economy: What is the Growth Trajectory*, Insights (May 2, 2016), <https://www.jpmorganchase.com/corporate/institute/institute-insights.htm>. This estimate is for one month and is an estimate of the number of people earning income in the sharing economy.

<sup>4</sup> Written statement of Caroline Bruckner, Managing Director, Kogod Tax Policy Center (May 17, 2016). In this survey, 22 percent of respondents reported earning income in the sharing economy. The statistics reported above are percentages of those who reported earning income in the sharing economy. See Caroline Bruckner, *Shortchanged: The Tax Compliance Challenges of Small Business Operators Driving the On-Demand Platform Economy* (May 2016).

- 69 percent did not receive any tax information from the sharing economy platform they used to earn their income.<sup>5</sup>

These results demonstrate both the need for guidance from the IRS and the opportunity to create a culture of tax compliance among participants in the sharing economy from the outset. In my 2013 Annual Report to Congress, I published a study detailing the factors that influence compliance in small business communities. The study found that the top two factors influencing compliance are taxpayer service and social norms among the small business community.<sup>6</sup> By providing targeted information to sharing economy participants, the IRS can both establish its taxpayer service presence and positively influence the norms in the community.

## **I. IRS Presence in a Sharing Economy**

The sharing economy can be described as “collaborative consumption” or a “peer-to-peer market” that links a willing provider to a consumer of goods or services (coordinated through a community-based online service). Typically, there are three parties involved in a sharing economy transaction. In this testimony, I will refer to them as service providers (the freelancers who provide the goods or services), service recipients (the consumers of such good or services), and service coordinators (the third-party platforms that facilitate the transactions).

Proponents of the sharing economy believe it promotes marketplace efficiency by enabling individuals to generate revenue from assets while the assets are not being used personally. For example, a car owner may allow someone to rent out his vehicle while he is not using it, or a home owner may rent out his home while on vacation.

The collaborative consumption model is not new – it has been used in online marketplaces such as eBay for years – but it has expanded significantly in recent years. Peer-to-peer services not only include short-term home rentals (Airbnb) and shared car services (Uber and Lyft), but also include:

- Sharing backseat with strangers (Hitch)
- Short-term car rentals (Relayrides)
- Selling handmade or vintage items (Etsy)
- Providing household errands (TaskRabbit)

Participants in the sharing economy typically do not fit the mold of the traditional employee, working “9 to 5” for a singular boss and receiving a Form W-2 from an employer. Rather, they may view themselves (or are treated thusly by third parties) as contingent workers or freelancers, serving hundreds of clients. The sharing economy

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<sup>5</sup> *Id.*

<sup>6</sup> National Taxpayer Advocate 2013 Annual Report to Congress vol. 2, 38 (Research Study: *Small Business Compliance: Further Analysis of Influential Factors*).

often includes an additional party in transactions – the service coordinator – which may or may not provide a Form 1099 to the service provider.

### **A. Scope of the Sharing Economy**

While there is no universal definition of a contingent worker or freelancer in the sharing economy, it is clear that non-traditional workers make up a significant percentage of the U.S. workforce. According to a report by the Government Accountability Office (GAO), there were 42.6 million contingent workers in 2005, which constituted an estimated 31 percent of the workforce.<sup>7</sup> In its report, the GAO defined “contingent work” as a work arrangement that is not long-term, year-round, full-time employment with a single employer.<sup>8</sup> Temporary workers, independent contractors, and part-time workers are examples of contingent workers.

In 2015, the GAO updated its findings on the contingent workforce, looking at data from 2006 and 2010. The GAO estimated that the proportion of the employed labor force in alternative work arrangements grew from 35.3 percent to 40.4 percent between 2006 and 2010.<sup>9</sup>

A 2015 study commissioned by the Freelancers Union estimated that there are nearly 54 million Americans — 34 percent of the U.S. workforce — working as freelancers.<sup>10</sup> This survey defined freelancers as “individuals who have engaged in supplemental, temporary, or project- or contract-based work in the past 12 months.”<sup>11</sup>

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<sup>7</sup> GAO, GAO-06-656, *Employment Arrangements* 10 (July 2006), <http://www.gao.gov/assets/260/250806.pdf>.

<sup>8</sup> *Id.* at 5.

<sup>9</sup> GAO, GAO-15-168R, *Contingent Workforce* 12 (Apr. 2015), <http://www.gao.gov/assets/670/669766.pdf>. The GAO’s estimates of the contingent workforce include alternative work arrangements, and have many more workers than those identified by Bureau of Labor and Statistic’s (BLS) more limited definition. For example, the GAO identified 42.6 million workers in alternative work arrangements in 2005, while the broadest BLS definition estimated 5.7 million contingent workers. GAO, GAO-15-168R, *Contingent Workforce* 11 (Apr. 2015).

<sup>10</sup> Edelman Berland, *Freelancing in America: A National Survey of the New Workforce* (2015), <https://www.upwork.com/press/2015/10/01/freelancers-union-and-upwork-release-new-study-revealing-insights-into-the-almost-54-million-people-freelancing-in-america/>.

<sup>11</sup> Edelman Berland, *Freelancing in America: A National Survey of the New Workforce* (Sept. 2014), <https://www.freelancersunion.org/53Million>.

Who are the 54 million freelancers? They can be broken out into the following five categories:<sup>12</sup>

- Independent Contractors (36% of independent workforce) — 19.3 million
- Moonlighters (25%) — 13.2 million
- Diversified workers (26%) — 14.1 million
- Temporary Workers (9%) — 4.6 million
- Freelance Business Owners (5%) – 2.5 million

According to the U.S. Census figures from 2013, small, self-employed and micro-businesses (with nine or fewer employees) account for over 78 percent of the overall small business community, representing more than 27.5 million entities nationwide. The self-employed have been growing faster than any other small business group over the past 10 years.<sup>13</sup>

There are many reasons why the sharing economy has grown as much as it has.

- **Cost.** It is often less costly for service recipients to use services offered by providers who identify as independent contractors than to use services offered by traditional employees. Employers are required to pay employment taxes for employees, and many offer costly benefits to full-time employees (such as retirement plans, paid leave, and health insurance). By classifying these workers as independent contractors, businesses are able to avoid these expenses, and pass the savings along to service recipients.
- **Technology.** With mobile networks and smartphone apps, a sharing economy is able to tap pools of latent labor supply, allowing service providers to deliver in real-time. Freelance workers can select engagements based upon how each job fits their own priorities and skills.
- **Lifestyle.** Freelance workers enjoy greater flexibility, control, and variety than their full-time employed counterparts. For example, an Uber driver has the luxury of electing to work only when it makes sense for his schedule, whereas a full-time taxi driver may have to adhere to rigid schedules set by the employer.

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<sup>12</sup> Edelman Berland, *Freelancing in America: A National Survey of the New Workforce* 6 (2015), <https://www.upwork.com/press/2015/10/01/freelancers-union-and-upwork-release-new-study-revealing-insights-into-the-almost-54-million-people-freelancing-in-america/>.

<sup>13</sup> Michael Cohn, 'Sharing Economy' Gets Little Tax Guidance, *Accounting Today* (May 12, 2016), <http://www.accountingtoday.com/news/tax-practice/sharing-economy-gets-little-tax-guidance-78084-1.html>.

## **B. Participants in the Sharing Economy May Not Fully Understand Their Tax Obligations.**

Understandably, many of the new service providers in a sharing economy may not fully comprehend their tax filing obligations or have any experience with the requisite tax record-keeping. These new entrants to the sharing economy will need to spend significant time learning about their tax compliance obligations and to devote many hours to recordkeeping. Yet, according to a recent survey conducted by NASE, 69 percent of entrepreneurs who participate in the sharing economy received absolutely no tax guidance from the companies with which they work.<sup>14</sup>

Professor Leslie Book of the Villanova University School of Law has written an article on the various types of noncompliance the IRS encounters. Professor Book explained that not all noncompliant taxpayers are willfully noncompliant; many of them are tripped up by “unknowing” or “lazy” noncompliance.<sup>15</sup> That is, some taxpayers are simply unaware of their tax compliance obligations. The NASE survey results underscore the importance of educating sharing-economy entrepreneurs and merchants about the fact that they are operating a self-employed, small business and need to understand certain basic tax obligations (*i.e.*, making required quarterly estimated payments throughout the year to avoid penalties).

Much of the compliance burden can be alleviated if tax is collected by third parties and reported to the IRS and to the service providers. This works well for workers in an employee/employer relationship – the employer withholds income and employment taxes throughout the year, and provides a Form W-2 to the employer and the IRS after the close of the year. In fact, IRS tax gap data shows that 99 percent of wages subject to withholding and third-party information reporting is reported by taxpayers to the IRS.<sup>16</sup> But for workers who fall outside the parameters of a traditional employee/employer relationship, the process may get more complicated. A driver of a shared car service may receive a Form 1099-MISC in January, reporting the gross amount received in fares for the prior year, but the issuer of the Form 1099-MISC typically has not done any withholding. The service provider may not have been aware of the consequences of being classified as a non-employee, and may not have set aside money for self-employment tax or have made quarterly estimated payments. Other service providers in a sharing economy may not receive any information reporting from the online marketplace provider.<sup>17</sup>

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<sup>14</sup> NASE, [http://www.nase.org/about-us/Nase\\_News/2016/04/29/nase-releases-new-survey-data-on-sharing-economy](http://www.nase.org/about-us/Nase_News/2016/04/29/nase-releases-new-survey-data-on-sharing-economy). The survey was sent in March 2016 to more than 40,000 small businesses and received over 500 responses, mainly from the self-employed, about their participation in the sharing economy.

<sup>15</sup> Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. KAN. L. REV. 1145 (2003).

<sup>16</sup> IRS, *Tax Gap Estimates for Tax Years 2008-2010* (Apr. 2016).

<sup>17</sup> The IRS issues Form 1099-K, *Payment Card and Third Party Network Transactions*, only when the total number of transactions exceed 200 and the aggregate value exceeds \$20,000 in a calendar year. See Internal Revenue Code (IRC) § 6050W(e).

### **C. The IRS Should Expand Its Education and Outreach to Sharing Economy Participants, Including by Developing a Publication on Sharing Economy Tax Issues.**

If we operate under the premise that most taxpayers want to comply with the law, the IRS needs to expand its presence within the sharing economy to enable that compliance. Providers of services want to be educated about what is expected of them. There are many ways in which the IRS can provide improved taxpayer service to this growing sector.

For example, many Uber drivers engage in an online forum where they can share information about or solicit advice on a wide range of topics.<sup>18</sup> There is even a sub-forum dedicated to tax compliance, focused on “1099 income, deductions, and the IRS.”<sup>19</sup> Similarly, Airbnb hosts have created an online forum where hosts can share advice with other hosts, and there is a sub-forum dedicated to “Regulations/Tax Issues.”<sup>20</sup> Could the IRS convey messages through such online forums? Certainly, the IRS could not provide tax advice, but it could point users to appropriate IRS publications or other existing communication. If the IRS wants to be really bold and proactive, it could designate a representative to respond to questions “AMA”-style on a Reddit forum for Airbnb or Uber users.<sup>21</sup> It is clear that there is a segment of the sharing economy that seeks guidance on how to comply with their tax obligations. Another benefit of these exchanges is that the IRS will learn about specific challenges and issues facing this segment of the economy and thereby do a better job of tailoring its guidance for both taxpayers and IRS employees.

The IRS could also get more creative in re-packaging existing content and tailoring it for participants in a sharing economy. For example, the IRS currently releases Publication 527, *Residential Rental Property*,<sup>22</sup> and Publication 463, *Travel, Entertainment, Gift, and Car Expenses*,<sup>23</sup> each year. While these publications contain helpful information, an Airbnb host would have to sift through the 24-page Publication 527 and an Uber driver would have to navigate through the 50-page Publication 463, and they still might not understand the how these rules apply to themselves as service providers in a sharing economy.

The IRS should develop and publicize a new publication for sharing economy participants. It need not be long and all-encompassing, but it should at a minimum provide a checklist of issues that first-time, self-employed persons participating in the

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<sup>18</sup> See [www.uberpeople.net](http://www.uberpeople.net).

<sup>19</sup> <http://uberpeople.net/forums/Taxes/>.

<sup>20</sup> <http://airhostsforum.com/c/regulations-tax-issues>.

<sup>21</sup> AMA stands for “ask me anything.”

<sup>22</sup> <https://www.irs.gov/pub/irs-pdf/p527.pdf>.

<sup>23</sup> <https://www.irs.gov/pub/irs-pdf/p463.pdf>.



sharing economy should be aware of. For example, this new publication should include information about the need to make estimated payments of income and employment taxes. It should also explain that self-employed persons pay both the employee and employer shares of employment taxes. The new publication should mention that self-employed persons generally need to file a Schedule C and generally may deduct expenses (e.g., actual vehicle expenses for Uber drivers, or a standard vehicle expense based on mileage), provided they keep contemporaneous and accurate records. This new sharing economy publication should cross reference other IRS publications that provide more detail on these and a few other issues that are relevant to service providers in a sharing economy. To be evenhanded, the publication should also briefly explain the factors underlying worker classification, and cross-reference other IRS materials on that topic.

In addition, the IRS should consider developing a one-page brochure that touches on some very basic points relevant to service providers in a shared economy. For example, this brochure can point out the significant difference in tax treatment when a home is rented out for 14 days or less per year versus a home that is rented by an Airbnb host for more than 14 days.<sup>24</sup> This brochure could contain a link to the new publication on the sharing economy.

The IRS should also consider creating a dedicated web page containing tax tips for freelancers engaging in a sharing economy. It could contain the same information that is contained in the brochure, along with a Frequently Asked Questions (FAQs) section that is updated periodically. The IRS should designate liaisons to monitor online forums to identify emerging issues for the sharing economy and address them via FAQs while more formal guidance is being developed. (FAQs should not be a substitute for formal guidance.)

Over the past few months, I have been hosting a series of Public Forums on taxpayer service. During a Public Forum on May 17, 2016, one panelist noted that although people generally don't use government online services, there is one type of online tool they find particularly helpful – namely, an online “wizard.”<sup>25</sup> This got me to thinking – why doesn't the IRS use technology to reach participants in the sharing economy? Why can't the IRS create an online wizard to walk taxpayers who are newly self-employed through the various steps one needs to take (e.g., obtain an employer identification number, make estimated payments, keep books and records)? Why not create a downloadable mileage log app for taxpayers to use, with pre-populated mileage rates for a given year? Why not develop a calendar function that permits taxpayers to add the estimated tax payment due dates to their smartphone calendars? There are many

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<sup>24</sup> For someone using a dwelling unit for both rental and personal purposes, the tax treatment of the rental expenses depends on how many days the dwelling unit was rented out during the year. If the property is rented less than 15 days during the year, income from the rental shall not be included in the gross income of the taxpayer (and rental expenses may not be deducted). See IRC § 280A(g); IRS, Publication 527, *Residential Rental Property* 3.

<sup>25</sup> Oral Statement of Rick Parrish, Forrester Research, National Taxpayer Advocate Public Forum (May 17, 2016).

ways the IRS can embrace technology to deliver services that taxpayers need. The sharing economy deserves more attention from the IRS, and steps like these would benefit millions of participants.

The IRS should increase and front-load outreach and education to improve awareness of self-employment requirements at the outset and thereby reduce inadvertent noncompliance. Although the IRS created the Taxpayer Education and Communication (TEC) unit within the Small Business/Self-Employed division in the aftermath of the IRS Restructuring and Reform Act of 1998 for precisely this purpose, the IRS has since largely moved away from maintaining a local presence.<sup>26</sup> I believe the lack of a local presence on the part of the IRS has a negative effect on taxpayer compliance.

Taxpayers who attempt to reach the IRS with tax law questions should be able to speak to someone about their substantive tax issue. Driving taxpayers to online content may be the desired goal of the IRS's "Future State" plan, but there are times when a taxpayer needs to speak to a live assistor. Congress needs to provide the resources for the IRS to properly staff its phone lines to achieve an acceptable level of service, and it needs to hold the IRS accountable for answering tax law questions via the phone all year round. There should be no reason for such questions to be deemed "out of scope." We are asking taxpayers to voluntarily comply with their tax obligations, and the IRS should be there to pick up the phone and answer questions.<sup>27</sup>

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<sup>26</sup> In a 2003 report, the GAO noted that TEC was to have over 1,200 staff by fiscal year 2002 in 15 major field locations, but had fallen woefully short of these goals. TEC had reached its staffing level of only 718 as of March 2003, and had reduced the number of major field locations to seven. GAO, GAO-03-711, *Workforce Planning Needs Further Development for IRS's Taxpayer Education and Communication Unit 2* (May 2003), <http://www.gao.gov/assets/240/23891>.

<sup>27</sup> Internal Revenue Manual (IRM) 21.1.1, *Accounts Management and Compliance Services Operations, Accounts Management and Compliance Services Overview* (Sept. 17, 2015), provides instructions regarding the kinds of questions IRS customer service representatives may answer. IRM 21.1.1.6.1(1) (Mar. 2, 2015) provides that "The areas discussed below are beyond the level of service (out of scope) that CAS, Accounts Management will provide:

- Tax form and schedule preparation
- Tax planning
- Legal opinions
- Highly complex tax issues (limited service)".

Exhibit 21.1.1-1 (Mar. 6, 2014) contains a list of out-of-scope topics and forms. Out-of-scope items include entity classification, e-commerce, depreciation and amortization (including Section 179 deductions), and questions about tax software.

## **Recommendations**

I recommend that Congress direct the IRS to take the following actions:

- Develop and publicize a new publication for sharing economy participants that includes a checklist of issues that first-time, self-employed persons participating in the sharing economy should be aware of.
- Develop a one-page brochure touching on some basic points relevant to service providers in a sharing economy and containing a link to the new publication for sharing economy participants.
- Create a dedicated web page containing tax tips for freelancers engaging in a sharing economy and a Frequently Asked Questions section that is updated periodically.
- Designate liaisons to monitor and participate in online forums to identify emerging issues for sharing economy participants.
- Increase and front-load outreach and education to improve awareness of self-employment requirements at the outset and thereby reduce inadvertent noncompliance.
- Develop online wizards, such as a mileage log app and an estimated tax payment calculator, to assist taxpayers in the sharing economy.

## **II. Proposals to Increase Tax Compliance of Workers in the Sharing Economy**

As the sharing economy becomes more prominent in American society, it is important to consider the tax consequences to individuals who are entering this workforce.<sup>28</sup> Many individuals might take on these new jobs completely unaware that they are classified as independent contractors and have no understanding of the reporting responsibilities associated with that classification.<sup>29</sup> This is especially true due to the fact that many are taking on these jobs as a secondary source of income.<sup>30</sup>

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<sup>28</sup> Between October 2012 and September 2015, the cumulative percentage of adults who have ever participated in the “online platform economy” grew approximately 47-fold. JPMorgan Chase & Co. Institute, *Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility* 5, 7 (Feb. 2016) (Defining “online platform economy” as “economic activities involving an online intermediary that provides a platform by which independent workers or sellers can sell a discrete service or good to customers.”). For a detailed description of the Uber business model, see *O'Connor v. Uber Technologies, Inc.*, No. CV 13-03826-EMC, 2015 WL 4554634 (N.D. Cal July 9, 2015).

<sup>29</sup> In a recent survey of entrepreneurs in the sharing economy conducted by the National Association for the Self-Employed, approximately 69 percent of respondents indicated that they received no tax guidance from their companies. Michael Cohn, “*Sharing Economy*” Gets Little Tax Guidance, *Accounting Today* (May 12, 2016). In addition, Uber recently settled a class action labor dispute covering 385,000 drivers.

As the National Taxpayer Advocate, I have made numerous proposals over the years designed to increase compliance among small businesses. The main goal of each is to inform taxpayers of the tax implications of their business and protect them from getting into trouble down the road. In this testimony, I set forth proposals I believe will help workers in the sharing economy comply with the tax laws.

**A. Many Taxpayers Not Subject to Tax Withholding Cannot Save Enough Money to Pay Their Tax Bills so, in Appropriate Cases, Taxpayers Should Be Encouraged to Schedule Monthly Estimated Tax Payments as Automatic Debits from Their Bank Accounts.**

Independent contractors who want to comply with their estimated tax payment obligations sometimes fail because the process of estimating income is cumbersome.<sup>31</sup> Taxpayers must remember oddly spaced payment dates (April 15, June 15, September 15, and January 15), which do not consistently coincide with calendar quarters, making it difficult to calculate net income and confusing taxpayers.<sup>32</sup> Saving enough money each quarter is difficult, especially for self-employed taxpayers who are juggling many different duties and many competing demands on both time and funds. When they fail to pay enough (or any) estimated taxes, they are more likely to understate their tax liability.<sup>33</sup> Anything the IRS can do to help taxpayers make their estimated tax payments more easily and lessen the burden of saving to make such payments is likely to increase compliance.

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The drivers had argued that they should be treated as employees because the company exerts significant control over their work, sets compensation, and enforces vehicle standards. Uber maintained that the vast majority of drivers prefer the flexibility of independent contractor status. The settlement allowed Uber to continue classifying drivers as independent contractors. Douglas MacMillan, Lauren Weber and Rachel Emma Silverman, *Uber Drivers Settle with Ride-Hailing Company in Labor Dispute*, Wall Street Journal (Apr. 21, 2016).

<sup>30</sup> JPMorgan Chase & Co. Institute, *Paychecks, Paydays, and the Online Platform Economy: Big Data on Income Volatility* 7, 24 (Feb. 2016), <https://www.jpmorganchase.com/corporate/institute/report-paychecks-paydays-and-the-online-platform-economy.htm>.

<sup>31</sup> In fact, according to a recent survey performed by the Kogod Tax Policy Center, approximately 34 percent of the respondents who earned income working with an on-demand platform company indicated that they did not know whether they were required to file quarterly estimated tax payments. Written statement of Caroline Bruckner, Managing Director, Kogod Tax Policy Center, for National Taxpayer Advocate Public Forum (May 17, 2016).

<sup>32</sup> IRS Publication 505, *Tax Withholding and Estimated Tax* (Mar. 2016); Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 19 (Feb. 2004). Interestingly, many casually refer to the estimated tax payments as “quarterly payments,” but the tax law refers to them as the “4 required installments.” IRC § 6654(c).

<sup>33</sup> Treasury Inspector General for Tax Administration, Ref. No. 2004-30-040, *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* 13 (Feb. 2004).

The IRS should make it just as easy for taxpayers to make their estimated tax payments as it is to pay their other bills. Most other creditors send customers bills to remind them when a payment is due, and many creditors offer the option of paying via automatic monthly withdrawals from the customer's bank account free of charge. Similarly, the IRS could send letters, texts, or emails to self-employed taxpayers each quarter to remind them to make their estimated tax payments. These reminders could list the various methods available to make payments.<sup>34</sup>

In these reminder notifications, the IRS should encourage taxpayers to pay by electronic funds transfer using the IRS's Electronic Federal Tax Payment System (EFTPS).<sup>35</sup> EFTPS has the potential to alleviate some estimated tax problems because it is free, convenient, and relatively easy to use. Moreover, taxpayers can use EFTPS to schedule automatic estimated payments up to one year in advance. The IRS should also encourage taxpayers to set up monthly, or even bi-weekly, advance estimated tax payments, just like most other recurring bills.<sup>36</sup> Signing up taxpayers for EFTPS could make estimated tax payments almost as automatic as withholding. A significant downside we see with the system is that it currently only has the capability to allow the user to schedule each payment individually, rather than set up re-occurring payments, and this limitation makes scheduling multiple payments time-consuming.<sup>37</sup> In addition, it is our understanding that EFTPS does not currently send payment reminder notices, although we also understand the IRS is working to update the system to send email notifications three days prior to a payment posting.<sup>38</sup>

## **Recommendations**

I recommend that Congress take the following actions:

- Revise IRC § 6654(c)(2) to align the estimated tax payment deadlines with calendar year quarters that are easier to remember, such as the last day of the

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<sup>34</sup> Taxpayers have many options to make payments: (1) mail a check; (2) pay cash for a \$3.99 fee at a 7-Eleven through the PayNearMe program 3) credit card payment, which involves varying fees depending on the provider; (4) Direct Pay, a free one-time electronic payment option which debits the taxpayer's bank account; and (5) the Electronic Federal Tax Payment System (EFTPS). For more details on these options, see IRS, *Payment Options: Pay Online, Installment Plans and More*, <https://www.irs.gov/Payments> (last visited May 9, 2016).

<sup>35</sup> See Treas. Reg. § 1.6302-4. In addition, employers are required to deposit employment taxes reported on Forms 941, *Employer's Quarterly Federal Tax Return*, or Form 944, *Employer's Annual Federal Tax Return*, using EFTPS. Treas. Reg. § 31.6302-1(h)(2).

<sup>36</sup> Some mortgage companies offer programs that electronically deduct mortgage payments bi-weekly rather than monthly.

<sup>37</sup> It is our understanding that the system would need to keep signed user authorizations on file for two years in order to enable re-occurring payments. Taxpayers in direct debit installment agreements (DDIAs) have the ability to set up re-occurring payments because such signed authorizations are kept for the requisite period. Wage & Investment, Electronic Payment Section, EFTPS Presentation to TAS (May 10, 2016).

<sup>38</sup> Phone Conversation with Wage & Investment, Electronic Payment Section (May 10, 2016).

month following the end of the calendar quarter (*i.e.*, April 30, July 31, October 31, and January 31).

- Direct the IRS to contact self-employed taxpayers by letter or, where a taxpayer so requests, by email each quarter to remind them to make their estimated tax payments. These reminders could point out the various payment methods available and offer taxpayers the option of making payments more frequently, such as monthly or even bi-weekly.
- Direct the IRS to encourage taxpayers to schedule payments in advance through EFTPS, so that the funds are automatically deducted from the taxpayer's bank account.
- Direct the IRS to update EFTPS to enable users to set up reoccurring payments and ensure the system has the ability to send out reminder emails several days in advance of the payment posting.

#### **B. Independent Contractors Should Have the Option to Enter into Voluntary Withholding Agreements.**

While many independent contractors wish to comply with filing requirements, they may have a substantial tax bill to pay because no federal taxes were withheld from their earnings during the tax year. Taxes are not generally withheld from payments made to workers who are classified as independent contractors.<sup>39</sup> Some workers hired as independent contractors are unaware of the tax consequences of accepting a non-employee job until they must file returns. Other workers are aware of the rules but do not save enough money to pay their living expenses and also their taxes or do not make required quarterly estimated tax payments.

Because research shows taxpayers are most compliant in paying taxes on income subject to withholding, the IRS should encourage taxpayers to enter into voluntary withholding agreements.<sup>40</sup> Service recipients would need an incentive to take on this extra administrative burden. However, we believe that many of the large companies participating in the sharing economy already have experience with income tax withholding obligations for their administrative staff that are classified as employees. In order to encourage companies to take on any additional tax compliance burdens associated with voluntary withholding agreements, the IRS could, on a case-by-case basis, provide a safe-harbor worker classification in which it essentially agrees not to challenge the classification of workers who are a party to such agreements. Thus, these agreements could reduce both underreporting by payees and the controversy associated with worker classification. The IRS has authority to accept such agreements under IRC § 3402(p)(3) but it may need to work with the Department of the Treasury to

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<sup>39</sup> IRC § 3402.

<sup>40</sup> For more information about the tax gap, see IRS, *The Tax Gap*, <https://www.irs.gov/uac/The-Tax-Gap> (last visited May 9, 2016).

issue regulations before it can use such authority. It may also prefer to receive additional and specific legislative authority to enter into such deals.<sup>41</sup>

### **Recommendations**

I recommend that Congress direct the IRS to take the following actions:

- Set up a program whereby taxpayers can enter into voluntary withholding agreements under IRC § 3402(p)(3).
- Determine the feasibility of the IRS agreeing to not challenge the classification of workers who are party to such agreements.
- Work with the Department of the Treasury to issue regulations setting forth the requirements for such agreements.

### **C. Additional Measures Should Be Considered for Taxpayers with a History of Substantial Tax Noncompliance.**

Because income-reporting compliance is nearly 100 percent when payments are subject to withholding, we have considered the feasibility of requiring withholding on certain payments made to substantially noncompliant independent contractors.<sup>42</sup> Withholding can impose significant burdens on the service recipient and in many instances is administratively unworkable. Therefore, I am not advocating universal withholding. But we should consider implementing the following steps to increase noncompliance among taxpayers who have a history of substantial noncompliance.<sup>43</sup>

#### **1. Require Monthly EFTPS Payments of Estimated Taxes**

Where a self-employed taxpayer has been substantially noncompliant for several years, the IRS could require the taxpayer to make monthly deposits of estimated taxes through EFTPS. While this would not address existing tax liabilities for previous tax years, it would help taxpayers maintain compliance in the future. The IRS could monitor compliance with this requirement closely so it could intervene quickly if the taxpayer misses a required payment. If the taxpayer consistently fails to make required payments, the IRS could impose a back-up withholding requirement, as described below.

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<sup>41</sup> National Taxpayer Advocate 2005 Annual Report to Congress 55-75 (Most Serious Problem: *The Cash Economy*).

<sup>42</sup> For more information about the tax gap, see IRS, *The Tax Gap*, <https://www.irs.gov/uac/The-Tax-Gap> (last visited May 9, 2016).

<sup>43</sup> For a more detailed discussion, see National Taxpayer Advocate 2005 Annual Report to Congress 381-396 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*).

## 2. Require Backup Withholding

Congress should amend IRC § 3406 to provide the IRS authority to require a form of “backup withholding” by the service recipient in cases where an independent contractor payee has a demonstrated history of substantial noncompliance with the tax laws, as defined by regulations. In my 2003 and 2005 Annual Reports to Congress, I recommended extending a modified withholding scheme to certain payments made to independent contractors. The rate of withholding was calculated based on IRS data on sole proprietors (Schedule C filers) in industries most likely to have inventories. According to the 2000 data, sole proprietors with inventories had expenses equal to approximately 78 percent of gross proceeds. Sole proprietors without inventories had expenses equal to approximately 71 percent of gross proceeds. To cover self-employment taxes of 15.3 percent for sole proprietors with inventories, we multiplied 15 percent times the 22 percent gross profit percentage (gross receipts minus 78 percent expenses) and rounded up the resulting 3.3 percent rate to 3.5 percent. We used the same logic to compute a five percent rate for those without inventories.<sup>44</sup>

Because profit margins often vary by industry, Congress could authorize the Secretary to establish withholding rates specific to certain trades and industries that maintain inventories or receive payments for materials and supplies. Absent industry-specific guidance, however, the withholding rate could be 3.5 percent on payments to sole proprietors who maintain inventories and five percent on payments to sole proprietors who do not.<sup>45</sup>

This backup withholding proposal is substantially different from the repealed three-percent withholding requirement imposed on government contractors by Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005. That provision added IRC § 3402(t), which required many government agencies to withhold three percent from most payments of \$10,000 or more for products or services they purchase. The withholding rules applied to government agencies with annual procurement budgets of \$100 million or more. Some types of transactions were exempt from the legislation, including payments of interest and payments to tax-exempt organizations. The provision was initially set to go into effect for payments made after December 31, 2010.<sup>46</sup> However, the American Recovery and Reinvestment Act of 2009 delayed the effective date for one year.<sup>47</sup> In addition, the IRS further delayed implementation by

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<sup>44</sup> National Taxpayer Advocate 2003 Annual Report to Congress 256-269 (Legislative Recommendation: *Tax Withholding on Non-Wage Workers*); National Taxpayer Advocate 2005 Annual Report to Congress 381-396 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*).

<sup>45</sup> National Taxpayer Advocate 2005 Annual Report to Congress 381-396 (Legislative Recommendation: *Measures to Reduce Noncompliance in the Cash Economy*); National Taxpayer Advocate 2003 Annual Report to Congress 256-257 (Legislative Recommendation: *Tax Withholding on Non-Wage Workers*).

<sup>46</sup> Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, § 511, 120 Stat. 345, 364 (May 17, 2006).

<sup>47</sup> American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, Division B, § 1511, 123 Stat. 115, 355 (Feb. 17, 2009).



regulation to apply to payments made after December 31, 2012.<sup>48</sup> The provision was eventually repealed before it became effective due to concerns about the negative consequences to the cash flow of contractors and the costs to government agencies of implementing the withholding provisions.<sup>49</sup>

Unlike the repealed provision, our proposal would not impose a blanket requirement on payments but would only apply with respect to contractors who have a history of substantial noncompliance. In addition, the rates would be calculated, ideally on an industry-by-industry basis, to ensure that the contractors have just enough withheld to cover self-employment taxes.

#### **D. Issue Compliance Certificates to Workers Maintaining Compliance.**

Congress should authorize the Secretary to issue “Compliance Certificates” to indicate that the certificate holder is exempt from any back-up withholding requirements. A taxpayer would be eligible for a Compliance Certificate if he or she has been in compliance with prior filing and payment obligations. If the taxpayer has been noncompliant, the IRS would still issue a Compliance Certificate if, for example, the taxpayer makes arrangements to satisfy past obligations and schedules a year’s worth of estimated tax payments through EFTPS. If an independent contractor presents a valid Compliance Certificate, the service recipient would know there is a low risk of backup withholding on payments to the worker.

In the United Kingdom, contractors in the construction industry are generally required to withhold on payments to subcontractors unless Her Majesty’s Revenue and Customs (HMRC) declares the subcontractor to be exempt from withholding. In the past, subcontractors could obtain exemption certificates from HMRC by demonstrating compliance. Holders of exemption certificates were required to show they had a good tax compliance record for the three years before they applied for or renewed their exemption certificate. Once they had a valid certificate, they were exempt from tax withholding requirements.<sup>50</sup> Currently, HMRC does not issue physical certificates but requires all contractors to “verify” subcontractors, at which point they determine the rate of withholding or if the subcontractor is exempt.<sup>51</sup> This general approach gives contractors an incentive to employ compliant subcontractors, as most contractors want to minimize their paperwork burden and avoid withholding requirements.

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<sup>48</sup> Treas. Reg. § 31.3402(t)-1(d)(1).

<sup>49</sup> Three Percent Withholding Repeal and Job Creation Act, Pub. L. No. 112-56, § 102, 125 Stat. 711, 712 (Nov. 21, 2011).

<sup>50</sup> Rebecca Bennyworth, *Business News: Construction Sector Faces More Compliance Problems (May 2, 2006)*, <http://www.accountingweb.co.uk/business/finance-strategy/business-news-construction-sector-faces-more-compliance-problems-by> (last visited May 10, 2016).

<sup>51</sup> HMRC, *Business Tax: Construction Industry Scheme (CIS)*, <https://www.gov.uk/topic/business-tax/construction-industry-scheme> (last visited May 11, 2016).

The Compliance Certificate could serve as the mechanism for market-driven compliance. When an independent contractor presents a service-recipient with a valid Compliance Certificate, the service recipient would know there is no risk of backup withholding on payments to that independent contractor. On the other hand, when an independent contractor does not have a valid Compliance Certificate, the service recipient immediately would know that backup withholding on payments to this independent contractor is possible. Market forces would act to oblige independent contractors to operate among the ranks of the tax compliant. The easiest way for a service recipient to avoid backup withholding would be to hire only independent contractors who present a valid Compliance Certificate. It follows that independent contractors who want to work would obtain Compliance Certificates. And in order to obtain a Compliance Certificate, an independent contractor would have to be tax compliant. Thus, tax compliance would become a condition of conducting business.

### **Recommendations**

I recommend that Congress take the following actions:

- Amend IRC § 3406 to require a form of “backup withholding” by service recipients in cases where an independent contractor has a demonstrated history of substantial noncompliance with the tax laws.
- Direct the Secretary to issue regulations defining “substantial noncompliance.”
- Determine the feasibility of implementing a Compliance Certificate program.

### **E. The Worker Classification Rules Are Complex and Create Uncertainty.**

Misclassification of workers can have serious consequences for the workers, the recipients of the services they provide, and tax administration in general. Whether a worker is classified as an employee or independent contractor affects the application of labor laws<sup>52</sup> as well as tax treatment of both the worker and the service recipient.<sup>53</sup> Classification also comes into play under the Affordable Care Act, which requires employers to report on health insurance coverage offered, and the insurance provided,

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<sup>52</sup> Such protections include the Fair Labor Standards Act, Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions. See Government Accountability Office, GAO-09-717, *Employee Misclassification: Improved Coordination, Outreach and Targeting Could Better Ensure Detection and Prevention* (Aug. 8, 2009).

<sup>53</sup> For a detailed discussion of the tax treatment of both classifications, see Joint Committee on Taxation, *Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007*, JCX-26-07 (May 7, 2007).

to employees.<sup>54</sup> Unfortunately, the worker classification rules are complex and ambiguous. The following aspects of the classification rules lead to confusion and may lead to the intentional or inadvertent misclassification of workers.

### **1. The Common Law Test Does Not Provide Clear Answers.**

The 20-factor test to determine proper classification is complex, subjective, and does not always produce clear answers. The potential for errors and abuse is high in those gray areas where not all factors yield the same result, particularly because there are no weighting rules.<sup>55</sup>

To provide more certainty in this area, I recommended in my 2008 Annual Report to Congress that the IRS develop an electronic self-help tool, similar to Employment Status Indicator (ESI) in the United Kingdom. Her Majesty's Revenue and Customs (HMRC) provides taxpayers with this free, web-based service which asks service recipients a series of questions and, based on the answers given, supplies an "indication of employment status."<sup>56</sup> Employers should be able rely upon the classification generated from the online tool, unless they misrepresent the information input into the system while answering questions or circumstances have materially changed.<sup>57</sup>

### **2. The Section 530 Safe Harbor Rule Creates Confusion.**

The safe harbor rule of § 530 of the Revenue Act of 1978 adds confusion to an already complicated set of classification rules.<sup>58</sup> Apparently, § 530 was enacted "to alleviate what was perceived as overly zealous pursuit and assessment of taxes and penalties against employers who had, in good faith, misclassified their employees as independent contractors."<sup>59</sup> However, interpretation of the provision has become an additional source of dispute and confusion.<sup>60</sup>

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<sup>54</sup> The Patient Protection and Affordable Care Act of 2010 (ACA), Pub. L. No. 111-148, 124 Stat. 119 (Mar. 23, 2010) (codified in scattered sections of the U.S. Code), as amended by the Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, 124 Stat. 1029 (Mar. 30, 2010).

<sup>55</sup> In Revenue Ruling 87-41, 1987-1 C.B. 296, the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists. To complicate the matter even further, the Department of Labor recently issued a memo in which it adopted an expansive interpretation of the definition of "employees" under the Fair Labor Standards Act, which may result in many workers currently treated as independent contractors being reclassified as employees. United States Department of Labor, Administrator's Interpretation No. 2015-1 (July 15, 2015).

<sup>56</sup> For more information on the ESI, see <http://www.hmrc.gov.uk/calcs/esi.htm> (last visited May 12, 2016).

<sup>57</sup> National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: *Worker Classification*).

<sup>58</sup> Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86 (Nov. 6, 1978) (codified as amended at 26 U.S.C. §§ 3401, 3101).

<sup>59</sup> *Boles Trucking, Inc. v. U.S.*, 77 F.3d 236, 239 (8th Cir. 1996) (citation omitted).

<sup>60</sup> The confusion stems from the following: (1) location of the provision outside the Tax Code, (2) the reliance on facts and circumstances, (3) the provision only applies to service providers and not workers,

### **3. Workers and Businesses Face Significant Consequences When the IRS Reclassifies a Worker's Status.**

Whether misclassification is inadvertent or deliberate, significant tax consequences result if the IRS subsequently reclassifies the worker after an audit. For example, the service recipient may be liable for employment taxes for a number of years,<sup>61</sup> interest, penalties, and potential disqualification of employee benefit plans. The worker may have to pay self-employment taxes and lose the ability to take certain business-related deductions. In addition, if the worker is classified as an employee, he or she may be barred from claiming a refund of self-employment taxes because the statutory period for claiming a refund expired while the IRS was challenging the employer's classification issue. Further, the worker has no right to petition the classification determination to the U.S. Tax Court under IRC § 7436. In my 2008 Annual Report to Congress, I proposed that Congress revise IRC § 7436 to allow both employers and employees to request classification determinations and seek recourse in the Tax Court.<sup>62</sup>

### **4. Lack of Published Guidance Likely Contributes to Misclassification.**

Because § 530 prohibits the Treasury Department and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance. Because general working conditions have changed significantly over the last four decades, such a prohibition is contrary to sound tax administration and likely increases the potential for both deliberate and inadvertent misclassification. Although the IRS has published training materials on this issue, they do not carry the force of law.<sup>63</sup> We also acknowledge that private industry may have legitimate concerns about any guidance issued by the government, especially if industry is not consulted beforehand. I urge Congress to require the IRS to consult with industry and report back to the tax-writing committees on the findings of such consultations, with the ultimate

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and (4) the application of the provision to employment taxes, which is statutorily defined to include income tax withholding. Pub. L. No. 95-600, § 530(c)(1), 92 Stat. 2763, 2885-86 (Nov. 6, 1978). Further, judicial decisions have made clear that there is no *de minimis* exception to the substantive consistency requirement of § 530. See *Institute for Resource Management, Inc. v. U.S.*, 90-2 U.S.T.C. ¶ 50,586 (Cl. Ct. 1990).

<sup>61</sup> IRC § 3509.

<sup>62</sup> IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending. This provision does not authorize the employee to petition the Tax Court. Section 530 provides a safe harbor rule allowing service recipients to treat workers as independent contractors, regardless of their actual status under the common law test, if there is reasonable basis for treating the worker as an independent contractor and certain other requirements are met.

<sup>63</sup> See, e.g., IRS Pub. 1779, *Independent Contractor or Employee* (Mar. 2012).

goal of allowing the Secretary of the Treasury to issue guidance based on such findings, including a specific industry focus.<sup>64</sup>

### **Recommendations**

In order to reduce the complexities and ambiguities associated with the worker classification rules, I recommend that Congress take the following actions:

- Replace § 530 with a provision applicable to both employment and income taxes, and require the IRS to consult with the industry and report back to the tax-writing committees on the findings of such consultations, with the ultimate goal of allowing the Secretary of the Treasury to issue guidance based on such findings, including a specific industry focus;
- Direct the IRS to develop an electronic tool to determinate worker classifications that employers would be entitled to use and rely upon, absent misrepresentation;
- Amend IRC § 7436 to allow both employers and employees to request classification determinations and seek recourse in the Tax Court; and
- Direct the IRS to conduct public outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.

### **III. Conclusion**

As the sharing economy continues to grow and evolve, the IRS has a unique opportunity to influence the tax compliance behavior of its participants. By establishing a presence in the community, providing service to the participants, and providing guidance to shape the norms of these taxpayers, it has the ability to impact the factors most likely to influence compliance among this population.

In this testimony, I have tried to offer some recommendations that would allow the IRS to assist these taxpayers in meeting their tax obligations and suggest steps Congress can take to ensure the IRS is able to meet the needs of these taxpayers effectively and efficiently.

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<sup>64</sup> National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: *Worker Classification*). Our initial recommendation published in the 2008 Annual Report to Congress required the Secretary of the Treasury to issue guidance. However, based on our discussions with small business groups, we subsequently refined the recommendation to propose that Congress mandate the IRS to hold a series of consultations with the industry and report back to the tax-writing committees on findings.