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By: Shu-Yi Oei and Diane Ring

There has been a lot of interest lately in new IRC Section 199A, the new qualified business income (QBI) deduction that grants passthroughs, including qualifying workers who are independent contractors (and not employees), a deduction equal to 20% of a specially calculated base amount of income. One of the important themes that has arisen is its effect on work and labor markets, and the notion that the new deduction creates an incentive for businesses to shift to independent contractor classification. A question that has been percolating in the press, blogs, and on social media[1] is whether new Section 199A is going to create a big shift in the workplace and cause many workers to be reclassified as independent contractors.

Is this really going to happen? How large an effect will tax have on labor markets and arrangements? We think that predicting and assessing the impact of this new provision is a rather nuanced and complicated question. There is an intersection of incentives, disincentives and risks in play among various actors and across different legal fields, not just tax. Here, we provide an initial roadmap for approaching this analysis. We do so drawing on academic work we have done over the past few years on worker classification in tax and other legal fields.[2]

A Very Quick Section 199A Primer

Just as a quick refresher, new Section 199A grants a deduction of up to 20% of a base amount of income, subject to several modifications. The Section is immensely complicated, but most pertinently for our purposes, Section 199A excludes the performance of services as an employee from the definition of "qualified trade or business."[3] This means that those working as employees are not eligible for the deduction. The size of the available deduction turns in part on the amount of "qualified business income" (the higher the QBI, the better for the taxpayer). But carve outs in Section 199A exclude from qualified business income the amount of reasonable compensation paid to the taxpayer for services rendered with

[1] *See also* Lily Batchelder & David Kamin, *The GOP Tax Plan Creates One of the Largest New Loopholes in Decades*, LA TIMES (Dec. 31, 2017), http://www.latimes.com/opinion/op-ed/la-oe-batchelder-kamin-tax-deduction-pass-through-income-20171231-story.html; Reuven Avi-Yonah et al., The Games They Will Play: An Update on the Conference Committee Tax Bill, (Dec. 28, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423.

[2] For our prior writings on this and related subjects, see Shu-Yi Oei, *The Trouble with Gig Talk: Choice of Narrative and the Worker Classification Fights* (forthcoming, LAW & CONTEMPORARY PROBLEMS 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3098425; Shu-Yi Oei & Diane M. Ring, *Can Sharing Be Taxed?* 93 WASH. U. L. REV. 989 (2016); Shu-Yi Oei & Diane M. Ring, *The Tax Lives of Uber Drivers: Evidence from Internet Discussion Forums*, 8 COLUMBIA J. TAX L. 56 (2017). For blog posts and other materials, see Shu-Yi Oei & Diane M. Ring, The Senate Tax Bill and the Battles Over Worker Classification (TaxProf Blog, Nov. 11, 2017); Shu-Yi Oei & Diane M. Ring, Work-Related Distortions in the Tax Reform Bills: Understanding the New Proposed Provisions (Part 1 of 2) (OnLabor Blog, Dec. 11, 2017); Shu-Yi Oei & Diane M. Ring, Work-Related Distortions in the Tax Reform Bills: Understanding the New Proposed Provisions (Part 2 of 2) (OnLabor Blog, Dec. 11, 2017); Shu-Yi Oei & Diane M. Ring, Will Proposed Tax Legislation Tilt the Worker Classification Debate, (OnLabor Blog, Nov. 16, 2017); Shu-Yi Oei, *The Trouble with Gig Talk: Choice of Narrative and the Worker Classification Fights* (forthcoming, Law & Contemporary Problems 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3098425; Shu-Yi Oei, *Slides from Oxford University Center for Business Taxation Conference on Different Ways of Working* (June 2017), https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Events/conferences/2017/Diff_ways/oei.pdf

[3] 199A(d)(1)(B).

respect to any qualified trade or business of the taxpayer as well as guaranteed payments paid to a partner for services rendered with respect to the partnership's trade or business.[4] Furthermore, the legislative history advises that qualified business income also does not include amounts paid by an S corporation to its shareholder that are treated as "reasonable compensation" of the shareholder. This means that compensation-like payments paid out to a taxpayer from her qualified trade or business, from an S corporation in which she is a shareholder, or from a partnership in which she is a partner, will not count as qualified business income. (More on this later.)

The exclusion of employees from being eligible for the deduction is what has prompted commentators to speculate that the introduction of Section 199A could lead to a broader shift in workplace arrangements from employee-based relationships to independent contractor-based relationships. But how big a factor is Section 199A likely to be, given everything else that is already going on?

Here are seven core observations that help advance the analysis:

1. Not a Safe Harbor

Unlike another proposed provision that did not make it into the final legislation (specifically, the New Gig Act), Section 199A does not create a safe harbor for classifying workers as independent contractors. The proposed New Gig Act language (which we discuss elsewhere: here and here and here) would have created a very liberal safe harbor for businesses that sought to classify workers as independent contractors for tax purposes. Effectively, the proposed rule would have obviated the need to meet the traditional 20-factor test[5] for classifying workers, and instead, would have allowed a virtually risk-free tax classification of workers as independent contractors by satisfying three easy tests.

Under the New Gig Act regime, the tax risk would be almost completely eliminated. Although classification would still be a potential issue in other regulatory fields, an employer could use the newly secured tax classification (under the proposed New Gig Act) to bolster a claim that the tax law's position should similarly be respected in other regimes. Not a guaranteed win, but a nice, costless boost to the argument. Moreover, businesses that have classified workers from the outset as independent contractors (for example, sharing economy platforms such as Uber or TaskRabbit) but are facing active challenges to this status, would gain new leverage in worker classification litigation by securing guaranteed tax treatment.

By contrast, the Section 199A nudge to independent classification status is wrapped up in the carrot of a 20% deduction. But that is a carrot,[6] not a safe harbor. And, it's a very complex carrot at that. The question then is how and whether the risks of classification challenges remain. We now explore these question.

2. Who Gets the Rewards? (Existing Independent Contractors vs. Newly Classified Independent Contractors; Sophisticated vs. Less Sophisticated Actors)

[4] 199A(c)(4)(A), (B).

[5] Rev. Rul. 87-41, 1987-1 CB 296; Independent Contractor (Self-Employed) or Employee? IRS, https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-oremployee.

[6] *See, e.g.*, Noam Scheiber, *Tax Law Offers a Carrot to Gig Workers. But It May Have Costs*, NY TIMES (Dec. 31, 2017), https://www.nytimes.com/2017/12/31/business/economy/tax-work.html?_r=1.

In thinking about the real impact of Section 199A in shifting worker classification, an important question is who exactly will be getting the 20% deduction. Is it rewarding those who already hold independent contractor status? Or will it result in a shift of marginal workers to independent contractor status? If the answer is the former (i.e., Section 199A provides benefits to existing independent contractors who currently operate as sole proprietors, partners and S corp shareholders, perhaps because they have already been forced into it by hiring firms), then the tax law would primarily be providing a benefit to this existing class of workers, but not prompting a wholesale shift in classification with all of the attendant implications. Some might interpret this as a good thing.

If, alternatively, the new law does encourage a shift, then the next question that arises is *who* is advocating and embracing the shift. To the extent sophisticated employees themselves are seeking to restructure their work arrangements to become classified as independent contractors and secure the 20% deduction (think, medical professionals, lawyers, consultants, or engineers who fall below the income threshold, where applicable), we may be less concerned that they are making a bad deal. Yes, they are surrendering various worker protections (such as overtime, minimum wage, child labor, health and safety, and antidiscrimination), but one might conclude that they are in less need of protection relative to other workers, sufficiently sophisticated to weigh the risks, and can self-insure against harms associated with foregoing these protections.

If instead, we anticipate that employers are initiating the shift and are initiating it with respect to less sophisticated and well-resourced workers, then we may be concerned about the impact of the loss of these worker protections. But an important question here is: Why would Section 199A be the incremental trigger for this shift? Presumably, the businesses would have benefited in the past by classifying workers as independent contractors in terms of minimizing certain costs and avoiding certain responsibilities. Why, if they have not done so already, would they be prompted to do so now? We note here that even before Section 199A, there has been ample commentary on how many sharing economy firms as well as other firms have already moved toward reclassifying workers as independent contractors, or have found other ways to reduce costs and strip worker protections (such as by subcontracting).[7] It may well be the case that for many workers, independent contractor classification is happening all by itself and needs little additional help from the tax law.

3. Will Workers Become Malleable? Will They Stay Malleable?

A potential answer to why more firms may move from employee to independent contractor classification in light of new Section 199A lies in the "cost-free" (to the employer) benefit that now attaches to independent contractor status. The theory would be that businesses eager to relinquish the burdens of employer status, can now approach employees with an enticement to switch – big tax savings in the form of the 20% deduction. The resistance and potential litigation that might have accompanied earlier efforts to shift may fade in the face of anticipated new dollars in the pocket.

But note that the pathway by which this incentive would run is a complex one: In the scenario we just described, existing employers who have not already made a shift would be the ones to initiate the shift,

[7] *See, e.g.*, Catherine K. Ruckelshaus, *Labor's Wage War*, 35 FORDHAM URBAN L.J. 373 (2007), http://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=2286&context=ulj.

and would have to do so under a strategy that explicitly counts on lowered worker resistance because of the availability of the new tax benefit.

Furthermore, even if workers originally support a shift to independent contractor status, if they later conclude that the benefit of the 20% deduction is outweighed by the costs of losing employee protections (especially if the tax deduction is more limited than anticipated—or nonexistent—due to the statutory guardrails described below), they may challenge their classification under various labor law regimes. On a side note, there is some evidence that many businesses have already been classifying their workers as independent contractors *inaccurately*.[8] The enactment of Section 199A may provide some potential protection to these businesses, at least to the extent these workers become more willing to accept and not challenge their independent contractor status because it now includes a (possible) tax deduction. Of course, if subsequent regulations under section 199A adopt a broad reading of the "reasonable compensation" exclusion from qualified business income (which would lower some workers' QBI), then previously placated workers may revisit their interest in challenging their classification.

But again, all this is a big "if." And besides, with the other types of procedural and legal buttressing some firms are already doing, its far from clear that the incremental Section 199A nudge is really going to be the thing that really keeps workers in check…

4. Firms Already Have Ways to Curb Worker Challenges

One of the ways firms already ensure that independent contractor classification is not challenged is by making workers sign mandatory arbitration clauses.[9] For example, Uber requires drivers enter into arbitration agreements, waiving their rights to pursue class action challenges. Such arbitration clauses have proven an effective strategy in stalling class action suits that claim that drivers have been improperly classified as independent contractors. The arbitration clauses force drivers to resort to piecemeal arbitrations, reducing the likelihood of fundamental transformation of the business model through a single class action litigation.[10]

We mention this because we think it's important to evaluate how the new putative tax incentive that keeps workers happy will play out in a world in which there are already ample strategies that firms employ to keep in their desired classification in place by reducing the likelihood of worker challenges.

5. The Limits of (Tax and Other) Reality

Just because workers and businesses are jointly onboard in trying to shift to independent contractor status, doesn't guarantee their success. They still must satisfy the underlying 20-factor tax worker classification test employed by courts and the IRS in determining appropriate worker status.[11] Precisely

[8] *See, e.g.*, *Independent Contractors: Prevalence and Implications for Unemployment Insurance Programs* (Feb 2000), https://wdr.doleta.gov/owsdrr/00-5/00-5.pdfhttps://wdr.doleta.gov/owsdrr/00-5/00-5.pdf.; TIGTA, *Employers Do Not Always Follow Internal Revenue Service Worker Determination Rulings* (June 14, 2013), https://www.treasury.gov/tigta/auditreports/2013reports/201330058fr.pdf.

[9] *See, e.g.*, Elizabeth Chika Tippett & Bridget Schaaff, *Misclassification in the Sharing Economy: It's the Arbitration Agreements*, (forthcoming, RUTGERS L. REV.), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3009913; Jill Gross, THE UBERIZATION OF ARBITRATION CLAUSES (May 24, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972234.

[10] *See generally* Oei, *Trouble with Gig Talk*, *supra* note 2.

[11] *See* sources cited *supra* note 5.

because new Section 199A is not a safe harbor, it does not relieve the parties of their obligation to match their actual substantive conduct to the claimed legal position. (But see the Section 530 safe harbor, discussed below.) Thus, a mere relabeling of a previous employer/employee relationship risks rejection, unless accompanied by meaningful actual change.

Moreover, businesses will likely not relabel workers just for tax purposes, they will do so for all of the legal regimes in which worker classification matters, including wage, health and safety, and other labor protections.[12] Why? Because in contrast to their incentives when dealing with, for example, derivatives or securitization, firms do not have an incentive to arbitrage worker classification. A major reason is that firms have an incentive to classify workers as independent contractors across fields. We are simply not going to see firms reclassify workers only for tax and not for other purposes.

The upshot is that in order to reclassify, firms must successfully meet the tests across all fields. Although the worker classification tests in the various legal fields share a common focus on control over the worker and economic realities, they are not identical. Businesses need to be attentive to the specifics of the tests and adjust their real conduct to support the newly claimed classification. Such moves are not costless. And the added tax incentives don't get rid of the existing obstacles to independent contractor classification.

Despite the above caution, there are however, existing techniques that might facilitate this relabeling of workers as independent contractors. For example, to the extent workers are no longer listed as employees of the business, but instead are partners in a partnership that provides services to the business, there may be some ability on the part of the business to argue that they now have "less control" over the workers than before.

6. The Section 530 Safe Harbor

In deciding whether to shift current employees to independent contractor status in response to new Section 199A, businesses must include in their calculus the fact that the protections of Section 530 will not be available. That rule bars the application of retroactive taxes, penalties and interest on an employer where the employer's classification of workers was both reasonable and consistently applied in prior years. Switching workers from employee to independent contractor status would not meet the "consistency" prong of the relief provision. On the other hand, consistent classifications of new groups of workers as independent contractors going forward may be protected by Section 530.

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[12] *See, e.g.*, Fair Labor Standards Act of 1938, ch. 676, 52 Stat. 1060 (codified as amended at 29 U.S.C. §§ 201–219 (2012)) (delineating minimum wage, maximum hours, and other protections); Family and Medical Leave Act, 29 U.S.C. ch. 28 (26 U.S.C. § 2611(3) (defining "employee" by cross-reference to 26 U.S.C. § 203), Occupational Safety and Health Act, 29 U.S.C. ch. 15, § 651 et seq. (delineating duties of employers and employees, among other matters); Cal. Labor Code § 351 (prohibiting employers taking tips from employees); Cal Labor Code § 226 (employer obligation to provide itemized statements to employees); Cal. Labor Code § 2806 (obligation to reimburse employee mileage costs); Age Discrimination in Employment Act of 1967, 29 U.S.C. ch. 14, § 621 et seq. (29 U.S.C. § 630(f) defining "employee"); Civil Rights Act of 1964, Title VII (prohibiting discrimination against employees on the basis of sex, race, color, national origin, and religion); Americans with Disabilities Act of 1990, 42 U.S.C. ch. 126, § 12101 et seq.

7. Guardrails in Section 199A Itself

In addition to the above constraints on easy access to Section 199A benefits, there are the guardrails built into statute itself.

The statute includes a number of limitations on the ability to take the Section 199A deduction—including those based on the nature of the services, the taxpayer's income level, and amount of capital gains earned by the taxpayer-worker. But perhaps one of the most significant (and arguably underexplored) guardrails as we contemplate the scope of any wholesale shifting of workers to independent contractor status, is Section 199A(c)(4). This subsection states that the critical statutory term "qualified business income" does not include "reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business."[13] Given that taxpayers would want their qualified business income to be very high (it is a central number in determining the base on which the 20% deduction will be calculated), a reduction in this amount severely limits any real benefit from Section 199A.

Thus, for example, workers reclassified as independent contractors and filing as sole proprietors may face the risk that all of their payments from the business for their services would be treated as their "reasonable compensation," thus leaving nothing to count as qualified business income on which a 20% deduction might be ultimately calculated. At this point the full scope and interpretation of the "reasonable compensation" requirement in Section 199A (and relatedly, the exclusions from qualified business income) are unclear. Among the open question are:

(1) Can any argument be made that amounts received by the independent contractor operating a sole proprietorship can be viewed as not "paid" as compensation per se?

(2) Even if much of what a sole proprietor receives in payment from the business is treated as part of her "reasonable compensation," can any fraction of that payment be treated as a return to something other than labor (for example, a return for some risk she has borne or an intangible input)? If so, could such payment form the basis of the worker's "qualified business income" so as to give rise to at least a small deduction?

(3) Are the special rules in Section 199A(c)(4), which detail what partnership payments do not count as qualified business income (which would be bad for the partners seeking the Section 199A deduction), the only limits on partners' qualified business income? Or does the more general "reasonable compensation" limitation also apply?

(4) Does the legislative history on the "reasonable compensation" limitation merely illustrate some applications of the rule? Or does it describe the rule's exclusive application?

(5) What kind of regulations will be drafted to exclude Section 707(a) income of a partner from qualified business income, particularly in light of the existing ambiguity in that partnership provision?

[13] IRC 199A(c)(4).

These and other open questions in the statute may stall the wholesale shift towards independent contractor classification that some have projected. Others have begun to explore them,[14] but the work is far from done.

Conclusion

The bottom line is that Section 199A is complex and, quite frankly, not very clear. In terms of the likelihood of it inducing a massive shift to independent contractor status of current employees, much turns on (1) the interpretation and enforcement of Section 199A guardrails (such as the "reasonable compensation" rule) and (2) the ability to satisfy the background requirements of independent contractor classification for both tax and for other purposes. The former turns primarily on the actions of the IRS and courts. The latter turns on a variety of factors, including the businesses' risk assessment (including assessment of whether the new 199A benefit will be enough to assure worker satisfaction and cooperation with independent contractor classification), the structures and realities of the industry in question, and firms' willingness to adopt meaningful change in their control and relationship with the worker.

Moreover, we are not operating from a clean baseline here. There are already massive tectonic shifts underway in workplace arrangements and worker classification. An open question going forward is the extent to which new Section 199A will play a material role in accelerating these shifts.

[14] David Kamin, *Uncertainty, Perverse Incentives, and More*, MEDIUM (Jan 11, 2017), uncertainty-perverse-incentives-and-more-a7af2d143a70.