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Summaries for the Fourth Annual IRS/SJSU Small Business Tax Institute

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Summaries for the Fourth Annual IRS/SJSU Small Business Tax Institute

An annual conference sponsored by the California Society of Certified Public Accountants (CalCPA), Internal Revenue Service (IRS), Mission Society of Enrolled Agents and San Jose State University's Lucas College and Graduate School of Business.

June 22, 2016
Santa Clara, CA

SJSU MST students (left to right) Fan Wang, Jacqueline Le, Chen Yang, Marla Hampton, Padmini Yalamarthi, Jie Tang, Yuting Ji, Jie Shen and Xuan Hong (front), Xiaotong Li, Dennis Conway and Aaron Grey (back) attended the Tax Institute.

Introduction

The Small Business Tax Institute provides premium tax education that brings together recognized practitioners and government representatives to provide insights on navigating taxes with the new economy clients. Certain sessions are summarized in the articles to follow. We encourage you to read these summaries and to visit the Tax Institute website to view current and past conference materials in greater detail. In addition to this Institute, there is the 32nd Annual TEI-SJSU High Tech Tax Institute that will be hosted on November 7&8, 2016 in Palo Alto, CA.

Residential Rentals

By: Padmini Yalamarthi, *MST Student*

The Fourth annual IRS-SJSU Small Business Institute conference on navigating taxes with new economy clients was held on June 22, 2016 at Santa Clara, CA. The first topic addressed was on residential rentals by the esteemed panel of presenters that included Ms. Sachiko K. Danish from Moss Adams, Mr. Kelly H. Myers from the IRS and Mr. Philip L. Robinett, CPA. Treatment of income from renting primary residences and other rental dwellings and their respective reporting requirements were the main issues addressed during this interactive session.

A dwelling unit is a house, apartment, boat or a vacation home with basic living conditions including a kitchen and toilet. The Internal Revenue Code (IRC) generally requires gross rental income from such properties be reported.

Ms. Sachiko commenced the discussion with the general rules for classification of residential real property rental income. According to Ms. Sachiko, the first factual question to be considered is whether the dwelling unit rented is used for personal use by the owner. If the unit is personally used by the taxpayer for a number of days during the year that exceeds the greater of: (1) 14 days or (2) 10% of the total days it is rented to others at a fair rental price, and if all or part of this property is rented out for fewer than 15 days for the year, then the rental income is exempt from tax regardless of the amount of income received for the year (IRC §280A(g)(2)). So if a homeowner rents out their home for a week during a Super Bowl for thousands of dollars, the dwelling is still considered used for personal use and the rental income is exempt from tax, irrespective of the high amount of income received. However, under this rule, expenses related to the rental activity are not deductible (unless deductible as a personal residence expenses – such as mortgage interest or property taxes).

If the dwelling unit is a rental home and not used personally and the average rental period per tenant/customer is either: (1) seven (7) days or less or (2) 30 days or less and the owner provides substantial services to the customer (such as maid service), the activity is not treated as a passive rental activity, but instead as a non-rental trade/business.[1] Such rental income is taxable and must be reported on Schedule C of Form 1040 if the owner is an individual. In addition to income tax, self-employment tax at 15.3% on such income is also applicable.

Conversely, if a dwelling unit is rented and none of the conditions above applies then the activity is considered a real estate rental activity and the rental income must be reported on Schedule E of Form 1040. No self-employment tax is applicable on the rental income reported on Schedule E of Form 1040.

There was additional discussion on IRC §280A regarding deductible rental expenses. It was noted that taxable rental income is gross rental receipts less allowable deductions. Non-capital ordinary and necessary expenses are normally allowable deductions from the gross rental receipts. If an entire dwelling unit is used for both personal use and rental purposes during the year, the expenses

[1] Treas. Reg. § 1.469-1T(e)(3)(ii).

must be prorated to the two types of uses based on the number of days used for each purpose. If only part of a dwelling unit is rented out, a taxpayer must allocate the expenses – typically based on based on the square footage of the unit associated with the rental and non-rental portions of the property.

Another important consideration when it comes to real property rentals is the special allowance of up to $25,000 for passive activity losses provided in IRC §469(i). Under this provision the activity must be the renting of real estate (tangible personal property does not qualify). The taxpayer must actively participate in the rental activity and there must be passive rental income. In addition, for most filing statuses the taxpayer's modified adjusted gross income (MAGI) must be less than $100,000. If these conditions are met, the taxpayer can deduct up to $25,000 of rental losses for the year. This maximum special allowance of $25,000 is reduced by 50% of the amount of MAGI that is more than $100,000. If MAGI is $150,000 or more, this allowance is fully phased-out / disallowed. The disallowed passive loss deductions for a taxable year can be carried forward to future tax years.

IRC §469 also addresses the treatment of real estate professionals' rental activities. A real estate professional may be able to classify his/her real estate rental activities as non-passive. To be classified as a real estate professional, during the year the taxpayer must spend (1) more than 50 percent of his/her time in the performance of personal services in real estate trades / businesses <u>and</u> (2) more than 750 hours in real estate trades/businesses in which he/she materially participates.[2] In addition, generally he/she must actively participate in each rental activity. Active participation includes making management decisions such as approving new tenants, deciding on rental terms, approving repairs and improvements in a significant and bona fide manner.

A number of relevant cases to substantiate these residential rental provisions were included in the presentation. In the case of *Agarwal, et. ux. v. Commissioner* the taxpayer, a real estate agent in California claimed her real estate business activities as non-passive under the real estate professional rules and deducted net rental losses on her return of $40,104 for 2001 and $19,656 for 2002.[3] The IRS stated that because the taxpayer was not a licensed real estate *broker* in California she could not claim her real estate activity as a business activity and therefore disallowed these losses on grounds of them being passive. The Tax Court observed that the taxpayer met all the required conditions of a real estate professional (more than 50 percent of her time performing services and more than 750 hours devoted to real estate activities) and as such concluded her rental activities were non-passive. The taxpayer was therefore allowed to currently deduct these losses.

In another case *Jende, et. ux. v. Commissioner,* the taxpayer was a retired educator who owned unfurnished homes in Ohio and Florida and rented them out to long-term tenants in 2005 and 2006.[4] The taxpayer also owned two condos in Tennessee and both a condominium and a timeshare in Florida. He deducted losses of $44,613 for 2005 and $45,131 for 2006 on these rentals as business losses. The timeshare in Florida and the condos in Tennessee had an average customer use of less than seven days in 2005 and 2006, and hence they were treated as non-rental business activities by the taxpayer. The condo in Florida had an average use of more than seven days. Jende

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[2] IRC §469(c)(7)(B).
[3] *Shri G. Agarwal, et ux. v. Commissioner,* TC Summary Opinion 2009-29.
[4] *Aris V. Jende, et ux. v. Commissioner,* TC Summary Opinion 2011-82.

stated that he spent substantial amounts of expenses for these properties including hiring a resort manager and maintenance workers, maintaining the swimming pool and common areas, as well as paying for utilities and insurance. He claimed substantial participation in real estate activities for these properties and treated his overall rental activity as a business. Participation in a business activity is considered material only any of the following apply: (1) the taxpayer participated actively for more than 500 hours during the tax year; (2) the taxpayer's participation was substantially all the participation in the activity for the tax year; (3) the taxpayer participated for more than 100 hours during the tax year and that individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners in the activity) for the year; (4) the activity was materially participated in by the taxpayer for any five of the 10 immediately preceding tax years or (5) the activity is a personal service activity. The Tax Court ruled that since Jende did not meet the requirements of material participation in real estate, the rental activity was passive. Hence the losses were not currently deductible beyond the $25,000 special allowance for taxpayers with a MAGI of less than $100,000.

In the next part of the session, Mr. Philip discussed the tax issues relating to new economy clients. Rental business activities such as bed and breakfasts and hotels are old economy businesses dealing with rental income taxation issues. These activities are normally more or less routine and the tax treatment is typically straightforward. On the other hand, "new economy" businesses identified in this industry are online renting platforms like Airbnb and VRBO. Under these platforms rental spaces or accommodations are listed by hosts and are booked by travelers. Each accommodation and each rental period is unique. Hosts may rent out whole dwelling units for a weekend or even part of their residential homes to travelers for months. This kind of diverse renting activity raises a lot of questions and ambiguity regarding the tax treatment of the rental income earned by Airbnb and similar hosts.

To clarify this confusion, Mr. Philip explained that these online platform hosts are subject to the same tax rules as applicable to other residential rentals. Rental income is normally taxable and related rental expenses are normally deductible, subject to the same rules and limitations as mentioned earlier in this article. It was noted that in addition to the income tax compliance rules, hosts must be aware of and adhere to the state and local tax laws as well including any applicable transient occupancy taxes.

Being aware of the tax treatment and reporting requirements will help homeowners plan their rental activities effectively and efficiently and take advantage of the tax deductions. The speakers stressed on the need for proper documentation to support the material participation and deduction of expenses such as repairs. It is important for a U.S. homeowner to remember that even non-U.S. based rental properties are reportable on a U.S. tax return. Overall, the session led by the knowledgeable speakers was informative and interactive.

Marijuana Operations

By: Fan Wang, *MST Student*

During the Fourth Annual IRS/SJSU Small Business Tax Institute on June 22, 2016 Mr. Hank Levy, CPA, ABV, CFE, CFF, covered a number of topics in his presentation entitled "The New Economy: Navigating Taxes with Marijuana/Cannabis Clients: A Modern Morality Tale."

Mr. Levy stated that federal laws have gone through a few phases of development regarding the taxation on illegal activity income. During the early part of the 20th century federal laws specified that the government generally could not collect taxes from illegal activities. Examples of illegal income during that period included bookmaking, bootleg liquor, bribes, drug trafficking, embezzlement, espionage, extortion, fraudulent schemes, kickbacks, etc.

Federal Laws on Taxing Illegal Income

According to Mr. Levy's research, in 1927 the Supreme Court ruled that the unlawfulness of a business had nothing to do with its taxation. Therefore, illegally earned income was subject to tax.[1] In 1933, the prohibition on alcohol ended when 21st Amendment granted the power of control over alcohol to the states. Several court cases later it was apparent that generally all illegal income would be subject to income tax, including that from marijuana businesses.

Disallowance of Federal Tax Deductions

In order to curb the unlawful manufacture, distribution, and abuse of dangerous drugs, also known as "controlled substances," Congress enacted the Public Law 91-513, the Comprehensive Drug Abuse Prevention and Control Act of,1970 (21 U.S.C. §801-971) and assigned marijuana as a Schedule I controlled substance, as one of the hallucinogenic substances.[2] The Act also required that the pharmaceutical industry maintain tight physical security and strict record keeping for certain types of drugs. Due to the high potential of abuse, no accredited medical use and a lack of accepted safety, marijuana has remained illegal at the Federal level and has been subject to strict scrutiny in terms of its business operations.[3]

Mr. Levy mentioned that after the Tax Court allowed all ordinary and necessary expenses to be deducted for a drug dealer in the 1981 case of *Edmondson v. Commissioner*,[4] Congress added IRC §280E in 1982 to disallow business expense deductions or credits in carrying on any trade or business consisting of trafficking in Schedule I and II drugs under the Controlled Substances Act.[5] However, the 1982 Senate Report associated with the IRC §280E legislation stated "To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective costs of goods sold is not affected by this provision of the bill."[6] Several court rulings in

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[1] *U.S. v. Sullivan*, 6 AFTR 6753 (1927).
[2] http://legcounsel.house.gov/Comps/91-513.pdf
[3] https://en.wikipedia.org/wiki/Comprehensive_Drug_Abuse_Prevention_and_Control_Act_of_1970
[4] *Jeffrey Edmondson*, TC Memo 1981-623.
[5] https://www.lexisnexis.com/legalnewsroom/tax-law/b/taxreformandpolicy/archive/2014/02/03/medical-marijuana-business-expenses.aspx?Redirected=true
[6] http://www.sjsu.edu/people/annette.nellen/website/Tax_Ethics_Marijuana_2016.pdf

recent years have affirmed that marijuana businesses may not deduct any ordinary and necessary expenses under IRC §162, even if they are legal under state law, except for cost of goods sold.[7] It was noted that because cost of goods sold can be deducted in a marijuana business, there is some potential use of the UNICAP rules under IRC §263A by taxpayers in this industry to attempt to increase their cost of goods sold as much as possible.

California Law Compliance

California tax laws generally comply with IRC §280E for individual taxpayers, but not for corporations.[8] This means that generally marijuana businesses owned by individuals may only deduct cost of goods sold, but generally *corporations* may deduct *all* ordinary and necessary business expenses if they are in the marijuana business for *California* tax purposes. However, both for individuals and corporations, if they have been convicted of violating state or local drug trafficking rules, then they may not claim *any* deductions – even cost of goods sold.[9]

Other California Issues

Mr. Levy mentioned that in spite of the legalization of medical marijuana in California after the enactment of the 1996 Compassionate Use Act, in 2003, California Senate Bill 420 was enacted and the resulting language in Health and Safety Code, Sect. 11362, states that no individual or group shall be authorized to cultivate or distribute marijuana for profit and it is only allowable when "qualified patients…and the designated primary caregivers of qualified patients…who associated within the State of California in order collectively or cooperatively to cultivate marijuana for medical purposes." As stated in the 2008 California Attorney General's report entitled "California's Guidelines for the Security and Non-Diversion of Marijuana Grown for Medical Use" the before mentioned 2003 legislation clarified that the sale or distribution or cultivation of medical marijuana can only be for non-profit purposes and reimbursements and allocations of fees were allowable only for medical marijuana grown in qualified arrangements to cover overhead costs and operating expenses. Very strict rules were also established, such as, making illegal a potential practice of dispensaries owners claiming themselves as the primary caregiver of their patients and offering marijuana to their patients in exchange for a cash donation to their non-profit business.[10]

Conclusion

The presentation concluded with a Q&A session where the audience raised some topics including the interaction of IRC §§471, 263A and 280E in order to ensure proper accounting for and the potential deduction of cost of goods sold.

As tax professionals we must be aware that the area of marijuana sales comes with cautions requiring due diligence in terms of law interpretation with tax research full of ethical issues when dealing with this generally (Federally) illegal and controversial business operation.

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[7] *Champ v. Comm.*, 128 T.C. 14 (2007), *Olive v. Comm.*, 139 T.C. 19 (2012), *Beck*, TC Memo, 2015-149, 8/10/2015.
[8] Cal. R&T § 17201.
[9] Cal. R&T § 17282 and § 24436.1.
[10] http://ag.ca.gov/cms_attachments/press/pdfs/n1601_medicalmarijuanaguidelines.pdf

New Economy Overview – Economic, Legal and Tax Matters

By: Jie Shen, *MST Student*

In this rapidly changing environment we are faced with new things every day. Keeping updated with this new economy and exploring the related tax opportunities are vital for tax practitioners. On June 22, 2016, the Fourth Annual IRS-SJSU Small Business Tax Institute was held to address these issues. Professor Annette Nellen, director of the MST Program at San José State University, gave her presentation on "New Economy Overview – Economic, Legal and Tax Matters."

Professor Nellen presented the new economy based on three main aspects:

The Big Picture – Part 1: What and Why of the Sharing and New Economies

Prof. Nellen began her presentation by explaining, in a broad perspective, what are new economy activities. These are the sharing resources activities that rely on digital-based platforms.

Prof. Nellen then discussed the concept of a sharing economy which is now booming. A sharing economy is a digitally-based peer-to-peer platform which helps to match one's skill, time or property with someone else who needs it.

The sharing and new economies are mostly developing in the following areas:

1. **Real property and personal property rentals**. For example, via Airbnb homeowners can rent out all or part of their homes or other properties. Examples of other related platforms in this area include: Filpkey, OneFineStay, Homeway, VRBO, Turo, and Getaround.
2. **Providing freelancing services**. By searching web platforms such as Taskrabbit, customers can find service providers for a variety of services like cleaning, running personal errands as well as very specialized services such as painting, writing and many others.

These new economies create new relationships between workers and the markets. With these digitally-based sharing platforms buyers and sellers can process transactions almost everywhere. No longer do the two sides have to be located in the same community for many types of services. This new economy platform provides flexibility and maximizes usage of time and assets by streamlining the process of connecting a service provider and their customer. In addition, it provides many more opportunities for generating income for services providers over traditional methods. Almost anyone who desires to earn extra income or set their own work hours can benefit from such sharing platforms.

The Big Picture – Part 2: Stakeholder Perspectives, Issues and Opportunities

It is always exciting to embrace good changes that come from new economy marketplaces. However, the act of growing into new economy systems is often accompanied with challenges. For example, government and lawmakers need to consider policies that promote the growth of new economies in a healthy and sustainable way. Prof. Nellen pointed out that one of the typical issues involved in the new sharing economy is how to define the real employer. The terms of use of some companies such as Uber indicate that the company is just a technology platform and not a traditional employer of the drivers by definition. No car or driver "belongs" to Uber. This issue leads to the questions of whether any new tax rules are needed, how should the worker classification rules fit into this new economy and what should the guidance be on how to report the income correctly – including the details of how to maintain good bookkeeping and retention of supporting documents.

Prof. Nellen further illustrated several considerations for legislatures, such as having an understanding of the new economy models and their social effects; providing guidance where none may exist for a new type of transaction; clarifying and adapting the existing law to cover these new platforms; providing tax incentives and removing barriers; understanding the millennials' need for more opportunities; allowing for different levels of tolerance by the public for complexity and ambiguity in the current tax system; and simplifying tax as much as possible on such new economy endeavors.

The Big Picture – Part 3: Due Diligence in Serving Your New Economy Clients

Prof. Nellen concluded with several important questions that can help tax practitioners to better perform due diligence in serving their new economy clients.

Here is an excerpt of some recommended questions that tax practitioners should ask their clients:

1. Do you generate funds from renting out your property? Do you have a Form 1099?
2. Do you provide services to clients you find via a website? Is the website a web host or platform?
3. Did you receive a Form 1099-K, *Payment Card and Third Party Network Transactions*, for any internet-related activity?
4. Did you have any other type of internet transactions that generated income or an expenditure?[1]

Prof. Nellen also suggested that tax practitioners should consider other perspectives in addition to federal taxes such as the state personal property taxes, local business licenses taxes, transient occupancy taxes, various business registration requirements at state and local levels, keeping up with evolving laws as well as the details of the client's terms of service agreements with their clients and vendors.

Conclusion

With the growth of the new economy, governments should work on how to improve the tax codes to increase voluntary, accurate tax compliance within the new economy. In the meantime, tax practitioners should continually update their knowledge regarding the new forms of technologies, markets, and tax laws.

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[1] Nellen, Annette, "Taxation and Today's Digital Economy" (Apr. – May. 2015 ed. of CCH's Journal of Tax Practice and Procedure). http://stage.sjsu.edu/people/annette.nellen/JTPP_CCH_June2015_Nellen_DigitalEconomy.pdf

Car Sharing and Other Personal Property Rentals

By: Xuan Hong, *MST Student*

The second half of the Small Business Tax Institute started with a popular topic of "Car Sharing and Other Personal Property Rentals." This session comprised Federal, state and local tax issues on the rental of cars and other items of personal property. The panel was comprised of Mr. Randy Warshawsky who is the owner of The Tax Man, Ms. Angie Dang who is an examination group manager from the IRS and Mr. Joel Busch, Professor at San Jose State University.

Federal Tax Issues on Rentals of Personal Cars

With the development of sharing economy companies like Zipcar, many people are now taking advantage of the economic value of their personal assets by renting out their cars to make more income. Just like other types of earnings, the income from renting vehicles must be reported on the taxpayer's tax return. To help offset this income, taxpayers can normally deduct expenses related to renting out their cars. However, unlike those in the traditional car rental business, most of these taxpayers mix renting with personal use of their cars, thereby bringing up some potential issues.

Mr. Warshawsky specified that the biggest issue is whether the rental of cars for these new "mix-use" taxpayers is a business or just a hobby. This is important because it would affect how to report income and how much expenses a taxpayer can deduct on the tax return. If it is a business, a taxpayer reports rental income and deducts expenses on Schedule C of Form 1040. The net profit on the Schedule C is subject to not only income tax but also self-employment tax. Any losses from the rental business can normally be deductible against the taxpayer's other income. In contrast, if it is a hobby, a taxpayer reports rental income on Line 21 of Form 1040 (as other income) and can only deduct expenses to the extent of rental income on Schedule A of Form 1040 as miscellaneous itemized deductions which are then deductible only to the extent that these expenses exceed two percent of the taxpayer's adjusted gross income. Unlike a business, there is no self-employment tax for income derived from a hobby. As we can see, whether it is a business or a hobby really makes a difference on a taxpayer's tax return, especially when the rental activity is not profitable.

On the issue of classifying a rental activity into a business or a hobby, Mr. Warshawsky discussed an issue of whether the primary purpose of the rental activity is for potential profits or for personal enjoyment. The primary motive of a hobby tends to be personal enjoyment. An example of an activity that is commonly classified as a hobby is when a taxpayer who loves dogs and owns many dogs decides to open up a dog care and walking "business" in which he receives, say $10 per dog per day for a small number of dogs. In this case, it would be hard to classify the dog activity (which would include expenditures benefitting his/her personal dogs) as a business because the primary motive of taking care and walking all of the dogs (including those of the taxpayer) is personal enjoyment. On the contrary, if the primary purpose of a trade or business is to make a profit it will normally be classified as a business, even if the activity is currently profitable or not. The key is that the activity must have a motive or potential to make profits. Accordingly, for the rental of personal cars, Mr. Warshawsky said "There is no way I would say this is a hobby." This is because people rarely seek out enjoyment from renting out their cars. IRC §183 and specifically Treas.

Reg. §1.183-2(b) provides a nine factor test to distinguish between a business and a hobby, including whether or not the activity was operated in a traditional business-like manner, the time and effort devoted to the activity and the level of personal satisfaction and pleasure derived from the activity.

Another issue Mr. Warshawsky mentioned was the depreciation of vehicles. Normally, a taxpayer can claim depreciation when the vehicle is converted from personal to business use, and the basis should be the lower of fair market value (FMV) or the taxpayer's basis at the date of conversion.[1] Kelly Blue Book (KBB.com) is a good resource to find the FMV of vehicles. Keeping accurate records on the personal and rental mileage is critical to deduct rental expenses properly. Taxpayers should allocate most expenses, including depreciation, between personal and rental usage based on the mileage records between the two types. Since it is not easy for taxpayers to record every trip using paper and pen, Professor Busch recommended that taxpayers should utilize new technology like a smartphone application such as Everlance to record and classify every trip easily and conveniently.

California Sales/Use Tax and Other Issues on Rentals of Tangible Personal Property

Similar to the Federal income tax issues of renting out tangible personal property (TPP), California conforms to the IRC §183 Federal hobby rules to classify rental activities as a business or hobby. However, in addition to state income tax issues, there are sales/use tax issues on rentals of TPP in California.

Generally, a taxpayer needs to pay sales tax when purchasing TPP within California or, in the case of purchasing outside California, pay use tax when the taxpayer uses or rents out the TPP in California. Use tax generally uses the same base and tax rate as sales tax.[2] If a taxpayer purchases TPP for resale without paying any sales/use tax and later rents out the TPP in California, the taxpayer generally has to pay California use tax.

There are two options to pay sales/use tax on rentals of TPP in California. First, a taxpayer can pay no sales or use tax on the purchase of the TPP and later pay California use tax based on the rental income from the rental activity. Alternatively, a taxpayer can fully pay sales/use tax upfront when making the purchase of the TPP and afterwards will not pay California use tax on the rental income if the TPP rented out is substantially in the same form as originally purchased.

Even though a taxpayer has to pay use tax on the rental income if he/she chooses the first option, certain payments are not subject to use tax. These payments include *optional* charges for services provided by a lessor, such as maintenance fees, assembly and disassembly charges, collision/property damage insurance fees, late payment charges (but extra payments on the late return of the TPP would be subject to tax) and DMV registration fees. Professor Busch specified that in the construction industry, even in a contract involving heavy equipment, the equipment owner may not be subject to use tax on its income if the activity is regarded as construction service instead of a rental. The primary distinction between a construction service and an equipment rental is whether or not the equipment owner is required to provide their own operator for the equipment.

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[1] Treas. Reg. § 1.167(g)-1.
[2] California City & County Sales & Use Tax Rates. https://www.boe.ca.gov/app/rates.aspx?LETTER=S&LIST=CITY

If the owner is required to provide its own operator to operate the equipment, which is common for cranes and water trucks, then the activity is a construction service and therefore is not subject to use tax. In contrast, if either the lessor or the customer could provide their own operator, then the equipment rental income is normally subject to use tax.

There are some other specific rules for the rental of cars in California. For example, for a car leasing business, if the title of a vehicle is in the name of the lessor, the lessor will follow the rules as mentioned above for rentals of TPP and generally pay use tax on their rental income. However, if the title to the vehicle is transferred to the lessee in a transaction, then sales or use tax is normally payable in full when transferring the title of the vehicle. Another special rule that is applicable in a Zipcar-like business is if the rental of the car includes gas provided by the lessor and the lessor pays use tax based on its total receipts, then the lessor can purchase gas sales tax free. Professor Busch also mentioned other local taxes affecting the car rental business. For instance, San Mateo County requires a 2.5% gross receipts tax on the car rental income regardless of whether or not the lessor is a traditional car rental company or an individual who only occasionally rents out their vehicle for extra income.[3]

Conclusion

The new sharing economy allows taxpayers more opportunities to earn additional income but with that comes more tax concerns and issues. With the increasing enactment of new tax rules, tax practitioners are facing more challenges and are recommended to keep their tax knowledge updated to provide better advice for their clients.

[3] San Mateo County Ordinance Code, § 5.150. https://www.municode.com/library/ca/san_mateo_county/codes/code_of_ordinances?nodeId=TIT5BURE_CH5.150BULITAOPVEREBU

Ethical Considerations of the New Economy: Focus on Cannabis

By: Marla Hampton, *CPA, MST Student*

A focus on the "New Economy" can hardly be complete without consideration of the evolving marijuana industry or, to use the preferred phrasing of professionals in that industry, "cannabis." One of the 2016 Small Business Tax Institute sessions focused largely on the ethical concerns relative to the provision of services to clients in the cannabis industry by CPAs and tax professionals. The session was presented by Arthur ("Kip") Dellinger, CPA who is a tax controversy expert with broad expertise in the areas of CPA tax practice, regulatory discipline, and malpractice matters. Mr. Dellinger is also a past co-chair of the AICPA Tax Practice Responsibilities Committee.

The Challenge for Tax Practitioners

Including cannabidiol, forty-one states and Washington D.C. have legalized medical cannabis and four of these states have legalized the retail sale of cannabis for recreational purposes.[1] However, as detailed later, it is very important to note that cannabis is still illegal at the Federal level. This November, eight more states, including California, will vote on whether or not the retail sale of cannabis for recreational use should be legalized. Both of the Conference's presenters on the topic area of cannabis (Hank Levy, CPA and Mr. Dellinger) expressed the opinion that California's recreational cannabis law will likely pass in November. Fortune magazine projects that marijuana sales will reach $6.7 billion in 2016 and noted, "It's time to take America's legal marijuana market seriously."[2] However, taking the marijuana industry seriously poses grave concerns for lawyers, CPAs, and other professionals whose roots run deep in what might aptly be referred to as the "Old Economy." While the kind of business growth cannabis is experiencing would normally be viewed as a prime target area to expand legal and accounting services into, the opportunity environment around cannabis exists as a professional service "No Man's Land" where business people in the cannabis industry are often left with few options for competent assistance in accounting, tax, and legal matters. In his session, Mr. Dellinger provided navigational tools for those brave enough to consider breaching the gap between the "Old Economy" professional world and the "New Economy" cannabis business models. Mr. Dellinger addressed what are probably the top concerns and possible predicaments for practitioners who are considering entering this market through these poised questions: **Can** I accept these clients? If yes, ***should*** I accept these clients? If so, ***how*** do I accept these clients?

CAN I Prepare Tax Returns for Clients in the Cannabis Industry?

As many of us are aware, providing services to the cannabis industry is contentious because some states have legalized some forms of cannabis production or sale, but cannabis remains an illegal drug under Federal law. The question therefore arises, if the industry is illegal under Federal law, is it illegal to prepare tax returns for that industry? There is a difference between U.S. Criminal Code (Title 18) and the Internal Revenue Code (Title 26). Section 61 of the IRC specifically

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[1] http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx
[2] Huddleston, Tom Jr. (2016, Feb. 1). Legal Marijuana Sales Could Hit $6.7 Billion in 2016. http://fortune.com/2016/02/01/marijuana-sales-legal/

dictates that all income *from whatever source derived* is includible as gross income (remember Al Capone?). Therefore, clients may be in violation of Title 18 but, as long as the return is prepared in compliance with Title 26 and its associated authority, the tax return preparation should not be viewed as illegal.

As tax professionals, not only are we subject to the law, we are also subject to Circular 230 as well as various professional Codes of Conduct. Although practitioners may legally be able to prepare returns for cannabis clients, CPAs may be especially concerned about whether or not doing so may create compliance issues with the AICPA's and the applicable state's Board of Accountancy's Code of Conduct. Mr. Dellinger recommended that practitioners review the AICPA guidance titled "An Issue Brief on State Marijuana Laws and the CPA Profession" as a resource.[3] This guidance does not prohibit services to clients in the cannabis industry. Rather, it provides legal history, analysis, and issues that any responsible professional should consider when working with clients in the cannabis industry. Seven state boards have issued specific guidance for CPAs (California is not one of them!) relative to cannabis and other states appear to be adopting a "wait and see" posture. However, neither the AICPA nor any state in which cannabis exists in a legalized form has prohibited licensed professionals from offering services in this industry. According to Mr. Dellinger, boards in states where cannabis is legal have indicated that CPAs will not be punished for helping their clients to comply with tax law. The Office of Professional Responsibility in its 2014 Report (Issue Two: Tax Assistance to Marijuana Businesses), asked the IRS to provide assurance to tax professionals that they will not be adversely affected by rendering tax service to the marijuana industry indicating that they do not consider it to be a prohibited activity under Circular 230 or otherwise.[4]

SHOULD I Prepare Tax Returns for Clients in the Cannabis Industry?

Having determined the legal and ethical ability to offer tax services to clients in the cannabis industry, practitioners must seriously consider whether or not they *should*. Mr. Dellinger highlighted a number of considerations in this category, one of them being our due care principle and its competence clause under the AICPA Code of Professional Conduct.[5] Due care requires us to accept engagements only if we believe we possess the applicable knowledge to perform them. This principle has been interpreted to include that we should have adequate understanding of a business segment to provide services in that area. Competent performance of services in the cannabis industry will require the same familiarity with business practices, terminology, and operating environment that any client engagement would require. However, the practitioner must also be vigilant regarding the legal and regulatory environment specific to cannabis. The practitioner must continuously monitor tax authority (such as applicable statutes, regulations, case law developments and procedures), professional standards, case law development, and other guidance relevant to practice in this arena. A practitioner who is not willing to devote the necessary time and energy for the fulfillment of due diligence and due care principles probably should not accept cannabis clients. Mr. Dellinger advised that practitioners should essentially "go big or go home" when it comes to accepting these clients. Because competent practice in this industry will

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[3] AICPA. (2016, Jan. 8). An Issue Brief on State Marijuana Laws and the CPA Profession. http://www.aicpa.org/Advocacy/State/Pages/StateMarijuanaLaws.aspx
[4] IRS Office of Professional Responsibility. (2015, Oct. 6). 2014 Office of Professional Responsibility Report. https://www.irs.gov/tax-professionals/2014-office-of-professional-responsibility-report
[5] AICPA, (2014, Dec. 15) Code of Professional Conduct. http://www.aicpa.org/research/standards/codeofconduct/Pages/default.aspx

create large resource demands, the cost/benefit analysis might not make sense for only a few clients. After careful consideration of all of the factors and risks, Mr. Dellinger advised that practitioners should only consider participation in this market as a specialty and either be very good at it or avoid it altogether.

Mr. Dellinger encouraged careful consideration of the impact of accepting cannabis clients on the practitioner's client base as a whole. Although cannabis is gaining legal ground, many individuals are still opposed to its legalization and hold deep prejudices toward the industry. Practitioners who accept cannabis clients may risk alienating their existing clients. With awareness of the fact when it comes to referrals that "like begets like," Mr. Dellinger suggested that practitioners should consider that accepting one cannabis client may result in referrals from that client of other cannabis business owners, their peripheral business partners, and their customers.

Lastly, practitioners should consult with their insurance carriers before accepting cannabis clients. Professional liability and errors and omissions coverages may not extend to services for clients in illegal businesses. Practitioners must carefully evaluate their risk exposure in determining whether or not they should offer services in this industry.

HOW Do I Take These Clients?

Mr. Dellinger emphasized that cannabis clients should be accepted carefully. Mr. Dellinger expressed that a cannabis engagement is like any other engagement except that the stakes are much higher. His strongest advice when it comes to an acceptance policy for cannabis clients was: "Never, ever, ever" represent a cannabis client who does not have a knowledgeable lawyer who specializes not only in cannabis but in the client's specific industry segment (i.e. growing, manufacturing, or selling). Retention of legal representation signifies that a client is serious about doing things legally and with adequate support. Mr. Dellinger also suggested obtaining a background or criminal record check of the client before acceptance.

Mr. Dellinger advised limiting services for cannabis clients to attestation and tax preparation. Other types of services (including but not limited to compilation) may create fiduciary relationships in appearance or in fact. Where a fiduciary relationship has been established and if a client becomes the subject of a criminal investigation, the practitioner could be implicated. Utilization of an extremely detailed and comprehensive engagement letter developed in consult with an attorney and the insurance carrier that includes specific terms of service and a termination clause that is air tight may mitigate potential risks.

Finally, even after a practitioner has achieved the requisite specialization in application of IRC §280E (see the summary of Hank Levy's presentation in a separate article in this Issue), AICPA tax standards, and all associated administrative and case law, Mr. Dellinger advocated for the liberal use of Form 8275 to disclose uncertain tax positions. This legal/not legal hybrid industry is new and unprecedented and, as such, represents a still-evolving area of tax law. It is probably more likely that practitioners will face uncertain tax positions on these returns than on any other return we prepare. After exercising due diligence, if there still exists no authority that clearly addresses the adopted position, the Form may be helpful in protecting the practitioner's license and the client's access to penalty relief because of its penalty protection provisions for the practitioner.

Moving Forward

Unless or until production and sale of cannabis is legalized at the Federal level, the cannabis industry will continue to present significant challenges to a variety of service professionals who have come to be regarded as indispensable to the success of any business enterprise in this country. While entering this specific New Economy market will not be the right choice for every practitioner, it is not illegal to do so. Cannabis businesses operating legally under state law have a great need for and present a promising specialization opportunity to competent, professional tax practitioners who are willing to make the required extra investments in due diligence and professional care.

Freelancing and Its Tax Considerations

By: Aaron Grey, *MST Student*

A five-member panel spoke at the Fourth Annual Small Business Tax Institute regarding the major tax implications for freelance work. The panel partially consisted of Harry Campbell, a ridesharing expert; Professor Annette Nellen of SJSU's MST program; and Torie Charvez, EA, past president of the California Society of Enrolled Agents.

What Does It Like to be a Freelancer?

Harry Campbell joined the panel remotely via conference call. Campbell is the founder of *The Rideshare Guy*, a blog and podcast that receives over 500,000 unique visitors per month.[1] *The Rideshare Guy* provides rideshare drivers, such as those for Uber and Lyft, with beneficial information, including getting started in the business, maximizing profit, and specifically to this panel, tax factors for rideshare drivers.

Campbell often performs poll within his subscriber base, centered on their experiences. In one recent survey, he asked about how drivers ordinarily file their taxes. About 31% of respondents use a CPA, 54% self-prepare by using software like TurboTax, and 9% use brick-and-mortar chains (e.g. H&R Block).[2] In the same survey, Campbell found that 50-60% of drivers work only 10 hours per week, and make an average of $10 to $20 per hour. Some drivers who choose to work during peak hours can make as much as $50 to $60 per hour. The average pay is directly proportional to the size of the city, so drivers in Los Angeles are likely to make more per hour than one in a smaller city like Gilroy, California. While at first glance the income may be look good, drivers are personally responsible for the operating expenses of operating their vehicle: gas, cleaning, maintenance, mileage, depreciation, etc. Therefore, these drivers need to carefully consider the issue of tax deductibility for these expenses.

Campbell also commented on the controversy of whether ridesharing drivers are contractors or employees. "Most drivers don't want to be employees… [they] like the flexibility of setting their own hours and certain work areas." The tentative categorization as contractors "works out pretty well" for Uber, as the company can save on payroll taxes and related expenses, as well.

There are several some tax surprises that new rideshare drivers probably overlook. If drivers are treating their line of work as self-employment, then the legal, tax, and accounting factors aligned with this classification must be followed. "[M]ost drivers don't look to make most of their income from driving… [yet] a lot of these drivers don't realize all the reporting requirements, tracking [of] expenses, keeping separate personal and business bank accounts [that are necessary]." If drivers plan on taking Schedule C of Form 1040 business deductions to arrive at their AGI, the substantial amount of work "may not necessarily be worth the extra $200 per month," Campbell said.

Worker Classification and Related Taxes.

[1] The Rideshare Guy: A Blog and Podcast for Rideshare Drivers. 23 Jun. 2016. http://www.therideshareguy.com
[2] Ibid. http://therideshareguy.com/wp-content/uploads/2015/02/How-do-rideshare-drivers-file-their-taxes-every-year-768x182.png

Professor Nellen continued the discussion by providing an overview on freelance worker classification. A top issue on worker classification is related to the Affordable Care Act. Should Uber drivers and other ride-sharers be considered *employees* rather than freelancers / independent contractors, Uber and other ride-share employers would be subject to the employer mandate of providing health coverage for drivers working 30 hours or more per week. A failure to provide these theoretical employees with healthcare and the related 1095-C tax forms would result in significant penalties for these companies.

Another consideration that freelance platforms, such as TaskRabbit, could potentially create is an employer-employee relationship for the customers using the service. Customers hiring a maid via the TaskRabbit platform for their regular help may risk turning themselves into an employer. The nature of the customer's controlling the maid's daily tasks, setting their hours, and the act of paying them (despite paying through a conduit) may create an employer-employee relationship. If so, nanny and employer taxes may be due as a consequence.

Professor Nellen further emphasized the importance of Form 8919, *Uncollected Social Security and Medicare Tax on Wages*. This form should be completed if the worker believes his/her role was as an employee, but they have been treated as an independent contract by the employer (i.e., the worker received a 1099 instead of a W-2). If it is ultimately determined that the worker is an employee, completing Form 8919 would prevent the worker from having to pay the full self-employment tax, but they would still be for the employee's share of social security and Medicare taxes.

Individual Income Tax Compliance for Freelance Drivers.

Finally, Torie Charvez spoke on the freelance tax compliance issues she encountered in recent practice, primarily with Uber drivers. Many taxpayers wanting to earn some extra cash fail to consider the tax consequences of performing these types of activities.

On the income side, drivers who received income from these companies, but not a 1099-K, assumed the lack of paperwork implied no need to report this income on their taxes. As sole proprietors, Charvez said, Uber drivers must report income, whether or not a 1099-K is received, on their Schedule C.

Drivers additionally have issues understanding deductible mileage tracking. To be accurately deductible, drivers must maintain a mileage log indicating all the business miles driven. Uber's app only tracks mileage from customer pick-up location to drop-off. Miles between two separate customer engagements are technically business-related, but not logged under the Uber app. Therefore, drivers need to recreate these missing miles on their mileage logs.

Ms. Charvez also advocated for having Uber drivers seriously treat and operate their activities as a true business to help avoid receiving inadvertent hobby treatment. This means maintaining a separate bank account for their business and using accounting software to monitor their transactions. The business treatment of these activities, to the extent that the driver would also need a home office (and related home office deduction) is usually somewhat of a stretch, however.

Home office deduction rules are so strict, that the mere act of tracking expenses on a computer in a "home office" is likely not the only activity drivers perform in their purported home office, which normally implies a disqualifying personal use. Normally to qualify for a home office deduction the home office must be used *exclusively* for business purposes with no personal use (among other requirements).

Uber drivers are also accountable for reporting and paying self-employment tax and making estimated tax payments. The full 15.3% employer and employee portions of social security and Medicare tax are the drivers' responsibility under the self-employment tax. In addition, drivers must make installment tax payments during the year towards future estimated tax liabilities. Additionally, taxpayers must consider the requirement to produce their own health insurance if they lack it through an employer. If the driver fails to possess a Form 1095-A, -B, or -C, then it is highly likely they are subject to penalties under the Affordable Care Act for not having health insurance.

Some drivers have had an employee-type mindset so they never consider these various factors and issues and believe the process of earning through ridesharing is somewhat easy and automatic. The self-employment classification and the administrative compliance burden has made many of Charvez's clients reconsider the value of extra Uber income.