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**Summer/Fall 2016**

# **The Contemporary Tax Journal**

**A Publication of the SJSU MST Program**

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## **The Contemporary Tax Journal Summer/Fall 2016**

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## **Letter from the Editor**

We are delighted to present to you the Summer/Fall 2016 edition of *The Contemporary Tax Journal*.

When I enrolled in the MST program in 2015, little did I know that it would turn out to be the most enriching experience of my life. The immense knowledge and the numerous learning experiences that I encountered on my journey, transformed me from an aspiring tax accountant to a competent professional. With immaculate curriculum and keen passion in all our MST program professors, it is no surprise that the program has produced some of the best tax professionals in the region. Being one of the few of the nation's student-oriented tax journals, it was a privilege for me to have chaired the Student editor's position for the 2016 Summer/Fall edition.

Our issue begins with the "Tax Enlightenment" section that covers topics such as tax consequences of virtual reality currency generated in virtual gaming worlds; recent developments in areas of the foreign earned income credit and exclusion of US citizens working abroad and the debt/equity characterization issue arising from transfer of assets to controlled corporations. This section also features an in-depth analysis of the employer's share responsibility rules under the Affordable Care Act.

The next section - "Tax Feature"- includes summaries from the Fourth annual IRS-SJSU Small Business Institute conference on navigating taxes with new economy clients that was held on June 22, 2016. Here we address issues such as the origins of taxing marijuana operations as well as the rekindled interest in the world of cannabis in recent times with the ethical predicaments a practitioner faces in taking on clients in this industry; the application of the residential rental rules in the context of new economy businesses such as Airbnb; tax issues in a sharing economy such as using personal cars for business purposes, characterization of these activities as a business or hobby and how the growth in the number of freelancers may cause ambiguity in areas of worker classification, challenges in tax compliance and recordkeeping.

The "Tax Maven" section captures the interview with former SJSU interim president Sue Martin where I had the opportunity to pen down her inspirational journey from the Treasury's office to the office of Dean and President. Not only is her story a motivation to all women professionals, but we believe that it will have a positive impact and reach on all aspiring young professionals.

*The Contemporary Tax Journal* has long been a forum where students can exhibit their ideas, opinions and tax understanding. We would like to thank all our authors for their valuable contributions and hope you find this issue enlightening and resourceful.

**Shilpa Balnadu**  
Student Editor

# The Foreign Earned Income Exclusion

By: Shilpa Balnadu, *MST Student*

## Introduction

Section 911 of the Internal Revenue Code (IRC) allows a “qualified individual” to elect to exclude a portion of earned income attributable to his or her presence in a foreign country. A “qualified individual” is defined as a:

- citizen of the United States and establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year, or
- citizen or resident of the United States and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.<sup>1</sup>

Generally, the bona fide residence test is met if an individual is either a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year and if such individual is either a

- U.S. citizen, or
- U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect.

However, it is noteworthy that neither does one *automatically* acquire bona fide resident status merely by living in a foreign country or countries for one year nor is a bona fide residence the same as domicile which is defined as the permanent home where one returns or intend to return. The IRS determines the bona fide residency based on facts and circumstances on a case-by-case basis.<sup>2</sup>

The total exclusion is generally limited to the lesser of:

- the individual's foreign earned income for the year, or
- the overall maximum exclusion allowed for the year, which for the 2016 tax year is \$101,300.<sup>3</sup>

Even if a qualified individual's foreign-source earned income is above the maximum allowed exclusion for the year, he/she may still be able to potentially claim a credit for foreign income taxes paid on the excess (of the annual exclusion) foreign-earned income.

There have been a number of recent challenges regarding the eligibility of a person to claim the foreign earned income exclusion. Two such cases are discussed in this article.

## Failure to File a Return and its Impact on Eligibility

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<sup>1</sup> IRC § 911(d)(1).

<sup>2</sup> See examples of situations where taxpayers may not be considered to have obtained bona fide resident status (Foreign Earned Income Exclusion – Bona Fide Residence Test) at: <https://www.irs.gov/individuals/international-taxpayers/foreign-earned-income-exclusion-bona-fide-residence-test>

<sup>3</sup> Rev. Proc. 2015-53, § 3.32, 2015-44 IRB 615.

In a 2016 court case, a U.S. citizen who was a full-time resident of Philippines had not filed US tax returns for the years 2000 to 2006 under the belief that he owed no taxes.<sup>4</sup> Consequently, the IRS prepared “substitute” tax returns for the individual for the years 2000 through 2006 which failed to factor the foreign taxes that the individual had paid, thereby resulting in a tax deficiency of over \$1.3 million. After the individual’s death, his estate (the taxpayer) late-filed income tax returns for those years and claimed the foreign income exclusion (as well as the foreign tax credit) and requested a tax refund for the years 2000 through 2006.

Per Federal law, American taxpayers living and working overseas are, under certain circumstances, permitted to adjust their U.S. tax liabilities by excluding some of the foreign-earned income as well as through the application of a credit for foreign taxes actually paid.<sup>5</sup>

The issue before the court was whether the taxpayer was entitled to the benefit of the exclusion and/or foreign tax credit.

One of the important requirements for claiming the foreign income exclusion is that the taxpayer must normally claim the exclusion election on a timely filed income return, in an amendment to a timely filed return, or within one year after the due date of the return.<sup>6</sup> Here the taxpayer did not do either of these and the IRS therefore contended that the taxpayer failed to qualify for the exclusion.

However, the taxpayer noted that the IRS had ignored the exception to the three normal filing deadlines for claiming the exclusion. The pertinent regulations do have a special exception which stipulates that when an income tax return is filed after the normal prescribed periods, a §911 election to exclude foreign-sources income can still be made allowed if the taxpayer:

- owes no federal income tax after taking into account the exclusion and files the required a return with the claimed exclusion either before or after the IRS discovers that the taxpayer failed to elect the exclusion, or
- even if the taxpayer owes federal income tax after taking into account the exclusion, they file the return with the claimed exclusion before the IRS discovers that the taxpayer failed to elect the exclusion.<sup>7</sup>

In addition to the above Treasury Regulation,<sup>8</sup> the taxpayer also relied on an IRS Chief Counsel Advice to claim the exclusion.<sup>9</sup>

In analyzing the taxpayer’s arguments, the court focused on these two, taxpayer-friendly prongs of the regulation. Under the first prong, if taxpayer owes no federal income tax after taking into account the exclusion, he can file late returns and take advantage of the exclusion whether or not the IRS has discovered his failure to elect the exclusion. Here, the taxpayer had interest and dividend income not subject to the foreign income exclusion, in addition to his foreign earned

<sup>4</sup> *Estate of Herrick v. U.S.*, 117 AFTR 2d 2016-1142 (DC UT).

<sup>5</sup> IRC § 901(a).

<sup>6</sup> Treas. Reg. § 1.911-7(a)(2).

<sup>7</sup> Treas. Reg. § 1.911-7(a)(2)(i)(D).

<sup>8</sup> *Ibid.*

<sup>9</sup> IRS Chief Counsel Advice 200226010 (3/20/2002), which includes a reference to Treas. Reg. § 1.911-7(a)(2)(i)(D): “The intent of this regulation is to allow a taxpayer whose only income at issue is excluded foreign earned income to file a late section 911 election.”

income, which by itself produced a tax liability of approximately \$73,000 for the years 2000-2006 - even with the application of the exclusion. Thus first prong of the exception did not apply to this case.

The second prong of the exception, however, applies if there is still some tax liability owing but the IRS has not discovered that taxpayer failed to elect the exclusion before the taxpayer claims the exclusion. The IRS did not apply the foreign earned income exclusion when it filed the substitute returns for the taxpayer and the court suggested that this was indicative of the fact that the IRS overlooked that the taxpayer's failure to elect the exclusion. In fact, the IRS was notified about the potential applicability of the exclusion only when the exclusion was applied for by the taxpayer in their late-filed tax returns. Therefore, the court concluded that the taxpayer had made a timely §911 election of the foreign earned income exclusion under the second prong of Subsection (D) of Treas. Reg. §1.911-7(a)(2)(i) and therefore the foreign earned income exclusion applied to the taxpayer's 2000-2006 tax returns.

### Exception of the Income Exclusion Provisions to Employees of United States

Another area of contention regarding the foreign income exclusion has been around the rule that the exclusion does not apply to the amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof.<sup>10</sup> The purpose of the exception was designed to prevent U.S. Government employees from escaping taxation on their income by both the United States and foreign governments. This limitation only applies to *employees* of the United States and not to *independent contractors* of the U.S. government.

In a recent tax court case, the taxpayer, a U.S. citizen, performed contract work for U.S. State Department's Office of Overseas Buildings Operations ("OBO") in various foreign locations.<sup>11</sup> The taxpayer and the OBO had executed a non-negotiable Personal Service Contract ("PSC") which specified the duties, the scope of the taxpayer's work, and the evaluation process. The taxpayer worked under direct supervision of an OBO project manager and could neither delegate nor freelance elsewhere. The salary was based on a 40-hour week and was based on time rather than on the building inspected.

During the years at issue, the OBO was responsible for providing the taxpayer with office space, a desk, office equipment, standard office supplies and utilities that would ordinarily be used by similar Government employees. The OBO was also responsible for giving the taxpayer access to Government-furnished equipment such as word processors, computers, typewriters, calculators, and copying machines, including necessary supplies.

The OBO issued the taxpayer Forms W-2, Wage and Tax Statement, and withheld Federal income tax and payroll taxes. The taxpayer had filed his US returns by claiming the foreign earned income exclusion.

Although there was no dispute that the taxpayer was paid by an agency of the United States, the taxpayer argued that he was an independent contractor and that therefore was entitled to exclude

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<sup>10</sup> IRC §911(b)(1)(B)(ii).

<sup>11</sup> *Alfred S. Co v. Commissioner*, TC Memo 2016-19.



his income from the OBO as “foreign earned income” within the purview of §911(b)(1)(A). On the contrary, the IRS argued that the taxpayer was a government employee and therefore not entitled to the exclusion.

The issue before the court was whether the taxpayer was an employee or an independent contractor of the U.S. government.

The court noted that the definition of an employee or independent contractor was not provided in the Internal Revenue Code and consequently it relied on other guidance. The court listed the common law rules and other enumerated factors indicative of employee-employer relationship which was analyzed as below:

*a. Degree of Control*

The court declared that of all of the factors the “right to control” was the “master test” in determining the nature of a working relationship.

The court analyzed this factor and noted the following:

- The OBO dictated the duties and supervised the performance of the taxpayer.
- The taxpayer worked under the direct supervision of an OBO project director and was required to maintain and complete daily and monthly reports,
- The taxpayer was not permitted to delegate the duties,
- The OBO dictated all terms of the service contracts,<sup>12</sup> and
- The OBO dictated the taxpayer's hours, pay, and leave.<sup>13</sup>

Although the amount of control the OBO had over the taxpayer’s day-to-day activities was limited, the taxpayer was subject to substantial control by the OBO during the years at issue. It was therefore concluded that the OBO had the right to exercise control over the taxpayer and in fact it exerted a substantial amount of control over him.

*b. Investment in Facilities*

The fact that a worker provides his or her own tools or goods generally indicates independent contractor status. Conversely, the fact that a worker has no investment in the facilities used in the work is indicative of an employer-employee relationship.<sup>14</sup> During the years at issue, taxpayer actually had invested in the equipment needed for his work which did not involve a risk of financial loss as he was able to keep his purchased tools after the termination of his employment. The OBO,

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<sup>12</sup> This included the taxpayer's duties, scope of work, process by which taxpayer would be evaluated, reimbursement policies, travel policies, and termination policies. The taxpayer, in fact, could not negotiate the terms of the PSCs and was required to abide by all terms and conditions mandated by the PSCs. For instance, the OBO set taxpayer's work schedule, including the specific days on which taxpayer was required to work, as well as the specific hours during which he was required to work. Additionally, the OBO determined the countries to which taxpayer would be sent to work as well as when he would be sent there. Moreover, taxpayer was paid a fixed annual salary in biweekly increments and in accordance with the Foreign Service Scale. In addition to his salary, the OBO permitted taxpayer to earn and accrue, among other things, home leave, annual leave, and sick leave. If taxpayer wished to take time off from work—to use either annual leave or sick leave—he had to request and obtain permission from the OBO.

<sup>13</sup> For instance, the OBO set taxpayer's work schedule, including the specific days on which taxpayer was required to work, as well as the specific hours during which he was required to work. Additionally, the OBO determined the addition to his salary, the OBO permitted taxpayer to earn and accrue, among other things, home leave, annual leave, and sick leave. If taxpayer wished to take time off from work—to use either annual leave or sick leave—he had to request and obtain permission from the OBO.

<sup>14</sup> *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, 271 (2001).

on the other hand, provided the taxpayer with government-furnished quarters, training services, and other supplies. Overall, this factor was considered neutral.

*c. Opportunity for Profit or Risk of Loss*

An opportunity for profit or the risk of loss on the basis of the worker's own efforts and skill indicates independent contractor status.<sup>15</sup> In contrast, earning an hourly wage or fixed salary indicates an employer-employee relationship.<sup>16</sup> During the years at issue the OBO paid the taxpayer an annual salary was not contingent on taxpayer's performance or completion of projects. Further since he made no monetary investment in the buildings, this factor indicates that the taxpayer was an employee.

*d. Right to Discharge*

The principal's retention of the right to discharge a worker is indicative of a common law employer-employee relationship.<sup>17</sup> During the years at issue the OBO had the right to terminate the PSC at any time for cause as well as upon 30 days' advance notice for the convenience of the United States. Accordingly, this factor indicated that the taxpayer was an employee.

*e. Integral Part of Regular Business*

Where a type of work is part of the principal's regular business, it is indicative of employee status.<sup>18</sup> Here, the taxpayer served as a mechanical engineer and performed a wide range of mechanical engineering functions in support of the planning, implementation, and oversight of the assigned projects. This type of work was within the scope of the OBO's regular business. Accordingly, this factor indicated that taxpayer was an employee.

*f. Permanency of Relationship*

A continuing relationship indicates an employment relationship, while a transitory relationship may be indicative of independent contractor status.<sup>19</sup> Here, the taxpayer worked exclusively for the OBO for five years in accordance with the PSCs. He did not offer his services to the public and did not perform services for any individual or entity other than the OBO, as would an independent contractor.<sup>20</sup> Accordingly, this factor was indicated that the taxpayer was an employee.

*g. Relationship Contemplated by the Parties*

<sup>15</sup> *Simpson v. Commissioner*, 64 T.C. 974 (1975); see also *Rosato v. Commissioner*, TC Memo. 2010-39.

<sup>16</sup> *Robinson v. Commissioner*, TC Memo. 2011-99 (citing *James v. Commissioner*, 25 T.C. 1296, at 1300 (1956)), aff'd, 487 F. App'x 751 [110 AFTR 2d 2012-5194] (3d Cir. 2012).

<sup>17</sup> *Rodriguez v. Commissioner*, TC Memo. 2012-286 (citing *Weber v. Commissioner*, 103 T.C. at 391); see also *Ellison v. Commissioner*, 55 T.C. 142, 152 (1970).

<sup>18</sup> *Simpson v. Commissioner*, 64 T.C. 974(1975); *Rosemann v. Commissioner*, TC Memo. 2009-185.

<sup>19</sup> *Ewens & Miller, Inc. v. Commissioner*, 117 T.C. 263, (2001); *Rosemann v. Commissioner*, TC Memo. 2009-185 [2009 RIA TC Memo ¶2009-185].

<sup>20</sup> *Jacobs v. Commissioner*, TC Memo. 1993-570; *Casety v. Commissioner*, TC Memo. 1993-410; *Gamal-Eldin v. Commissioner*, TC Memo. 1988-150 [¶88,150 PH Memo TC], aff'd without published opinion, 876 F.2d 896 (9th Cir. 1989).

The withholding of taxes is consistent with a finding that an individual is a common law employee.<sup>21</sup> Here, the OBO provided taxpayer with Forms W-2, withheld Federal income tax and payroll taxes, and remitted these amounts to the IRS. On the contrary, the record indicated that during the years at issue taxpayer personally believed that he was not an employee of the OBO. Overall, this factor was considered neutral.

After considering all the evidence, the court concluded that the taxpayer was indeed an employee of the OBO and accordingly not entitled to the exclusion of income under IRC §911(a).

## Conclusion

Both of these cases have application beyond IRC §911. It can be observed that at a broad level the cases reflect the importance of being compliant and cognizant of the tax rules so as to be able to avail the tax saving opportunities offered by the law. The *Herrick* case highlights the importance of understanding the compliance obligations, including special taxpayer-friendly provisions, and observing those requirements. The *Alfred* case is a reminder of the complexity in describing employer and employee relationship as it relates to the new age economy and reiterates long-standing factors established by IRS and the courts in resolving this issue. As the tax law is wrangled with numerous exceptions, reliefs and conditions, understanding and interpreting of the law poses new challenges and opportunities to tax professionals in providing the appropriate assistance to clients.

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<sup>21</sup> *Packard v. Commissioner*, 63 T.C. 621, 632 (1975); *Rosato v. Commissioner*, TC Memo. 2010-39.

## Gamers Beware: Level 99 Boss... Taxes!

By: Fenny Lei, *MST Student*

### Background

It has been 36 hours since you last slept and ate something other than a preservative-laden product disguised as food in the form of perhaps a microwavable burrito. This was all worth it because you are about to finally beat that raid boss and have a chance to roll against other party members for his loots. If you understood the last two sentences, then you have probably ventured into the land of Massive Multiplayer Online Role-Play Game (“MMORPG”) at some point. The world of MMORPG has an intriguing gameplay system, a complex economic system and social hierarchy that at times mimic the real world. Players are represented through customized avatars that become increasingly more powerful through the completion of tasks and defeating high-level monsters, colloquially known as “Bosses”. The appearance of a valuable in-game item is the usual concomitant reward to the defeat of a Boss. The probability of the appearance of a particular in-game item is the drop rate. Lower drop rate for an item indicates its rarity and potential desirability. Striving for wealth, power or popularity motivates players to dedicate countless hours. For many players, the world of MMORPG is no longer just a hobby; instead its influence is leaking into the real world, blurring the boundaries of reality, and becoming a lifestyle. Global spending in MMORPG games exceeded \$12 billion in 2012 and was projected to reach \$17.5 billion in 2015.<sup>1</sup> In the game World of Warcraft (“WoW”), each player spends a daily average of 3.1 hours in game, which translates to approximately 20 hours per week or 1,040 hours per year.<sup>2</sup> This burgeoning market therefore carries high potential for new tax revenue. What if the hours you spend in the virtual game world have taxable consequences? Will you have second thoughts before you acquire that super rare Kraken Club or conjure up diabolical plans to amass large amounts of in-game currency?

### Introduction

In recent years, virtual currency transactions have become gradually more pervasive in the economy, exerting their influence on various industries and individuals. Tax authorities are still searching for more definitive and structured methods to regulate these transactions. As a result, the Government Accountability Office (“GAO”) issued a report on this subject that studied the tax implications of virtual currency transactions.<sup>3</sup> The GAO divides the virtual exchange systems into three categories: closed-flow system, hybrid system and open-flow system. The categorization of these three systems depends on three components:

1. Interaction between U.S. dollar and virtual currency.
2. Interaction between real goods and services and virtual currency.
3. Interaction between virtual goods and services and virtual currency.

<sup>1</sup> “Global MMO Games Spending Exceeds \$12 Billion – SuperData Research.” SuperData Research. N.p., (12 Jul. 2012. Web. 05 Jul. 2016). <https://www.superdataresearch.com/blog/global-mmo-games-spending-exceeds-12bn/>

<sup>2</sup> Tarng, Pin-Yun, Kuan-Ta Chen, and Polly Huang. “An Analysis of WoW Players’ Game Hours.” Department of Electrical Engineering, National Taiwan University, n.d. Web. 05 July 2016. [http://www.iis.sinica.edu.tw/~swc/pub/wow\\_player\\_game\\_hours.html](http://www.iis.sinica.edu.tw/~swc/pub/wow_player_game_hours.html)

<sup>3</sup> U.S. Government Accountability Office, GAO-13-516, Virtual Economies and Currencies: Additional I.R.S. Guidance Could Reduce Tax Compliance Risks (2013). <http://www.gao.gov/assets/660/654620.pdf>

In a closed-flow system, exchange of virtual currency, goods and services is limited to the virtual world and has no measurable economic impact in the real world. An example is a small game with no secondary market for its in-game currencies. In a hybrid system, economic exchange can impact the real world if the players choose to engage in transactions that convert in-game assets to real currency or goods and services, albeit potential limitations posed in the End User License Agreement (“EULA”) by the game distributor. An example is the aforementioned WoW. Players can then use third-party websites to facilitate the exchange of in-game currency “Gold” and items between sellers and buyers and set different exchange rates according to the supply and demand of each server. Blizzard, the owner of WoW, expressly prohibits such trades in its EULA and they enforce it by banning violating player accounts. Other similar games have comparable EULAs in place to curb this type of behavior. Despite these efforts, IGE, a third-party website that specializes in selling virtual currency and avatars for various MMO games, estimated the volume of real money trade (“RMT”) secondary market was approximately \$880 million in 2004.<sup>4</sup> In another example of a hybrid system, Second Life, players earn “Linden Dollars” for services performed or goods sold in its virtual domain and Linden Dollars can be readily cashed out by converting Linden Dollars to USD within the game itself at a set rate. According to the GAO report, players exchanged \$150 million worth of Linden Dollars in the third quarter of 2010 alone. Based on the above facts, we can conclude there is a fairly lucrative secondary market for virtual currency and items in hybrid systems. In open-flow systems, virtual currency is freely exchanged with government issued legal tender and goods and services without the confines of the virtual world in hybrid and closed-flow systems. One example of an open-flow system currency is Bitcoin, which is mined by users through mathematical algorithms and is widely accepted as an alternate form to cash.

The IRS has made some efforts in addressing convertible virtual currencies, namely Bitcoin, categorizing it as property, and not currency, in Notice 2014-21.<sup>5</sup> This notice expands the scope of convertible virtual currency to include either:

1. A virtual currency that has an equivalent value in real currency, or
2. A virtual currency that acts as a substitute for real currency

This article focuses on classification and tax implications of virtual assets in Second Life and WoW under newly issued IRS Notice 2014-21.

## **Income Realization**

The GAO report begins its analysis by comparing virtual currency transactions to the bartering system. Barter is when two parties exchange goods or services without exchanging currency. An example is when a house painter paints an accountant’s house in exchange for the service of filing his tax returns. According to IRS Publication 525, bartering transactions are reported on 1099-B, or a similar statement and taxed at the market value of the goods or service received by both parties. The logic behind taxing barter transactions is the definition of income. According to IRC Section 61, “... income is from whatever source derived [.]” Over the years, income has been defined to include various forms and methods of receipt. Income can be in forms of currency, currency equivalent or services. It can also be received through various methods: constructive, prepaid or

<sup>4</sup> Lehdonvirta, Vili. "How Big Is the RMT Market Anyway?" Virtual Economy Research Network. (02 Mar. 2007. Web. 15 Apr. 2016). [https://virtualeconomyresearchnetwork.wordpress.com/2007/03/02/how\\_big\\_is\\_the\\_rmt\\_market\\_anyw/](https://virtualeconomyresearchnetwork.wordpress.com/2007/03/02/how_big_is_the_rmt_market_anyw/)

<sup>5</sup> IRS Notice 2014-21.

assigned. Virtual currency transactions in hybrid systems are comparable to the bartering system because they involve exchanges of goods or services with real world currency value. Here are two cases to illustrate in-game transactions.

**Case One:** Judy spent 10 hours per week for the last 5 months completing various tasks in WoW to level up her avatar to obtain more value creating tools. At the maximum level of 65, she started to join raids of high-end dungeons and acquired a re-sellable item with an extreme rare drop rate of 0.1%. That item is worth approximately \$2,000 on eBay and other third-party websites. Along with that rare item, she also accumulated 30 million Gold which can be sold to third-party website at an exchange rate of 1 million Gold to \$20. In addition, as a high level crafter, she was able to craft items for other players in game for a nominal fee. She had total convertible in-game assets estimated at \$2,600, which she had accumulated over 200 hours of playtime.

**Case Two:** George developed virtual real estate for Second Life as a hobby. He purchased plots of virtual land within the game, built houses on the land and sold the finished product for a profit to other players. Last year, he received 50 million Linden Dollars for his services as a virtual real estate developer. According to a previously published conversion rate, 50 million Linden Dollars was worth approximately \$185,185.<sup>6</sup> In addition, he held virtual real estate property worth 20 million Linden Dollars. He chose not to convert the Linden Dollars to USD in that tax year because he was waiting for a more favorable rate.

Should their virtual assets be taxed? If taxed, when is the appropriate time?

To answer these questions, let us define these types of virtual assets and explore various income recognition possibilities. The two types of virtual assets in question are: virtual currency and virtual assets such as in-game items or virtual real estate. As mentioned before, Linden Dollars should be considered a convertible virtual currency under IRS Notice 2014-21 and thus taxed as property like Bitcoin. In contrast, non-convertible virtual currencies are those intended specifically to a particular virtual domain and cannot be exchanged for real currency under the governing rules of that particular domain.<sup>7</sup> At first glance, Gold falls within the definition of a non-convertible virtual currency because its original purpose under the EULA is only for economic transactions within the game. The Financial Action Task Force (“FATF”) mentions one exception to the general definition of non-convertible virtual currency: if the virtual currency has an unauthorized secondary market. WoW players are able to purchase or sell Gold through facilitation of third party websites, giving Gold value in real currency and thus effectively changing its characterization to convertible virtual currency. Due to the convertible nature of Gold and Linden Dollars, they both should be treated as property for tax purposes. By and large, players, as individuals, are cash basis taxpayers and report income when cash or property is actually or constructively received. Gold and Linden Dollars are properties so they should be reported at fair market value at time of receipt, barring any exceptions, since they can be traded for real currency through third party websites. However, for these types of virtual assets earned, the issue of receipt becomes an issue for tax purposes – in particular the issue of constructive receipt. The constructive receipt rules state that income items that are not actually received are nonetheless constructively received in the taxable

<sup>6</sup> Wong, Grace. "How Real Life Money Works in Second Life?" CNN. (02 Dec. 2008. Web. 15 Apr. 2016).

[http://money.cnn.com/2006/12/08/technology/sl\\_index/index.htm?section=money\\_technology](http://money.cnn.com/2006/12/08/technology/sl_index/index.htm?section=money_technology)

<sup>7</sup> “Virtual Currencies Key Definitions and Potential AML/CFT Risks.” Financial Action Task Force. N.p., (Jun. 2014. Web. 10 Jun. 2016).

<http://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf>

year during which the income item is credited to the taxpayer's account or otherwise made unconditionally available so the taxpayer may draw upon it at any time without substantial limitations or restrictions preventing the taxpayer from receiving the income.<sup>8</sup>

In the first case, Judy earned \$2,600 worth of convertible virtual currency (Gold) and a virtual, rare item through 200 hours of playing time over five months. In reference to the analysis of convertible virtual currency in the previous paragraph, her Gold should have been recorded at fair market value at receipt and taxed in the year of its receipt in her account. However, her access to the income for the rare item was limited by the EULA that expressly prohibited selling or trading of in-game items for cash. Cashing out her in-game item would directly violate the EULA and jeopardize her account status. She would potentially have to surrender a substantial right, the ownership of her avatar (the rare item) and ability to participate in the game, if her activities were detected by Blizzard. Substantial limitations and restrictions such as this are at the heart of the exceptions to constructive receipt and this restriction could arguably prevent Judy from constructively receiving income associated with that rare, in-game item.

In the second case, the fact pattern is slightly different. Virtual asset attributes remain equal to those in the first example. Linden Dollars, as a convertible virtual currency should be taxed in the same manner as Gold. However, the EULA did not limit George's ability to engage in selling virtual assets for cash. The virtual real estate was credited to George's account and available for him to withdraw upon or dispose of as he chose. George's access to the income had no substantial limitations. His choice of not withdrawing the income should have had no bearing on the inclusion of it as constructively received.

If the IRS chooses to enforce the above tax implications then there are three major issues to consider: compliance enforcement, administrative burden and valuation of virtual assets. Tax compliance enforcement of the above transactions is difficult partly due to the transient nature of virtual currency. The responsibility of reporting and documentation ultimately lie with the administrator of the virtual currency especially if the administrator is subject to the rigorous reporting standards outlined in the Bank Secrecy Act, which aimed to prevent money laundering.<sup>9</sup> Moreover, Blizzard and Linden Lab will be obligated to issue Form 1099 if the player earns an aggregated amount over \$600 in that tax year.<sup>10</sup> The administrative burden and costs associated with reporting and documenting virtual transactions of each player will undoubtedly be significant. The valuation of virtual assets at fair market value has a limited basis that is possibly dependent on the secondary market if it is available to that particular virtual item. For example, George receives a customized in-game sofa from a friend as payment for service provided but it is not resellable. What is the real world value of the string of codes manifesting itself as a sofa?

## **Conclusion**

Years ago, the idea of virtual assets and currency was probably unfathomable. In today's world, I cannot remember the last time I paid with cash for an item over \$100 or in person. Many transactions happening today are conducted through a digital medium like credit cards, PayPal or Bitcoin transfer. In addition to the digital economy, virtual reality technology is advancing rapidly,

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<sup>8</sup> Treas. Reg. § 1.451-2.

<sup>9</sup> FIN-2013-G001.

<sup>10</sup> Treas. Reg. § 1.6041-1.

and soon the convergence of virtual reality and reality will be inevitable. Virtual currency and assets make up a large part of today's economic transactions. Unfortunately, regulations are not keeping step with the growth of this market. As a result, the U.S. government is losing valuable tax revenue and opportunities to educate the public on the tax ramifications on non-traditional, virtual world-type activities. Politicians and tax authorities must update the tax codes and regulations written decades ago effectively and efficiently to meet the needs of a more modern economy.



## Employer Shared Responsibility Provisions under the Affordable Care Act

By: Xuan Hong, MST Student

In the United States, about 55.4% of the population receives health insurance through employment.<sup>1</sup> On March 23, 2010, President Obama signed and enacted the Patient Protection and Affordable Care Act, also called the Affordable Care Act (“ACA”), with the goal to provide more people with affordable and valuable health insurance coverage and an overall better healthcare system. The ACA added IRC Section 4980H which states certain employers have responsibilities to provide their full-time employees and their dependents (“full-time employees”) with minimum essential health coverage (under the employer Shared Responsibility provisions, dependent generally refers to employee’s children under the age of 26). This requirement is often referred to as the Employer Shared Responsibility provisions (ESRP). On February 10, 2014, relevant and final Treasury regulations were issued. Starting in 2015 the ESRP went into effect with certain employers then required to begin to comply with the new insurance coverage requirements.

### Overview of the ACA

If certain employers do not provide minimum essential coverage (MEC) to 95% of their full-time employees and at least one full-time employee receives the premium tax credit (PTC), the employers may have to make the Employer Shared Responsibility payments to the IRS. However, even if employers provide MEC to 95% of their full-time employees, the employers may still be subject to the Employer Shared Responsibility payments if the coverage is not affordable or does not provide a specified, minimum level of value and at least one full-time employee receives the PTC (the PTC is discussed later).

### Which Employers Are Subject to the New ACA ESRP Rules?

The ESRP are only applicable to certain large employers. The only determining factor of whether an employer is an Applicable Large Employer (ALE) is the number of its full-time and full-time *equivalent* employees.<sup>2</sup> This is true regardless of the entity type of the employer. An ALE is an employer, regardless of a corporation, a government entity, a non-profit employer or even an Indian tribal government entity, which has an average of 50 or more full-time employees (including full-time *equivalent* employees) in the year. Normally, the current year ALE status depends on the number of full-time employees in the previous year. To determine the ALE status, full-time employees are employees who work an average of at least 30 hours in a week or 130 hours in a month. The number of full-time *equivalent* employees can be calculated by summing the work hours per month of all non-full-time employees (but not in excess of 120 hours) and then dividing by 120. For example, an employer has total 20 non-full-time employees, and they each work 90 hours in one month. We multiply 20 employees by 90 hours and then divide by 120 hours. Therefore, the number of full-time *equivalent* employees of the employer is 15.

<sup>1</sup> Health Insurance Coverage in the United States: 2014, page 5, US Census Bureau, Issued Sep. 16, 2015.

<https://www.census.gov/content/dam/Census/library/publications/2015/demo/p60-253.pdf>

<sup>2</sup> Employer Shared Responsibility Provisions, IRS.gov.

<https://www.irs.gov/Affordable-Care-Act/Employers/Employer-Shared-Responsibility-Provisions>

Exceptions and special rules include:

1. Based on the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, in terms of determining whether an employer is an ALE, if an employee has medical care through the military including Tricare or Veterans' coverage, the employee is not counted into the 50 full-time employee threshold calculation.<sup>3</sup>
2. The work hours for Non-US source income, such as certain overseas work, are not counted into the full-time calculation.
3. Volunteer work hours for a government or tax-exempt employer are not counted into the full-time calculation.
4. If an employer had 50 or more full-time employees for no more than 120 days in the prior year and the full-time employees in excess of 50 were seasonal workers, the employer would not be classified as an ALE.<sup>4</sup>

### **What are the Responsibilities of ALEs under the ACA?**

Under the ESRP, ALEs have two main responsibilities. First, ALEs must generally provide qualified health insurance coverage to their full-time employees. If ALEs fail to do this, normally they must pay to the IRS Employer Shared Responsibility payments, provided at least one full-time employee claims the PTC. Second, ALEs have information reporting responsibilities. They must report health insurance coverage information to both the IRS and the full-time employees.

### **What is an Employer Shared Responsibility Payment?**

The Employer Shared Responsibility payment is not a self-assessed payment but is calculated by the IRS based on the employer's information reporting and employees' tax returns. An employer does not report or send the payment unless is requested by the IRS. There are two types of Employer Shared Responsibility payments:

➤ First type:

If an employer did not provide MEC to at least 95% of its full-time employees and their dependents up to age 26 for any month and at least one full-time employee requested and received the PTC, the employer would have to pay this first type of Employer Shared Responsibility payment to the IRS. The annual payment is equal to \$2,000 multiplied by the number of full-time employees. The number of full-time employees is the actual full-time employees minus 30. This \$2,000 annualized payment is determined on a monthly basis (i.e., \$166.67 per applicable month) and is indexed for inflation starting in 2015.<sup>5</sup>

➤ Second type:

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<sup>3</sup> Public Law 114-41, Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Sec. 4007(a)(1), added subpara. (c)(2)(F), Exemption the exemption for health coverage under Tricare or the Veterans administration, to IRC 4980H, effective for months beginning after 12/31/2013.

<sup>4</sup> Seasonal workers, different from seasonal employees which are relevant for determining full-time employees, are "workers who perform labor or services on a seasonal basis, as defined by the Secretary of Labor, and include retail workers employed exclusively during holiday seasons." Q&A #54.

<https://www.irs.gov/affordable-care-act/employers/questions-and-answers-on-employer-shared-responsibility-provisions-under-the-affordable-care-act>

<sup>5</sup> In 2015, the adjusted \$2,000 amount is \$2,080 and it increases to \$2,160 in 2016.

If an employer did provide MEC to at least 95% of its full-time employees but the coverage is not affordable or providing a specified, minimum level of value and one or more full-time employee received, in any month, the PTC by purchasing their insurance through the ACA-created health insurance Marketplace, the employer would have to pay the second type Employer Shared Responsibility payment to the IRS. The payment is equal to \$3,000 multiplied by the number of full-time employees who received the premium tax credit. For any employer, it is, at most, subject to only one type of payment, and the dollar amount of the second type cannot exceed that of the first type. Like the first type mentioned above, this \$3,000 payment is the annual figure (i.e., the payment is \$250 per applicable month) and is indexed for inflation starting in 2015.<sup>6</sup>

### What is Minimum Essential Coverage under the ACA?

The minimum essential coverage (MEC) requirement is relevant to the first type of the Employer Shared Responsibility payment. IRC §5000A(f) provides that MEC includes eligible employer-sponsored plan which is “a group health plan or group health insurance coverage offered by an employer to the employee which is a governmental plan, or any other plan or coverage offered in the small or large group market within a State.”<sup>7</sup>

### What is Affordable and Minimum Value Requirements under the ACA?

The ESRP require an ALE to provide MEC that is affordable and provides a specified, minimum level of value to their employees, otherwise the ALE may be subject to the second type of the Employer Shared Responsibility payment.

#### ➤ Affordable:

Normally, an insurance premium is affordable if an employee’s contribution does not exceed 9.5% (as adjusted annually) of his/her household income.<sup>8</sup> However, it is not easy for an employer to clarify all employees’ household income. Therefore, for purpose of the ESRP, an employer can use three safe harbors to determine if its health insurance coverage is affordable for its employees.

#### Three Safe Harbors:

1. **Form W-2 Safe Harbor.** An employer sponsored health insurance coverage is generally considered affordable if a full-time employee’s contribution for the lowest cost MEC does not exceed 9.5% (as adjusted annually) of his/her Form W-2 wages from that employer.
2. **Rate of Pay Safe Harbor.** An employer sponsored health insurance coverage is affordable if an employee’s monthly contribution does not exceed 9.5% (as adjusted annually) of his/her monthly salary or, in the case of an hourly pay employee, his/her wages for 130 hours.
3. **Federal Poverty Line Safe Harbor.** An employer sponsored health insurance coverage is affordable if an employee’s contributions for the year do not exceed 9.5% (as adjusted annually) of the Federal single individual poverty line for a single individual, which is currently \$11,880.<sup>9</sup>

<sup>6</sup> In 2015, the adjusted \$3,000 amount is \$3,120 and increases to \$3,240 in 2016.

<sup>7</sup> IRC § 5000A(f)(2).

<sup>8</sup> As IRC § 36B(c)(2)(C)(iv) requires, this percentage is updated annually for inflation. The percentage is 9.56% for 2015 and 9.66% for 2016. See Notice 2015-87.

[https://www.irs.gov/irb/2015-52\\_IRB/ar11.html](https://www.irs.gov/irb/2015-52_IRB/ar11.html)

<sup>9</sup> Federal Poverty Level (FPL), HealthCare.gov, the U.S. Centers for Medicare & Medicaid Services.

➤ **Minimum Value:**

Generally, if an employer sponsored health insurance coverage could cover 60% or more expected health care expenses, it generally meets the minimum value requirement. The minimum value calculator developed by U.S. Department of Health and Human Services can help employers to determine if their health insurance has minimum value for their employees.

### **What is the Premium Tax Credit under the ACA?**

As we can see, no matter what type of payment is applicable, one trigger is the premium tax credit (PTC). Generally, employee who purchased health insurance through the Health Insurance Marketplace, such as Covered California, is qualified for the PTC if an employer does not provide health insurance coverage or the provided coverage is not affordable or does not provide a specified, minimum level of value to their employees. In fact, an employer does not know if any full-time employee claimed the PTC. Therefore, starting in 2016, health insurance marketplaces need to notify certain employers if their employees are eligible for the PTC since the employees claim that the employer-based insurance is not affordable or providing minimum value. This is called Federally-Facilitated Marketplace's (FFM) 2016 Employer Notice Program.<sup>10</sup>

### **What is the Information Reporting Responsibility under the ACA?**

The ACA also added IRC Section 6056 which states that an ALE has the information reporting responsibility no matter whether or not it provides qualified health insurance to its employees. Normally, for each full-time employee, an ALE must send Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, along with Form 1094-C, *Employer-Provided Health Insurance Offer and Coverage*, to the IRS by February 28 (or March 31 if the ALE files returns electronically) of the following year and also send a copy of Form 1095-C to its full-time employee by January 31 of the following year.

Reg. §301.6056-1 states the required information on the return:

1. The ALE's name, address and employer identification number.
2. The name and contact information of the ALE's contact person.
3. The health insurance coverage information: the covered period and the employee's lowest cost monthly premium.
4. The number of full-time employees and the name, address and taxpayer identification number of employees covered under the health plan.
5. A certification of whether the ALE provided an opportunity to its full-time employees to enroll in an affordable and minimum value health insurance plan.

Because the information reporting provisions went into effect in 2015 and 2016 is the first year for qualified employers to fulfill this requirement, there is transition relief for this provision. Specifically, an employer is required to provide Form 1095-C to its employees by March 31, 2016 and file information returns to the IRS by May 31, 2016 (or June 30, 2016 if the employer files

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<https://www.healthcare.gov/glossary/federal-poverty-level-FPL/>

<sup>10</sup> Frequently Asked Questions Regarding The Federally-Facilitated Marketplace's1 (FFM) 2016 Employer Notice Program.  
<https://www.cms.gov/CCIIO/Resources/Fact-Sheets-and-FAQs/Downloads/Employer-Notice-FAQ-9-18-15.pdf>

returns electronically). If an employer fails to file on time, it may be subject to \$250 penalty per form (adjusted annually for inflation).

To sum up, an employer who has 50 or more full-time employees (or full-time equivalent employees) must generally either provides qualified MEC to its full-time employees or pay Employer Shared Responsibility payments to the IRS. Additionally, the employer is also responsible to file information returns to both the IRS and its employees.

## When is a Transfer of Assets to a Controlled Corporation by Related Parties a Sale or Contribution of Capital?

By: Ophelia Ding, *MST Student*

### Substance Over Form

Tax consequences are often determined by the substance of the transactions, not the form. Courts and the IRS view a transaction that is lacking in substance or business purpose as a potential shield for tax evasion. The earliest interpretation of the substance over form tax doctrine traces back to a 1924 Supreme Court case, in which the Court clearly stated that it is more important to examine “what was actually done, rather than the declared purpose of the participants.”<sup>1</sup>

Another landmark and often-cited Supreme Court case, further introduced the doctrine of substance over form.<sup>2</sup> The IRS assessed that the taxpayer understated her tax liabilities by creating transactions that were lacking any real substance. In this case the taxpayer created a new corporation to transfer the shares she owned of a different company into this new company. The taxpayer then immediately dissolved the new company and distributed the shares to herself which were subsequently reported as a net capital gain. The taxpayer asserted that the transactions between the corporations and herself should be respected as a corporate reorganization with the resulting capital gain treatment. However, the IRS contended that there was no economic substance in the purported business reorganization, with the new company being formed merely for the purpose of transferring shares to the taxpayer without any other business purpose or function, except to have the transfer of stock to the newly-formed corporation avoid ordinary income treatment to the taxpayer.

The *Gregory* case manifested the substance over form doctrine by stating that transactions need a business purpose to be considered as having economic substance. It is crucial to examine the motivations behind the transactions to ensure they did not just serve the purpose of lowering the taxpayer’s tax liabilities. Although over 80 years have lapsed since the ruling, the doctrine still applies today. This was demonstrated recently in a tax court case which reinforced that transactions without a real business purpose at arm’s length are not considered to have economic substance, and taxes will be assessed accordingly.<sup>3</sup>

As we might remember, many properties went “under water” during the years of the Great Recession of the late 2000s (where the fair market value of the properties were lower than the amount owed to the lenders). As a result, many lenders acquired properties at foreclosure from these “under water” borrowers. These are known as Real Estate Owned (REO) properties. Many lenders used third-party brokers to assist in the repossessing of the properties and preparation of the properties for resale. The brokers then entered into agreement with the lenders to sell the properties.

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<sup>1</sup> *Weiss v. Stearn*, 265 U.S. 242 (1924).

<sup>2</sup> *Gregory v. Helvering*, 14 AFTR 1191 (USSC, 1935).

<sup>3</sup> *J.M. Bell, et ux. v. Commissioner*, TC Memo 2015-111.

In the *J.M. Bell case* the taxpayers were Mr. Bell, a licensed real estate broker and his wife, Mrs. Bell, who was a licensed real estate agent and appraiser. Mr. Bell was mainly operating his real estate business through his sole proprietorship (Michael Bell & Associates, dba Realty World MBA (“MBA”)) prior to 2008. However, with the increase of his REO business, he decided to incorporate his sole proprietorship business (“MBA”) in September of 2008. After the minutes of the new corporation (MBA Real Estate, Inc. (“MBA Inc.”)) were signed to appoint Mr. Bell and Mrs. Bell as President/Treasurer and Vice President/Secretary, respectively, of the new corporation the board of directors authorized MBA Inc. to purchase the assets of MBA.

The agreement MBA Inc. entered into with the taxpayers was to purchase all tangible and intangible assets of the sole proprietorship for a total purchase price of \$225,000. Without any appraisal, the taxpayer allocated \$25,000 of the purchase price to a franchise license agreement the taxpayer had with Realty World Northern California and the remaining \$200,000 evenly to the 40 contracts between the taxpayer and the existing clients of MBA to sell REO properties. Of the 40 contracts, 39 had no certainty of income.

Under the agreement, MBA Inc. would pay the taxpayer the purchase price through monthly installments of \$10,000 or more, and each unpaid installment amount would be subject to 10% interest. There was no security for the purchase price, nor was there a promissory note. The taxpayer reported their earnings from the “installment sales” as long-term capital gains. The IRS sent a deficiency notice recharacterizing the entire gain from the sale as ordinary income instead.

The main issue before the court was whether the transfer of assets from MBA to the newly incorporated MBA Inc. was a sale or a capital contribution subject to §351 (transfer to corporation controlled by transferor). If the transfer was treated as a §351 capital contribution, then the monies paid by MBA Inc. to the taxpayer would be treated as dividend income by the taxpayer with no corresponding deduction for the corporation. On the other hand, if the transfer was treated (as it was on paper) as a sale, then capital gain would generally result for the taxpayer over a number of years until the installment method with no required carryover of the basis of the assets to the corporation. The taxpayer asserted that the form of the transaction (a sale) should be upheld by the court. The position of the IRS was that the entirety of the transactions fit the requirements of a §351 capital contribution.

The court noted that even though the transaction is a transfer between related parties, it does not automatically constitute as lacking of economic substance. The court referred to the 11 factors enumerated by the Ninth Circuit for determining whether the transfer should be considered a sale (debt) or a capital contribution (equity):

1. the names given to the certificates evidencing the indebtedness;
2. the presence or absence of a maturity date;
3. the source of the payments;
4. the right to enforce payment of principal and interest;
5. participation and management;
6. a status equal to or inferior to that of regular corporate creditors;
7. the intent of the parties;
8. "thin" or adequate capitalization;

9. identity of interest between creditor and stockholder;
10. payment of interest only out of "dividend" money; and
11. the ability of the corporation to obtain loans from outside lending institutions.<sup>4</sup>

As described in these factors, it is important to note that the court considers all the facts and circumstances of the case as a whole without singling out any factor as controlling.

### Factors in Favor of the Taxpayer

#### **Title of the Debt Instrument**

The court considers the language of the instrument to determine if it is more like a typical promissory note or a stock certificate which in turn would determine if the transfer was a sale or a capital contribution. The agreement MBA Inc. entered with the Bells did not contain the language typical of a stock certificate but instead resembled a debt instrument.

#### **Maturity Date**

A capital contribution agreement generally does not come with a fixed maturity date as the payment is largely tied to the earnings of the business. The taxpayer's agreement with MBA Inc. had a fixed date for the latest repayment.

#### **Intent of the Parties**

This factor focuses solely on the objective evidence specifying the intent of the parties. Based on the evidence, the Bells intended to sell all of the sole proprietorship's assets of Mr. Bell. Additionally, the agreement they entered into is similar to a promissory note. This factor weighed in favor of a sale.

### Factors in Favor of the IRS

#### **Payment Source**

The payment source determines if the transaction was a sale or capital contribution. The repayment of capital would usually depend on the earnings. Conversely, for a sale repayment would not be dependent upon the earnings of MBA Inc. Here, MBA Inc. had no means of repaying without income indicating that the payment source was the earnings of MBA Inc.

#### **Right to Enforce Payments**

There is usually an obligation of payment if the transaction was a sale. There was no security agreement in the repayment of the purchase price, Therefore, MBA Inc.'s obligation on repayment was not enforceable by the taxpayer. This resembles a stock instrument, which denies the stockholder's right to enforce payment.

#### **“Thin” or Adequate Corporate Capitalization**

Thin capitalization of the corporation indicates a capital contribution. MBA Inc. had no assets before the agreement, and its capitalization remained inadequate after the \$500 cash contribution made by the Bells. This factor weighed in favor of a capital contribution. **Identity of Interest**

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<sup>4</sup> *Hardman v. U.S.*, 60 AFTR 2d 87-5651 (9<sup>th</sup> Cir. 1987).



A capital contribution will increase the shareholder's interest in the company. The taxpayer became MBA Inc.'s sole shareholders after the transfer, which evidenced a capital contribution.

### **Interest Paid Only with E&P**

This criterion is similar to "Payment Source" described above. Even though the agreement did not indicate that payment would be made from the earnings, MBA was not able to pay the taxpayer if it did not have income. Therefore, the repayment shared the same characteristics of a dividend. This factor weighed in favor of a capital contribution.

### **Ability to Obtain Loans from Other Sources**

If a corporation was able to borrow funds from other sources, it would be an indicator that the shareholder acted in the same manner as an outside creditor. With its "thin" capitalization and improbable source of income, it was highly unlikely MBA Inc. would be able to obtain any other funds from a third party that was at arm's length with the same terms and conditions. This factor weighed in favor of a capital contribution.

### Neutral Factors

#### **Participation and Management**

Typically, a shareholder's percent of interest or voting rights would increase after a capital contribution. The taxpayers became MBA Inc.'s sole shareholders after the transfer, but the interest in the company and voting rights of the taxpayers did not increase as a result of the transfer.

#### **Status in Relation to Other Corporate Creditors**

Generally, equity participants are lower in the hierarchy of repayment in the event of a liquidation. There was no evidence indicating the Bells' right to repayment in relation to other creditors.

Although some of the above factors weighed in favor of a sale, when considering all 11 steps as a whole and utilizing the doctrine of substance over form, the court held that the transactions were part of an overall plan of a capital contribution rather than a sale.

The above case emphasizes that tax determinations look to the substance over form as they relate to the facts of a given case. On numerous occasions the courts have placed more weight on the motivations behind the economic transactions than the form of the transaction, especially in the event the form is used solely for tax reduction purposes. It is therefore incumbent on the tax preparer and taxpayer to be cognizant of this issue while they choose their strategies to minimize tax liabilities.

## 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 Yalamarathi, 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 32<sup>nd</sup> Annual TEI-SJSU High Tech Tax Institute that will be hosted on November 7&8, 2016 in Palo Alto, CA.

## Residential Rentals

By: Padmini Yalamarathi, *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.<sup>1</sup> 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

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<sup>1</sup> 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 and (2) more than 750 hours in real estate trades/businesses in which he/she materially participates.<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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*

<sup>2</sup> IRC §469(c)(7)(B).

<sup>3</sup> *Shri G. Agarwal, et ux. v. Commissioner*, TC Summary Opinion 2009-29.

<sup>4</sup> *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 20<sup>th</sup> 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.<sup>1</sup> In 1933, the prohibition on alcohol ended when 21<sup>st</sup> 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.<sup>2</sup> 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.<sup>3</sup>

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*,<sup>4</sup> 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.<sup>5</sup> 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.”<sup>6</sup> Several court rulings in

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<sup>1</sup> *U.S. v. Sullivan*, 6 AFTR 6753 (1927).

<sup>2</sup> <http://legcounsel.house.gov/Comps/91-513.pdf>

<sup>3</sup> [https://en.wikipedia.org/wiki/Comprehensive\\_Drug\\_Abuse\\_Prevention\\_and\\_Control\\_Act\\_of\\_1970](https://en.wikipedia.org/wiki/Comprehensive_Drug_Abuse_Prevention_and_Control_Act_of_1970)

<sup>4</sup> *Jeffrey Edmondson*, TC Memo 1981-623.

<sup>5</sup> <https://www.lexisnexis.com/legalnewsroom/tax-law/b/taxreformandpolicy/archive/2014/02/03/medical-marijuana-business-expenses.aspx?Redirected=true>

<sup>6</sup> [http://www.sjsu.edu/people/annette.nellen/website/Tax\\_Ethics\\_Marijuana\\_2016.pdf](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.<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

## 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.<sup>10</sup>

## 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.

<sup>7</sup> *Champ v. Comm.*, 128 T.C. 14 (2007), *Olive v. Comm.*, 139 T.C. 19 (2012), *Beck*, TC Memo, 2015-149, 8/10/2015.

<sup>8</sup> Cal. R&T § 17201.

<sup>9</sup> Cal. R&T § 17282 and § 24436.1.

<sup>10</sup> [http://ag.ca.gov/cms\\_attachments/press/pdfs/n1601\\_medicalmarijuanaguidelines.pdf](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?<sup>1</sup>

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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<sup>1</sup> 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/JTTP\\_CCH\\_June2015\\_Nellen\\_DigitalEconomy.pdf](http://stage.sjsu.edu/people/annette.nellen/JTTP_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.<sup>1</sup> 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.<sup>2</sup> 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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<sup>1</sup> Treas. Reg. § 1.167(g)-1.

<sup>2</sup> 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.<sup>3</sup>

## **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.

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<sup>3</sup> San Mateo County Ordinance Code, § 5.150.

[https://www.municode.com/library/ca/san\\_mateo\\_county/codes/code\\_of\\_ordinances?nodeId=TIT5BURE\\_CH5.150BULITAOPVEREBU](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.<sup>1</sup> 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.”<sup>2</sup> 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

<sup>1</sup> <http://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx>

<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup>

### **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.<sup>5</sup> 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

<sup>3</sup> AICPA. (2016, Jan. 8). An Issue Brief on State Marijuana Laws and the CPA Profession.

<http://www.aicpa.org/Advocacy/State/Pages/StateMarijuanaLaws.aspx>

<sup>4</sup> 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>

<sup>5</sup> 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.<sup>1</sup> *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).<sup>2</sup> 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.

<sup>1</sup> The Rideshare Guy: A Blog and Podcast for Rideshare Drivers. 23 Jun. 2016. <http://www.therideshareguy.com>

<sup>2</sup> 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.

## Tax Maven

### The Contemporary Tax Journal's Interview of Dr. Susan Martin

By: Shilpa Balnadu, *MST Student*

Dr. Susan Martin, interim President of San Jose State University for 2015/2016, is a renowned figure in the academic world. An academic by profession, she has had an eclectic career, from serving as the auditor general and the commissioner of revenue to holding school administration roles, including such provost and president. Exuding confidence and enthusiasm, she met with Professor Nellen and me at her office in Tower Hall at San Jose State University to provide us a first hand record of her journey from tax professional to university president and the challenges she faced. Very few people carry an aura that has a lasting impact on others. Dr. Martin is one of those few. Learning of her stalwart character, determination to succeed, and tenacity to meet challenges was inspiring.

The following captures our conversation with Dr. Martin.

**1) [CTJ] How did you get involved in the tax field? Was that your plan when you started college?**

**[Martin]** When I was in college, women, including myself, were inclined toward an education degree because back then women predominantly ended up as teachers. As I was part of the Debate and Forensics Club in high school, my natural choice was to major in public speaking. For family reasons, I began my post-college career as secretary in the Department of Microbiology at the University of Texas, Austin. During my tenure, I worked closely with scientists who had grants and found myself handling their degree grants, paperwork and accounts. This spurred me to get an accounting degree. The fact that I was bullied for being the only woman in the class strengthened my resolve to be at the top of the class. Thereafter, while pursuing an MBA, I interned with Ernst and Ernst preparing tax returns. This was my first brush with taxation and I thoroughly enjoyed it.

**2) [CTJ] When did you decide to take the CPA exam?**

**[Martin]** I took the CPA exam while working on my MBA at Michigan State University. A little known fact about me is that I used to race Porsches. I was the first woman president of the Michigan Motorstadt Porsche Club. Since most of the men in the club worked for the office of the Auditor General, they convinced me to apply, and I did. On my interview day, the Auditor General met with me and remarked that it was about time the state has a woman auditor, thus making me the first woman auditor in the office. While very few auditors were CPAs, the AG himself was, and this motivated me to become a CPA. The fact that a woman passed the exam created quite a stir!

**3) [CTJ] What led you into state government work and the position of Michigan Commissioner of Revenue?**

**[Martin]** A few years after the birth of my first child, I resigned from the AG's office and went back to pursue my PhD at Michigan State University. As students, we had the option of working

as graduate assistants. So in my first year I was assigned to assist the governmental and non-profit accounting professor who also happened to be the Deputy Treasurer for Local government for the State of Michigan. When she was resigning from the post, she called and asked me if I was interested in applying for her position at the Treasury's office. Not being one to shy away from an opportunity, I interviewed with the State Treasurer and was called in to start as the Deputy Treasurer the following week. At first, the entire situation appeared daunting—carrying the responsibilities of the Deputy Treasurer and pursuing the PhD program full-time, all with an infant at home. But I followed my instincts and grabbed the opportunity. Although the initial timeline indicated to me was 18 months, it extended to three years, but the exposure and experience were worthwhile.

Later, while working on my dissertation and also applying for professor positions, I received a call from the State Treasurer asking if I was interested in serving as the Commissioner of Revenue. In an era when such roles were demarcated for men based on seniority, the idea seemed incongruent, but I couldn't resist saying yes. So to cut a long story short, I became the Commissioner because I became the graduate assistant to the Deputy Treasurer (laughs.)

**4) [CTJ] *Interestingly Sheryl Sandberg notes in her book Lean In that while men tend to apply for a job if they meet just 60 percent of the position requirements, women generally don't apply unless they meet 100 percent of the requirements.***

[Martin] Exactly! This is why I always tell students not to hold back and risk missing a life altering opportunity just because they think they can't. Take my own example, I hardly knew anything about supervising, let alone administering property taxes or local government accounting and audit. Ultimately, the learning from the experience was immense and enriching.

**5) [CTJ] *How did you not only go back to teaching, but then work your way up to university president?***

[Martin] After the birth of my second child, I decided to go back to teaching, which was what I had eventually planned to do. You see, although I enjoyed public speaking and was a dynamic and animated orator, gallivanting the country and making public appearances with an infant was unheard of in my time. However, shortly after settling at Grand Valley State, I got called into being the coordinator of the Master of Science in Taxation Program. I later became Director of International Business Programs. Not only did this give me a lot of management experience, but also triggered the events that led to my eventual move to the provost's office and then to university president.

Interestingly, along the way I was passed over for a dean position, so I thought my administrator stint had come to an end. But then, the president of the university, along with the assistant provost and the vice president of financial affairs announced their retirements. What followed was the second interesting call of my career from the then associate provost, who was aware of my accounting background. He asked if I would consider the post of Assistant Provost while he was filling in as the Interim Provost, and for the second time, I thought why not?! Once again I was performing double duty as professor and as assistant provost. My 18 years at Grand Valley State culminated with the position of Executive Associate Vice President of Academic Affairs.

From that position, I went to University of Michigan–Dearborn, to serve as Provost and Vice-Chancellor of Academic Affairs for two years. When Eastern University Michigan called me to consider the position of president, the university was facing plummeting enrollments and was in a challenging condition. The university had lost two presidents in five years and was looking for

someone who could restore the university's declining fame. Although the task seemed insurmountable, my 18 years of experience at Grand Valley gave me the confidence to meet the challenge and work to bring about a turnaround. I was mainly drawn by the student diversity. My belief in the institution and its employees and students was confirmed as we soon witnessed an increase in enrollments and several new ventures and initiatives. It turned out to be a very meaningful experience in my life. After serving for seven years, I decided to go back to teaching. During my last week at Eastern, I got a call from Chancellor White of the California State University system asking me to serve as interim president at San Jose State. In what turned out to be the third time in my career, I thought why not! I owe it to my husband for pushing me to explore beyond known territories (he came with me to teach in SJSU's Economics Department).

When I came to San Jose State, I was struck and drawn by the similarities between EMU and SJSU—different people but similar attitudes. Although SJSU has a character of its own, at some level, these universities share similar traits.

And the city itself is rich with learning. The kind of networking opportunities available, and the vibe of the people are invigorating. An interesting thing that is unique to Silicon Valley is the wide use of the expression “seek failure fast—the faster you fail, the more you succeed.” Sounds counterintuitive, but if you believe that, then why not take up something that is beyond your reach. This way even if you fail, you succeed. So yes, Silicon Valley has taught me a lot!

**6) [CTJ] *How do you think your accounting and tax background helps you in your role as university president?***

**[Martin]** Tax not so much as accounting. Accounting knowledge significantly helped me at times when the universities were facing financial challenges. It is unusual for business professors to be president, and so unless you have the support of your colleagues, becoming one is a rarity. In my case, however, when I became president at EMU, the university and the state of Michigan were in dire financial condition. Despite that, during the 2009 crash, we promoted a 0-0-0 percent increase in room, board and tuition, while most of the other universities did at least a 7 percent tuition increase. The idea was to ameliorate students' financial distress and showcase empathy. This transformed the reputation of the school. Unfortunately, the following year, the state of Michigan cut our funding by 15 percent putting further pressure on our already depleting resources. I wouldn't have been able to cope with it if I wasn't a 'numbers lady.' As I work on budgets every day, those skills helped me grapple with the situation. I could negotiate and work with the figures more objectively and confidently. While the state was facing massive layoffs, I continued to secure investments for restructuring, the science building, faculties and facilities. So yes, I practically apply accounting every day!

**7) [CTJ] *So were these investments through fundraising?***

**[Martin]** In schools as old as SJSU and EMU, you have a wide donor pool and potential for large fundraising. To think that SJSU has 400 alumni currently serving as CFOs in the Silicon Valley and so many more holding prestigious positions, is nothing short of an asset for the university. When you reach out to them it is not about seeking money, but giving them an opportunity to reconnect with their alma mater. For most it rekindles fond memories and adds meaning to their lives to return the gratitude either financially or through imparting learned skills.

**8) [CTJ] *What stands out as two of your most significant accomplishments in your career?***

**[Martin]** Well, being the first woman president of EMU and holding the office for seven years in

the face of imminent crisis definitely is a high point of my career. Using all my experience and knowledge to bring the campus together and accomplish what we did is gratifying.

The other big accomplishment is my family! Three children, who have all completed college, my six grandchildren and my husband who I love dearly, are my pride.

**9) [CTJ] Do you think changes in taxation since the 1990's affect the challenges graduate tax students face? If yes, how?**

[Martin] As a teacher and student of tax, I have observed that earlier, the emphasis was on getting the numbers right through manual calculations; if they did not tally up, a student would be at loss. Now the workplace need has gone beyond that. Students are encouraged to be professional in their coursework and articulate how a particular law works, its origin, a policy's purpose and its components. Clarity, articulation and professional communication skills are the key in today's tax world.

**10) [CTJ] What qualities do you believe make for a successful student and professional in the tax field?**

[Martin] Integrity- that is, be true to yourself and your values, have your beliefs in perspective and do not waiver from them and be willing to walk away from mediocrity. You need to know who you are and be confident about yourself.

The second critical trait that makes for a successful student is to be articulate. This cannot be emphasized enough. One key to this is a willingness to listen. When I meet people to discuss their issues, I make it a point to put my cell phone away. This way I am committing my full attention and conveying compassion and interest.

**Fun Questions:**

**11) [CTJ] If you could have dinner with anyone, who would it be?**

[Martin] Amelia Earhart. What she did during her time is very inspirational and I would definitely have liked to have known her.

**12) [CTJ] What is the most unusual item in your office or something in your office that has special meaning to you?**

[Martin] I would first like to show some non-traditional memorabilia that are of great emotional significance. (Shows us the game day ball presented by the EMU football team after their victory over Central Michigan in October 2011 and a picture of her rappelling the side of a campus building.) Now these two are connected, and I'll explain why. EMU students invited me to attempt rappelling from a 60- foot building. What I had agreed to do was what ROTC cadets do! A 60-year-old being suspended by a rope in mid-air and using body strength to keep balance is not a usual sight, so naturally, the event received media coverage. Although a perilous maneuver, I went for it nonetheless. Once I lunged off the ledge of the building, the descent was smooth and quite exhilarating. Coming back to the connection now, EMU and Central were rival football teams and EMU was witnessing a rough game season that year. To motivate the team, I asked the coach to show the video of me rappelling to reignite the team's faith and show the team that if I could do this, so could they. And motivate it did! The team ended up winning against Central and as gratitude, presented me the actual game ball, which is all battered and is hardly given away to anyone, but the whole incident and correlation of events was emotional and memorable.

Coming to the more traditional paraphernalia, one is this (shows us two certificates of appreciation

from the IRS), when in 1998, I was appointed to the Electronic Tax Administration Advisory Committee which had the unthinkable task of achieving e-filing for 80 percent of returns. The other is the token of appreciation for serving on the IRS Commissioner's Advisory Council for two years.



*Shilpa Balnadu, MST Student and Dr. Susan Martin, April 6, 2016, in Dr. Martin's office at SJSU.*