JAN/FEB 2017

Today's CPA

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Tax Season Affects All CPAs

By Kathryn W. Kapka, CPA | 2016-2017 TSCPA Chairman and **Jodi Ann Ray, CCE, IOM** | TSCPA Executive Director/CEO

All TSCPA members are affected by federal taxation, whether as taxpayers or advisors to businesses and individuals. This time of year begins tax season for many. The Society is constantly working to provide you with the information and resources that you need.

The Tax Topics column by **Jason Freeman**, JD, CPA-Dallas, provides valuable insights into a wide range of related matters. In this issue, he discusses possible tax reform for businesses and individuals that might be enacted as a result of the presidential election. His recent columns have covered employment tax enforcement, taxation of virtual currency and state taxation of Internet access. You can access them at tscpa.org.

There is a wealth of tax-related information on the TSCPA website. In the Public Practice Center, log in as a member and select Tax Issues for information on the latest federal and state taxation legislation, rulings and regulation. There is a compendium of the Federal Tax Policy Committee's activity, as well as their blog. You can access the archive for the monthly tax e-newsletter. (Email pwyatt@tscpa.net to be added to the distribution list.) The IRS telephone directory for Texas offices is available there.

In addition, there is a link to dive into the vast pool of online information from the American Institute of CPAs Tax Section. Among the many issues it is addressing, AICPA has identified several priorities that it would like to see addressed in potential tax reform proposals. These include repeal of the Alternative Minimum Tax, harmonization of education-related tax provisions and consolidation, and reform of the multiple retirement savings provisions in the tax code.

If you read TSCPA's weekly *Viewpoint* member e-newsletter recently, you learned that **Carol Warley**, CPA-Houston, testified on behalf of TSCPA's Federal Tax Policy and Business Valuations, Forensic and Litigation Services committees at an IRS public hearing in Washington, D.C. The topic was proposed regulations under IRC Section 2704 concerning the valuation of interests in corporations, LLCs and partnerships for estate, gift and generation-skipping transfer tax purposes.

Through *Viewpoint*, you can pick up on developing news from the Internal Revenue Service (IRS). For instance, through the Security Summit initiative, the IRS, state tax agencies and industry partners made plans for 2017 to improve identity theft protections for individual and business taxpayers. New or expanded features include:

- New data elements transmitted by the tax industry with every tax return have been updated and expanded.
- The Form W-2 Verification Code initiative started by the IRS last year will expand to 50 million forms in 2017 from 2 million in 2016.
- The tax industry will share with the IRS and states 32 data elements from business tax returns.

As part of the effort, the Summit partners will launch a new Identity Theft Tax Refund Fraud Information Sharing and Analysis Center, or ISAC.

Viewpoint also reported on a scheme identified as part of the IRS Security Summit process wherein several tax professionals received emails pretending to be from tax software companies. The email scheme requested the recipient to download and install what was said to be an important software update, via a link included in the email. The article included IRS recommendations for businesses to safeguard taxpayer data.

TSCPA provides tax and other information for the public at its ValueYourMoney.org website. The Consumer Tax Talk section has FAQs, articles and resources for individuals. Just some of the topics are: deductions, dependent care tax credit, educational expenses, tax breaks for the disabled and e-filing.

As stated in the November/December issue of *Today's CPA* where the TSCPA legislative session agenda was outlined, we will monitor proposed bills to learn about any efforts to impose a sales tax on professional services. Please read the Capitol Interest article in this issue, and visit the Governmental Affairs section of the website, to stay current on all of the legislative developments affecting you.

Looking ahead, we are preparing for the Business and Industry *Today's CPA* issue in March/April. Excitement is building for the announcement of TSCPA's first B&I Award recipient during April. Stay tuned!

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YOU'VE GOT THE DESIRE. NOW GET THE DESIGNATION.

Tax Reform Under a Trump Administration

By Jason B. Freeman, JD, CPA | Column Editor

The election of Donald J. Trump – an outcome that defied most conventional polling models – literally changed the prospect for major tax reform overnight. With a Republican-led congressional coalition at his back, President-elect Trump is likely to make good on many of his campaign promises when it comes to changing the tax code. The reform to come could be sweeping; it could rewrite longstanding tax norms and usher in a new era of tax law, the likes of which we have not seen since Reagan's 1986 tax reform.

Republican-led tax reform is likely to come from several sources, including Trump's tax plan and the House Republican tax reform plan, commonly referred to as the House Republican or GOP blueprint – an effort headed up by House Ways & Means Committee Chair Kevin Brady and introduced in June of 2016. The two are not entirely parallel and both face criticism from deficit hawks, so reconciling them may provide an early glimpse into how the art of the deal will work in a Trump presidency. But they are largely moving in the same direction and any tax reform in the coming year is likely to involve a few sure-fire themes: across-the-board rate cuts, a move to simplify the tax code and faith in supply-side economics.

Trump has pledged to place a temporary moratorium on the development of federal regulations currently in the pipeline; this move will slow many of the 250-plus regulatory projects in the works at Treasury. Some, of course, will not survive – and those may include a few high-profile regulations. The controversial proposed regulations under section 2704, for instance, may very well be put on the shelf for the next four years. Likewise, we could even see the controversial earnings-stripping rules under section 385 go by the wayside. Most current projects, however, are not particularly controversial or political, and we will likely see many of the current regulatory projects ultimately completed.

For those wondering what to expect in the way of tax reform from a Trump administration bolstered by a Republican-controlled Congress, what follows is a brief summary of the high points for many of the features that we can potentially expect to see.

Personal Tax Reform

Tax reform is likely to result in lower individual tax rates. Both the Trump plan and the GOP blueprint would consolidate the seven current tax brackets into three and drop the top rate to 33 percent. His plan would retain the current capital gains rate structure, providing a maximum rate of 20 percent on such income and would nix the 3.8 percent net investment income tax (NIIT). The blueprint, on the other hand, would tax capital gains and dividends as ordinary income, but would provide a 50 percent exclusion of such income, effectively creating three tax brackets of 6, 12.5 and 16.5 percent. It would likewise get rid of the NIIT.

Trump's plan would more than double the standard deduction (for instance, it would increase from $12,600 for married filing jointly taxpayers to $30,000), but would eliminate the $4,050 personal exemption for each person in the taxpaying household. It would also eliminate the head-of-household filing status. The proposed increase to the standard deduction would dramatically reduce the number of taxpayers who itemize deductions, greatly simplifying the process of preparing returns for many. However, eliminating the personal exemption (even with the increased standard deduction) could mean that, without other offsets, some families of five or more may actually see a tax increase.

Trump's plan would cap itemized deductions at $100,000 for single taxpayers; $200,000 for joint. The House blueprint, on the other hand, would eliminate all but two itemized deductions: the mortgage interest deduction and the charitable contribution deduction. We may ultimately see some combination of these proposals.

The Trump plan would also add a child care deduction available for up to four children and elderly dependents. The deduction would be capped at the average cost of care in the taxpayer's state and would not be available to taxpayers earning more than $250,000 ($500,000 for joint filers). His plan also proposes to expand relief through the Earned Income Tax Credit for low income taxpayers. The GOP blueprint is not quite as liberal and would provide a child care tax credit of $1,500 per child that would be phased out for married households with income from $110,000 to $150,000.

Both Trump and the GOP blueprint also favor eliminating several taxes. Both would repeal the individual Alternative Minimum Tax. Both also call for eliminating the estate, gift and generation-skipping transfer taxes. In their place, Trump proposes a tax on capital gains on assets held until death, with an exemption of $10 million for married couples ($5 million for single taxpayers).

Business Tax Reform

Current proposals pose even more sweeping changes for corporate and business taxes. The United States currently has one of the highest corporate tax rates in the world. Many have argued that this, combined with our worldwide system of taxation, puts U.S. companies at a competitive disadvantage in a global economy and incentivizes inversions, as well as efforts to move profits to offshore subsidiaries in order to take advantage of deferral opportunities. Republican plans take aim at these concerns.

For starters, current proposals would significantly lower the corporate tax rate – from 35 percent to either 15 percent (under Trump's plan) or 20 percent (under the blueprint). A more competitive corporate tax rate would decrease the incentive for U.S. companies to invert; it would also decrease the incentive to move profits to low-tax offshore jurisdictions.

Current proposals also seek to incentivize U.S. companies to repatriate their foreign earnings. According to estimates from the Joint Committee on Taxation, U.S. companies have stashed some $2.6 trillion offshore. Under current law, bringing those funds back to the United States triggers costly taxes. Trump, for his part, is proposing a deemed repatriation of all corporate profits held offshore in foreign subsidiaries; that deemed repatriation would impose a one-time tax at a rate of 10 percent on such earnings sitting in cash (a lower rate may apply to other foreign earnings). The House blueprint contains a similar proposal with slightly lower rates.

President-elect Trump is also calling for an end to deferral on foreign-source income. Initially, under his plan, U.S. companies would be taxed immediately on their worldwide income. After some revisions, however, his plan appeared to drop this anti-deferral provision, making it unclear whether he may be backing off of this position or favoring a territorial income tax system that would only tax U.S.-source income. The House blueprint, on the other hand, favors a novel destination-based territorial tax system that would provide taxing jurisdiction based on the location where goods or services are consumed rather than the location where they are produced. In effect, it calls for a shift towards a consumption-based tax approach that would tax imports, but would not tax exports. For that reason, it could potentially run afoul of World Trade Organization (WTO) restrictions.

Trump's plan provides a separate regime for pass-through business entities. Under his plan, income from pass-through businesses (e.g., partnerships and S corporations) would be subject to tax at a 15 percent rate, in line with the proposed rate for corporations. The House blueprint would tax such income at a top rate of 25 percent. These proposals, in their current form, would likely increase the incentive for wage earners to restructure to provide their services as independent contractors.

Trump's plan also takes aim at the controversial taxation of carried interest – sort of. Under his plan, returns from investment funds that are paid to investment managers as "carried interest" would be taxed as ordinary income, rather than capital gains (as it is currently treated). However, it is not clear how this proposal would mesh with the lower tax rate his plan proposes for partnership income. Most funds that would be affected by the change are organized as partnerships, and if the "carried interest" were ultimately treated as partnership income, it would actually be subject to a lower rate than the capital gains rate. This is an area where plan details will have to be clarified in the months ahead.

Finally, both the House blueprint and Trump's plan would repeal the corporate alternative minimum tax, as well as most tax expenditures or credits for businesses other than the research and development credit. Under the House plan, businesses would be able to currently expense investments in tangible and intangible property, except for land. But they would only be able to deduct interest expenses to the extent of interest income. Under Trump's plan, firms engaged in manufacturing in the United States would be able to elect to expense capital expenditures, although they would give up the ability to deduct interest expenses. The House blueprint also addresses net operating losses, which it would limit to 90 percent of the net taxable amount for the year and allow to be carried forward indefinitely, though not back.

The Months Ahead

Tax reform is a virtual certainty in the near future. The changes to come show signs that they will be sweeping – a mixture of Trumpian ideas and a House Republican think-tank that has been itching for major reform for years. As the new administration moves quickly to implement its initiatives during its first 100 days, look for reform that challenges some longstanding tax norms and rethinks, on the corporate and business side at least, the fundamental rules of our current system. ■

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Measuring Success

By Mano Mahadeva, CPA, MBA | Column Editor

Investors periodically look at key measures to assess a company's sustainability and value. In other words, they look for a yearly increase in top-line growth and greater efficiency as the company grows. Top-line growth has two components – same store or organic growth (i.e., the core business showing steady growth) and inorganic growth, which is a robust pipeline of new products, services or acquisitions. Greater efficiency has two components – capital efficiency and operational efficiency – i.e., improving leverage as we spend money on capital items and hire capable people. To keep investors engaged and enthused, we need a level of discipline and skill necessary to continuously gather and measure relevant business data to share our success.

Measurement of relevant data plays a vital role in setting strategy, organizational objectives and manager compensation. But we won't know if we are succeeding unless we define what these data measures are and track them. So many questions abound. What needs to be measured? When should they be measured? How should they be measured? Ambiguous answers to these types of questions or ignorance typically result in mismanagement by business leaders.

Example 1 – A company had a dashboard of measures, about a page long, begun and agreed to by a group of leaders many years ago. Over the years, some of them left the organization and new leaders added more measures to the already existing list. The font sizes became smaller as more measures were crammed onto the same page. As new products and services were added to the company, more measures were added to the existing list, so now the one page that had small fonts became two pages with small fonts. Soon, the organization lost focus across all areas as division heads were overwhelmed with tracking and analyzing too many measures.

Example 2 – The head pharmacist of each pharmacy across a network was incented to keep inventory low at the last day of each month. So the pharmacists bought an estimated amount of inventory on the first day of each month and ran it low to near zero at month end. This resulted in some lost sales due to no availability of product. The sellers of products wanted to see periodic sales across the month versus a one-time sale each month. So the company shifted to an economic order quantity model with appropriate incentives for the buyers, across each month, which satisfied all constituencies.

From these examples, it is important to understand why everyone within the organization needs to understand the adopted measures (definitions and relevance) and the behaviors they create. In the first scenario, it was clear that there were too many measures and that there was no regular review of how they were relevant to present performance. As a result of chasing all measures, the organization lost its focus on the overall mission.

In the second scenario, the department heads understood the measure, but their focus was not aligned with that of the company. Also, the definition of the measure was not well thought out and improperly aligned incentive compensation of the department heads and that of the company's goal of low inventory.

Measures are important in that they highlight what is important for success. They provide a medium to communicate objectives, activities and performance within the company. They provide a way to monitor and reward performance by aligning strategic objectives with that of personnel incentives. They also create constructive feedback in a timely manner.

Measures need to be simple and easy to understand. Everyone needs to understand how these fit within the big picture. We need to have a few of them, versus too many, so that we remain focused. The definitions of each must be unambiguous, consistent and operationally grounded. We need to confirm that the data used in calculations are not mislabeled in any way. Results need to be timely and accessible by those who use them. And the assumptions underlying actions need to be constantly questioned to make certain that the measurements used are still valid.

Do not measure for measurement's sake. And don't do so without looking for evidence that they are relevant and that they work. Better information and better decision making can help uncover new opportunities and create a competitive advantage. It is important that the entire company has bought in, as it helps to create a culture of celebration and success.

Mano Mahadeva, CPA is CFO with Solis Health in Addison, Texas. He serves on the Editorial Board for TSCPA. Mahadeva can be reached at mmahadeva@solishealth.com.

Auditing in the 21st Century: Is There a Robot in Your Future?

By C. William (Bill) Thomas, CPA, Ph.D.

No doubt we live in an electronic age. Devices like smart phones, self-driving cars, drones and the "Internet of things" – wherein just about everything is interconnected – surround us. So what does this portend for the future of auditing? Will auditors be replaced by robots? Is human auditor an endangered species? Read on for some speculative thoughts.

Can R2D2 Do That?

The use of information technology (IT) in auditing is not a new thing. Auditors have been using the computer as an audit tool to perform repetitive and mechanical processes for many years. Such tasks as footing, sorting, calculation of sample sizes and selection, and comparisons of data across different data files are common.

In recent years, however, IT has evolved to the point that it can actually be programmed to learn and make complex decisions. Software now exists that can execute tasks that would previously have required both a human and a computer. This software is called Robotic Process Automation (RPA). RPA tools do not infiltrate the IT system, but rather sit at the presentation layer, following instructions to perform highly standardized and repeatable administrative activities like accounts payable transaction processing or order entry. For those of us who remember, RPA works like a player piano, doing effectively what a human is trained to do, within well-defined parameters.

Beyond RPA, another higher-order class of software is being developed called Cognitive Technology, which is designed to interact, reason and learn in a way that is similar to humans. For example, IBM's Watson, a supercomputer in the cognitive class, has demonstrated the ability to "think" (to discern a probabilistic answer from a question posed in the form of a pun, riddle or metaphor). Watson has demonstrated that it can parse a complex question, recognize its true meaning, analyze volumes of data, form a correct hypothesis and solve the problem as fast as a human can.

RPA and cognitive technologies are now being converged to develop a process called Cognitive Automation, or "smart robotics," that can potentially automate new classes of knowledge work. Thus, robots are becoming "smarter and more intuitive" and more useful in a wide range of business and government applications. For example, data mining is being used in law enforcement to extract knowledge from a vast array of sources to determine crime patterns, target profiles and assess threats. Is it much of a stretch to speculate that a similar technology might be used in auditing to extract knowledge from "big data" files (financial as well as nonfinancial), determine patterns and target financial statement accounts that possess high risk of misstatement? As an extension, isn't it also conceivable that technology might be used to assess internal controls, assign risk factors to various management assertions, and design and implement a substantive test audit of an entire database, without the use of sampling?

In recent years, large firms have made extensive use of offshoring and outsourcing menial audit work to processing centers in developing countries. There were obvious advantages of this kind of activity, because of the low cost per hour and the fact that these centers were halfway around the world, so they could work while auditors here slept, and the completed work would be available the next morning. Cognitive automation is largely replacing this kind of audit-related activity. When you think of the number of tasks on a typical audit that involve rather menial work, it is not much of a stretch to conceive of a way to leverage technology to create effective and efficient solutions for these types of tasks.

> "SOFTWARE NOW EXISTS THAT CAN EXECUTE TASKS THAT WOULD PREVIOUSLY HAVE REQUIRED BOTH A HUMAN AND A COMPUTER."

What Can't R2D2 Do?

So will all auditors eventually be replaced by robots? Most experts don't think so. The human brain is an amazing organ, possessing the capability to make judgments and, moreover, to express emotions. The judgment process involves recognition of issues, consideration of alternatives, researching authoritative literature, choosing among alternatives and communicating choices among decision makers. Although some of these steps can be automated, there will always be some audit-related activities for which there is no substitute for the human touch. Imagine sitting down to a cup of coffee with a robot, discussing your business strategy, taking the robot on a plant tour, having the robot meet with the audit committee to discuss important business problems and brainstorming potential fraud issues. Most experts feel that the use of IT on the audit can only elevate humans to new heights of critical thinking, not replace them. ■

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East Texas Still in Swing with Scholarship Fundraiser

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

The East Texas Chapter recently celebrated its 20th annual premier scholarship fundraising event. Now named the Tal Glenn Memorial Golf Tournament, it is a great tribute to a beloved chapter president, community leader and TSCPA committee chair. From its beginning, Glenn was passionate about the tournament and its work helping accounting students. His spirit lives on and infuses the participants with a great feeling of purpose.

The story began in 1996 with the formation of an educational fund, a 501(c)(3) organization whose primary purpose is to provide educational scholarships to worthy accounting students from east Texas or those attending universities in the area. Having the fund in place has played a role in obtaining tournament sponsors and memorial donors who might be able to deduct their contributions.

There are two volunteers who have been involved throughout the 20 years, past presidents **Amy Proctor** and **Mike Thomas**, along with Executive Director **Ann Tague**. All agree that the most effective way to get commitments is making personal contact. A representative of Title Sponsor Edward Jones, **Chris Hazelip**, has given his time and called upon his network of business relationships to help expand on the work being done by members. Thomas says: "The growth in sponsorships has been what moved our fundraising to a higher level. It's hard for members to make the personal contacts needed to get commitments, but that's what it takes." **Carmen Carpenter**, with Citizens National Bank of Texas, has also worked with the chapter in helping promote the event.

2015 saw the beginning of Intuit's contribution as Lunch Sponsor. A new development is the addition of nonplaying sponsorships. To grow participation in that category, the chapter matches up to $2,500 in donations for honorees or memorials.

The chapter has a committee dedicated to the success of the event. For the 2016 event, it was chaired by **Royce Read**, CPA, of Henry & Peters, who served with co-chairs **Tom Seale**, CPA, Citizens National Bank, and **Chris Hazelip**. A group of volunteers was involved in tasks such as fundraising, securing gift bag items, assisting with registration and putting out sponsor signs. Executive Director **Ann Tague** made site arrangements and coordinated the extensive details.

To serve the members, the tournament has been held throughout the east Texas area. Coming full circle, the 20th event was played at the same location as the first, Willow Brook Country Club in Tyler. Its exclusivity adds to the appeal of participating in the tournament for the opportunity to play there. Every advantage helps the chapter compete with the many other area tournaments vying for players from the business community.

Over the years, a great feeling of camaraderie among participants has developed. Proctor enthuses: "We have many teams that are

"THERE'S ALSO A GREAT MIX OF PEOPLE ON THE TEAMS. WE HAVE CPAS, FINANCIAL ADVISORS, BANKERS AND TRUST OFFICERS, ACCOUNTING PROFESSORS, ESTATE-PLANNING ATTORNEYS, ACCOUNTING SOFTWARE VENDORS AND CLIENTS."

the same four players together each year. We're so blessed to have that kind of support!" She adds: "There's also a great mix of people on the teams. We have CPAs, financial advisors, bankers and trust officers, accounting professors, estate-planning attorneys, accounting software vendors and clients." Expanding the chapter's reach into the community, there was a team from the Tyler Young Professionals Network.

Letters of gratitude from scholarship recipients help remind the volunteers of the importance of what they are doing. A past beneficiary spoke at the recent tournament and told about how important it was to have the financial assistance while she worked her way through school.

Starting with two scholarships totaling $1,000 given from the money raised the first year, more than 150 scholarships for more than $200,000 have been bestowed so far. Those who have gone on to become CPAs – and those who will be doing so in the future – have benefitted from the chapter's hard work. And the positive effect they are having in the business world is immeasurable. Thanks to a dedicated group in east Texas, the future is bright indeed. ■

Inbound Tax Planning: What Your Clients Need To Know Before Immigrating

Part 1 – Income Tax Planning

By John R. Strohmeyer, J.D., LL.M.

The digital economy makes it easy for people and money to move across international borders. If the United States is not involved, then generally a nonresident of the United States will have few, if any, interactions with the Internal Revenue Service (IRS). However, as more foreign citizens look to the United States as a place to invest, advisers need to be aware of the tax laws that apply to nonresidents. [1] Why? When a nonresident becomes a "resident" of the United States for tax purposes, the rules change dramatically, and if not anticipated, the consequences can be severe.

Any person who is considering spending more time in the United States should be aware of the two tax systems that affect individuals: the federal income tax and the federal "wealth transfer" taxes – the estate tax, the gift tax and the generation-skipping transfer tax. Addressing either of these tax systems would be enough to fill volumes, so this article will be divided into two parts, and this Part I will only address the income tax aspects of the immigration process. Part II of this article will address the wealth transfer taxes.

Because of the complexity involved in planning for any one of these taxes, both articles only provide a cursory introduction to the concepts involved in immigration tax planning. And beyond the rules outlined in both parts of this article, the United States is a party to over 50 bilateral income tax treaties and several bilateral estate and gift tax treaties, each of which creates a unique taxing regime between the two countries. For these reasons, many concepts have been abbreviated or left out entirely to provide a brief overview.

Decades ago, Congress implemented a worldwide taxation system, meaning that U.S. citizens and residents are subject to U.S. income tax on their worldwide income. This is dramatically different than most countries, which use a territorial system to impose income tax only on the income generated within that country's own borders. To offset potential double taxation, the United States allows taxpayers to use worldwide expenses to reduce worldwide income, and grants a foreign tax credit for foreign income taxes paid on income generated outside of the United States.

Because of the differences between the U.S. worldwide tax system and the territorial taxation system, nonresidents must know how and when they will be treated as residents for U.S. tax purposes. For income tax purposes, non-citizens are divided into two groups: residents and nonresidents. An income tax resident is a person who satisfies one of two tests: the legal permanent resident test and the substantial presence test.

continued on next page

The legal permanent resident test (also known as the "green card test") is satisfied if a person is a lawful permanent resident of the United States (because they have been granted a "green card," and with it, the right to legally reside in the United States) at any point during the tax year.[2]

The substantial presence test, although more complicated, is satisfied if a person is present in the United States for at least 31 days during the calendar year, and for 183 or more total days during the current year and the previous two years (with only a fraction of each day from the prior two tax years being counted). A person who can demonstrate a closer connection to another country may qualify for an exemption to the substantial presence test.[3]

Both tests produce a clear result based on bright-line rules. Once determined to be a resident under either test, residents must file income tax returns to report and pay tax on their worldwide income. Additionally, residents must comply with foreign asset reporting requirements (e.g., the FBAR, Form 5471 and Form 8938).

But if not determined to be a resident, then nonresidents are only subject to income tax on income derived from sources within the United States. And instead of a single set of tax rules applicable to all income, the income derived by a nonresident breaks down into four broad categories of taxation.

Effectively Connected Income (ECI) – Nonresidents are generally taxed in the same manner on effectively connected income as citizens and residents: only the net income (i.e., applicable deductions are allowed) is taxed at graduated rates. The determination of whether income is effectively connected with a U.S. trade or business is a two-prong test. Under the first prong, the taxpayer must be engaged in a U.S. trade or business, while under the second prong, any income must be effectively connected with that U.S. trade or business.

It is possible for a nonresident to have both effectively connected income and non-effectively connected income in the same year. If the nonresident has both, the filing of a return will almost always be required. If the nonresident only had non-effectively connected income and income tax is withheld at the source, no return would likely need to be filed.

A nonresident's income from the conduct of a U.S. trade or business includes income from the performance of personal services within the United States at any time during the tax year. However, if the services are performed for a foreign employer, the aggregate compensation does not exceed $3,000, and the nonresident is present in the United States for 90 days or less during the tax year, the nonresident will not be treated as being engaged in a U.S. trade or business.[4]

A foreign person who trades in stocks, securities or commodities in the United States is not treated as conducting a U.S. trade or business (and is not subject to U.S. income tax on his/her "effectively connected income" from the securities or commodities trading) if the foreign person does not have an office in the United States through which, or under the direction of which, the securities transactions are affected.[5] Safe harbor rules enable a foreign individual to avoid being treated as conducting a U.S. trade or business even if he/she or it has an office in the United States that otherwise would cause that income to be effectively connected income if the transactions are for the taxpayer's own account.[6]

Fixed, Determinable, Annual or Periodical Income (FDAP Income) – FDAP Income is generally passive income realized by nonresidents earned from U.S. sources that is not "effectively connected" with a U.S. trade or business (e.g., dividends, interest, rent and royalties). FDAP Income is taxed at a flat 30 percent rate. A significant drawback to being taxed at a flat rate is that a taxpayer is taxed on the gross amount received, and is not allowed deductions for the expenses of producing such income. The flat 30 percent tax is also imposed on original issue discount on certain debt obligations,[7] net gains from the sale of capital assets of taxpayers who have been present in the United States for 183 days or more during the taxable year[8] and 85 percent of any Social Security benefits.[9]

Sales of U.S. Real Property and the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA Income) – Nonresidents may elect to treat their real property gains as effectively connected income. Before the enactment of the FIRPTA in 1980, a foreign person could invest in U.S. real property without being subject to U.S. income tax on the later sale or disposition of that U.S. real property, providing a great advantage to foreign investors. FIRPTA treats a foreign individual's gain and loss from the disposition of a U.S. real property interest as income or loss effectively connected with a U.S. trade or business. Additionally, while income from real property (e.g., rent and royalties) would be treated as FDAP income (and subject to 30 percent tax), nonresidents may elect to treat that income as effectively connected income so that it is taxed on a net basis at graduated rates.

Generally, the purchaser of a foreign person's real property must withhold 15 percent of the purchase price (not the gain on the sale), and remit that amount to the IRS.[10] The withholding rate is 10 percent if the purchase price is less than $1,000,000 and the property is acquired for use as a residence.[11] This withholding may not be the actual amount of tax due on the disposition, and is only an advance payment toward the final income tax due. So, the foreign investor will need to file the appropriate income tax return (e.g., Form 1040NR and Form 1120F) to report the sale. Any tax withheld on the sale will be credited against the amount of tax due on the return.[12]

There are several exceptions to this withholding. For example, if the purchaser acquires the property to use as a residence and the amount realized does not exceed $300,000, then no withholding is required.[13] Additionally, no withholding is required if the seller provides the purchaser with an affidavit stating, under penalty of perjury, the seller's United States taxpayer identification number and that the seller is not a foreign person.[14]

Income Not Subject to Income Tax – A few types of income, such as interest generated by assets held in a bank account, escape income tax entirely. For example, a foreign taxpayer is not subject to U.S. tax on U.S. source capital gain not effectively connected with a U.S. trade or business. Interest on bank deposits with U.S. banks paid to nonresidents or foreign corporations is not taxed in the United States if the interest is not effectively connected with the foreign person's U.S. trade or business.[15]

Conclusion: Many Traps for the Unwary

Even this brief introduction to the U.S. income tax shows the varied rules, exceptions, requirements and exemptions that apply to both U.S. residents and nonresidents. These rules are complicated and present many traps for the unwary. But the increased amount of investment in the U.S. by foreign citizens looking for a safe haven for their investments presents opportunities for these tax traps to be sprung. The tax planning needed to avoid these tax traps will take on a greater importance in the coming years as it becomes easier to transfer money and property into the United States.

In Part II, concepts involved in planning for the wealth transfer taxes are addressed because that planning is an integral part of the planning process when a person considers immigrating to the United States.

Footnotes

1. See Jesse Drucker, *The World's Favorite New Tax Haven Is the United States* (available at http://www.bloomberg.com/news/articles/2016-01-27/the-world-s-favorite-new-tax-haven-is-the-united-states).
2. Code § 7701(b)(1)(A)(i).
3. Code § 7701(b)(1)(A)(ii), (b)(3). An individual may also elect under Code § 7701(b)(4) to be treated as a resident alien in the year before satisfying the substantial presence test.
4. Code § 861(a)(3).
5. Code § 864(b)(2).
6. Code §§ 864(b)(2)(A)(ii), (B)(ii).
7. Code § 871(a)(1)(C). Original issue discount accrues over the life of the debt instrument under rules in Code § 1273. Nonresidents are taxed on accrued OID when payments are made on the instrument or when an OID obligation is sold or exchanged.
8. Code § 871(a)(2). Note that in most cases, a person who is present in the United States for more than 183 days during a taxable year is treated as a resident for U.S. federal income tax purposes and would be subject to tax at graduated rates on his/her worldwide income. Thus, the scope of the rule under Code § 871(a)(2) is narrow. But certain persons, including students and foreign government officials, may avoid U.S. resident status even if present in the United States for more than 183 days in a year and can be subject to the Code § 871(a)(2) regime.
9. Code § 871(a)(3).
10. Code § 1445(a); Treas. Reg. § 1.1445-1(c)(1).
11. Code § 1445(c)(4), Treas. Reg. § 1.1445-1(b).
12. Treas. Reg. § 1.1445-1(f)(1).
13. Code § 1445(b)(5).
14. Code § 1445(b)(2).
15. Code §§ 871(i)(2)(A), 881(d).

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Base Erosion and Profit Shifting: Opportunities and Obstacles for Multinationals

By Greg Bostick, MT, and C. William (Bill) Thomas, CPA, Ph.D.

Base erosion and profit shifting (BEPS) has become a prominent issue in the world of international taxation over the last three years. The terms "base erosion and profit shifting" are used to describe the practice of shifting assets and reported profits of multinational corporations (multinationals) to jurisdictions outside the United States that have low tax rates, thus eroding the U.S. tax base and causing the U.S. government to forego large amounts of tax revenue.

BEPS did not become a prominent public issue until after the worldwide financial crisis of 2008 and the subsequent Eurozone debt crisis. The explosion of enormous budget deficits in many powerful countries such as the United Kingdom, Spain, France, Japan and the United States has raised concerns about worsening BEPS. Members of the Organization for Economic Co-operation and Development (OECD) and G20 have pushed for these countries to work on a plan to combat the issue. The members of the OECD and G20 already agreed to require constituent multinationals with €750 million ($850 million in the United States) or more in annual revenues to report income and taxes paid on a country-by-country basis beginning Jan. 1, 2017 and to automatically exchange these reports to other member countries starting in 2018 to help disseminate information regarding how and where countries shift profits.

Widespread support from the public for halting or slowing down BEPS has largely come through the media, with attacks against aggressive tax planning on the part of multinational corporations, accusing them of not paying their "fair share" of taxes in their home countries. However, a major point that may have been overlooked by the general public is that most multinationals that are engaged in BEPS do so quite legally. Tax planners for these companies have found loopholes in tax treaties that permit BEPS. This is precisely the reason that affected countries and the OECD are proposing action to curtail or limit BEPS as much as possible. This article will discuss why companies pursue BEPS, how they accomplish it and why home countries are concerned with it. In addition, the article will briefly describe OECD recommendations to member countries to limit the practice.

Why Companies Pursue BEPS

BEPS allows a company to lower its worldwide tax obligations and, as a result, maximize after-tax income and cash flow. To illustrate BEPS, the United States has a maximum marginal tax rate for corporations of 35 percent while Ireland's and Bermuda's corporate tax rates are 12.5 percent and 0 percent respectively. For a simple example, assume a U.S.-headquartered company has $1 million of income taxed at the maximum marginal rate. If the income is attributed to activities in the United States, the company will have a tax obligation of $350,000 and $650,000 remaining after satisfying that obligation. On the other hand, if the income is attributed to activities in Ireland, the company will have a tax obligation of $125,000, resulting in $875,000 of after-tax income and cash flow. The company retains 35 percent more income and pays 64 percent less tax if the income is attributed to Ireland than if it is attributed to the United States. If the income is attributed to activities in Bermuda, the same company would pay $0 in tax and retain the entire amount of pre-tax income and cash.

Common Ways BEPS is Accomplished

The most common ways that BEPS is accomplished are:

- Loans from branches located in low tax jurisdictions to branches located in high tax jurisdictions;
- Exploiting the mismatching treatments of hybrid instruments and entities;
- Transfers of income-generating intangible and tangible assets to business segments or divisions located in low tax jurisdictions; and
- Avoiding withholding taxes via derivative contracts and inversions.

A main reason multinationals are able to accomplish BEPS is that many countries' and jurisdictions' tax systems are created essentially in a vacuum, without regard to consideration of how other tax systems work. Multiple entities across multiple companies in multiple countries are often not aligned with each other and do not communicate with each other, creating vast differences in the way income might be taxed in one country versus another. For example, one country might create a tax system with largely domestic entities in mind and then depend on certain economic incentives such as foreign tax credits for taxes paid by corporations in other countries.

Loans

Controlling the jurisdiction in which the income is assigned is commonly accomplished by creating a branch in a low income tax

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jurisdiction and then allocating income to that jurisdiction. This often occurs when a company is headquartered in a country that has been granted an exemption for foreign branches through domestic law or treaties. The branch in the low tax jurisdiction loans money to the headquarters located in a high tax jurisdiction. The interest associated with the repayment of the loan is treated as deductible by the headquarters. Simultaneously, the interest becomes taxable income for the branch, but at a much lower marginal rate. The payment allows the company to lower its tax obligation by lowering taxable income in the high tax jurisdiction via the interest deduction and increasing taxable income (interest) to the lower tax jurisdiction.

Mismatching Treatments of Entities and Financial Instruments

Various countries treat certain entities differently from each other for tax purposes. BEPS can be accomplished when one country views an entity as taxable and another country views it as a "flow-through" entity. For example, suppose a branch located in Country 1 is classified as a taxable entity in that country and as a flow-through in Country 2 where the parent company is located. The branch receives a loan from its parent company. The difference in classification of the branch in Country 1 vs. Country 2 allows the group as a whole to claim a deduction for interest paid by the branch in Country 1 on a payment that is not taxed to the parent in Country 2 due to the flow-through status of the branch in that country.

In addition, differences may exist between countries in the way they treat financial instruments for tax purposes. For example, suppose Multinational 1 sells a financial instrument to Multinational 2. In Multinational 1's tax jurisdiction, the instrument is treated as equity, while in Multinational 2's jurisdiction, it is treated as debt. Therefore, a payment from Multinational 2 to Multinational 1 is treated as a debt payment and the interest expense deducted in Multinational 2's tax jurisdiction while being treated as a receipt of dividend by Multinational 1 in its jurisdiction where dividends are largely tax exempt. As a result, neither company is subject to tax on the distribution, resulting in "double non-taxation" of the distributed profits.

Movement of Income-Generating Assets

Multinational companies may accomplish BEPS by moving income-generating intangible and tangible assets from a high tax jurisdiction to a branch in a low tax jurisdiction. The branch in the low tax jurisdiction then licenses certain intellectual and intangible property to the other branches in high tax jurisdictions. The profits from the license agreements are taxed in the low tax jurisdiction, and the license fee expenses are deducted in the higher tax jurisdictions reducing taxable income. A branch in a low tax jurisdiction can also provide services using tangible assets to other branches and re-allocate profits to the more favorable (low) tax jurisdiction. These services and intellectual property are often difficult to value, therefore making it difficult for taxing authorities to dispute the transfer pricing of the service of intellectual property. Many multinationals price these services high to allocate more income to the lower tax jurisdiction and then value intellectual property low to avoid recognizing income from the transfer in the high tax jurisdiction.

Avoidance of Withholding Tax

Some multinationals also employ strategies to avoid withholding tax requirements. Withholding tax is a tax levied on the income of a nonresident or foreign-headquartered entity. Interest and dividend income is often subject to withholding tax, so many companies use the fees associated with derivative contracts rather than loans to shift profits between branches. Instead of loaning money between branches, derivatives are sold between branches with fees attached to the contract. The branch buying the derivative is typically in the higher tax jurisdiction and able to deduct the fees while the other branch in the lower tax jurisdiction recognizes the fees as income.

Other multinationals perform an inversion to try to avoid controlled foreign corporation (CFC) withholding requirements. An inversion occurs when a company engages in a transaction in which a parent company of the organization located in a higher tax jurisdiction with CFC withholding requirements is replaced by another company in a lower tax jurisdiction without CFC withholding requirements. In an inversion, a foreign company (lower tax jurisdiction) buys assets or equity ownership of another company (higher tax jurisdiction). The assets of the company are then owned by the foreign company with a lower marginal tax structure. The shareholders benefit by trading their stock in a company located in a high tax jurisdiction for stock in a company located in a lower tax jurisdiction. In essence, the legal location of the company changes through a corporate inversion from the United States to another country without changing the operational structure or functional location of a company.

The United States government recently took action to curb companies from performing inversions. The U.S. issued updates to treasury regulations for Internal Revenue Code (IRC) sections 385 and 7874. The regulation for section 385 limits the benefits of inversions by reducing the amount of debt the U.S. subsidiary can issue to the foreign parent. Previously, following an inversion, a newly acquired U.S. company could issue debt as a dividend distribution and then the parent company could transfer the debt to a low tax jurisdiction. This series of transactions allows the former U.S.-headquartered company to receive the benefits described above in the loans section. The newly issued regulation treats these distributions now as stock in order to limit the benefits a company gains from inversions and stop companies from receiving the benefits associated with loans to related parties in low tax jurisdictions.

The regulation for section 7874 limits a foreign-headquartered company's use of funds from a stock issuance connected with the previous acquisition of a U.S. company in a transaction that will be treated as an inversion under current tax law. To accomplish this, the regulation excludes stock of the foreign company that can be attributed to the assets of an American company acquired within three years prior to the signing date of the latest acquisition when calculating the foreign parent's ownership percentage to determine whether an acquisition is treated as an inversion.

Why the OECD is Concerned with BEPS

The OECD has stated it believes BEPS poses "serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and nonmembers alike." OECD member countries assert that the avoidance of tax revenues should be limited and that multinationals in their countries should pay their "fair share" of tax. Economic studies surrounding BEPS show that preventing BEPS will not substantially raise tax revenues as a percentage of total tax collected. The semi-elasticity of the profits being shifted has been estimated to be at most 13 percent and as low as 4 percent for every 10 percent drop in tax rate. The average member country of the OECD in 2011 raised 8.8 percent of its total revenues from taxes on corporate profits. Even 13 percent of that 8.8 percent would only be equivalent to 1.14 percent of total revenues. However, the absolute monetary number shows why a country such as the United States would be concerned about BEPS. A 1.14 percent increase in tax revenue is estimated to amount to over $26 billion.

The OECD provides a recommended approach for countries to address possible differing funding structures by multinationals. It recommends that countries use a fixed ratio rule. The rule will limit an entity's net deductions for interest and for other payments equivalent to interest to a specific percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA). The OECD believes this rule should apply to at least the entities in multinational groups. Understanding that not every country is in the same situation, the OECD recommends ratios that range between 10 percent and 30 percent. The organization believes this range will ensure that countries apply a ratio that is low enough to combat BEPS while allowing countries to apply a percentage they feel is fair for the businesses in their countries.

Because the fixed ratio rule does not take into account the fact that groups in different industries may require differing amounts of leverage, the OECD also proposes a group ratio rule. An entity with net interest expense exceeding a country's fixed ratio percentage would potentially be allowed to deduct interest up to the percentage of the net interest to EBITDA ratio of its worldwide group under the group ratio rule. The OECD also recommends countries allow up to a 10 percent increase to the ratio of the group's net third party interest expense when double taxation would occur without the increase.

The OECD also addresses the situation in which a capital-rich branch provides funding for other branches and the headquarters of the multinational corporation but performs few other activities. If this capital-rich branch does not control the financial risks associated with the loans and provides cash without considering the risks, then the profits from interest will not fully be allocated to the capital-rich branch and will instead be allocated to both branches, with the capital-rich branch only recognizing profits at an amount not exceeding the expected return of a risk-free investment (ex., the return for U.S. Treasury Bills) and possibly less if the transaction is not commercially rational. A transaction is not commercially rational if it is overly risky compared to a company's historical transactions.

Examples include the following. Branch A in Country 1, the debtor branch, has an EBITDA of $1 million. Branch B in Country 2, the creditor branch, loans Branch A in Country 1 $10 million at 7 percent interest. Country 1 currently employs a fixed ratio rule of 20 percent. Branch A may only deduct up to $200,000 of the $700,000 of interest it owes to Branch B from its taxable income.

Under the group ratio, the allowed interest deduction varies based on the overall consolidated group net interest to EBITDA

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ratio. Assume the same facts as the previous example, except that Country 1 employs the group ratio rule. Branches A and B belong to Consolidated Group X, which currently has a net interest to EBITDA ratio of 0.6 or 60 percent. Under these facts, Country 1 would allow Branch A to deduct $600,000 of the $700,000 of interest it owes to Branch B from its taxable income. The extra 10 percentage rule would apply if Branch A had borrowed from a third party outside of the country instead of from Branch B. Under this rule, the ratio would be 70 percent (60 percent plus 10 percent), which would allow Branch A to deduct all $700,000 it owes in interest to that third party.

To illustrate the capital-rich provision, assume that Branch B is a capital-rich branch that loans Branch A money at the behest of their parent company without assessing or documenting the risks associated with the determination of the amount and interest percentage of the loan. In this scenario, Branch A can only deduct the interest up to the amount of the expected return of a risk-free investment, in this case a U.S. Treasury Bill with a 3 percent return. This means Company A can only deduct up to $300,000 of the $700,000 of interest it owes to Branch B. However, if the business of Branch A is overly risky and no party would reasonably loan money to it, Country 1 can rule that only an amount less than 3 percent such as 0.5 percent can be deducted. This ruling would limit Branch A's deduction to $50,000.

Mismatching Treatments of Entities and Financial Instruments

The OECD has not provided specific guidance regarding mismatching entities, but rather takes the position that entities should be viewed on a case-by-case basis. In this regard, the OECD proposes to include a new provision with detailed explanations in the OECD Model Tax Convention to ensure that benefits of tax treaties are granted in appropriate cases, but also that such benefits are not granted in cases in which neither country treats the income of an entity as the income of one of its residents.

To combat the use of mismatching financial instruments, the OECD recommends linking rules that align the tax treatment of an instrument with the tax treatment in the counterparty jurisdiction but otherwise do not tamper with the commercial outcomes of the instrument. These rules automatically apply by default, and the OECD provides an order for rules to be considered starting with a primary rule and then a secondary or defensive rule. The primary rule will first be applied in a situation of mismatching instruments. However, if the primary rule is not employed, then the counterparty jurisdiction will apply a secondary or defensive rule to effectively garner the same results. The rules cannot be used simultaneously. This prevents more than one country from applying the rule simultaneously and avoids double taxation.

The recommended primary rule provides that countries deny a taxpayer's deduction for a payment up to the amount it is also deductible in another country or up to the amount the payment fails to be included in the recipient's taxable income in the counterparty jurisdiction. When the primary rule is not applied, the counterparty jurisdiction can generally apply a secondary or defensive rule. Depending on the nature of the mismatch, the secondary or defensive rule will require the deductible payment to be included in income or deny the duplicate deduction.

To illustrate the primary rule, assume that a specific instrument is viewed as a debt instrument in Country 1 and an equity instrument in Country 2 where approximately 70 percent of earnings from equity instruments are deducted or exempted from taxable income. Branch B in Country 2 makes a payment associated with a particular financial instrument to Branch A in Country 1 of $1 million. Under the current rules, Branch A's payment of $1 million to Branch B would be fully deductible by Branch A as an interest payment while Branch B would only be taxed on $300,000 since the payment would be classified as a dividend. Under the primary rule, Branch A would only be able to deduct up to the amount Branch B is forced to recognize as income for tax purposes. That means Branch A can only deduct $300,000 of the payment while Branch B would still be taxed on $300,000. The rule ensures that the company does not gain the benefit of deducting the additional $700,000 of the payment while not being forced to pay taxes on that amount.

Movement of Income-Generating Assets

The OECD makes clear that for intangible assets, legal ownership alone does not necessarily generate a right to the return that is generated by the use of the intangible asset. The group of companies performing important functions, controlling economically significant risks and contributing assets rather than the company owning the intangible asset will be entitled to an appropriate return from such assets reflecting the value of their contributions.

Also, the OECD recommends a "nexus-approach" to limit BEPS through the movement of income-generating assets. The organization developed this approach to combat the abuse of intellectual property (IP) regimes, which is a special tax regime used by several countries to incentivize research and development by taxing patent revenues differently from other commercial revenues. The approach limits the amount a taxpayer can benefit from an IP regime to the extent that the taxpayer incurred the research and development expenditures that produced the income generated by the use of the IP. The approach tracks expenditures as a measurement for activity. The OECD believes that a "substantial activity" requirement will guarantee that the entities benefiting from IP regimes actually engaged in the R&D activities, and incurred the expenditures associated with the research and development associated with the IP. The "nexus-approach" can also be applied to other income derived from transferred tangible property.

Avoidance of Withholding Tax through Derivatives and Inversions

To prevent BEPS, fee payments associated with derivatives can be treated the same way as loans for tax purposes since they are classified as payments economically equivalent to interest. The payments will then be included in the calculation for the fixed or group ratios.

The OECD lays out six building blocks that will help decrease the incentives for a company to perform an inversion:

(1) The organization begins by defining a Controlled Foreign Company (CFC) as a foreign company that is controlled by shareholders in the parent jurisdiction.

(2) The OECD recommends that CFC rules only apply to controlled foreign companies that have effective tax rates that are meaningfully lower than those applied in the parent jurisdiction.

(3) It recommends that countries define CFC income for which CFC rules apply.

(4) It recommends that countries use the rules and definitions of the parent jurisdiction to compute the CFC income to be attributed to shareholders. The OECD also recommends that CFC losses should only be offset against the profits of the same CFC or other CFCs in the same jurisdiction.

(5) The OECD recommends the amount of attributed income to a jurisdiction should be calculated by reference to the proportionate ownership or influence located within that jurisdiction when possible.

(6) The OECD emphasizes the importance of both preventing and eliminating double taxation, and it recommends, for example, that jurisdictions with CFC rules allow a credit for foreign taxes actually paid, including any tax assessed on intermediate parent companies under a CFC regime. It also recommends that countries consider relief from double taxation on dividends on and gains arising from the disposal of CFC shares where the income of the CFC has previously been subject to taxation under a CFC regime.

These recommendations will help countries implement effective CFC rules resulting in a lower number of developed countries without CFC withholding requirements. Also, if a multinational relocates to countries where it does not have substantial economic activity, the OECD recommendations regarding the movements of assets will limit the amount of income shifted to these countries without substantial economic activity. These recommendations, if implemented, will help decentivize companies to perform inversions to avoid CFC withholding tax, as multinationals will have fewer countries in which to relocate their headquarters to avoid tax.

A Step in the Right Direction

BEPS is clearly an issue that affects the tax revenues of countries across the world. The recommendations of the OECD to curb the acts of BEPS have taken a step in the right direction. Whether these recommendations will be implemented by OECD members into domestic law and/or tax treaties has yet to be determined.

Although many countries such as the United Kingdom and United States have expressed keen interest in implementing these recommendations, implementation will take time. The United States has even already taken actions to limit the opportunities for and benefits of U.S.-headquartered companies performing inversions. However, OECD member countries will surely continue to provide recommendations to combat BEPS in the future as new strategies to exploit loopholes in the international tax environment are employed by multinationals. ■

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Charitable Contributions and Grants Beyond the U.S. Border

By Cory Halliburton

Once upon a time, a U.S. charity received written curriculum materials from a school organization located in a very poor and far away island country. The kind and cute children identified in photographs submitted were clearly engaged in learning; a charitable class and purpose were identified. The colorful stamps affixed on the school's governing documents appeared authentic, and the school's leaders' correspondence and pleas for financial help were thoughtful and well written.

Indeed, the U.S. charity was extremely excited and anxious to execute this long-awaited program to advance education and charity on a global scale. The intended grant was substantial, and thus the U.S. charity ultimately, albeit reluctantly, decided to engage a consultant to travel to and perform a site-inspection of the school. Upon return, the consultant provided photographs of the "school" – an abandoned shack with no desks, no windows, no chairs, no blackboard, no students, no curriculum and no teachers. Nothing. The solicitation was a sham.

The U.S. charity was perilously close to contributing hundreds of thousands of dollars for the exclusive benefit of a foreign scam artist. The due diligence put forth by the U.S. charity was commendable and avoided potential violation of a multitude of tax regulations. Moreover, the U.S. charity and all involved learned many valuable lessons through the process.

Now more than ever, individuals, private foundations and public charities have a strong desire to advance charitable missions globally. However, there are specific and sometimes complex tax regulations and real-life challenges that should give pause to those eager to cross borders with intended charitable contributions or assets dedicated exclusively for charitable purposes.

This article provides information about how individuals and domestic charities (public charities and private foundations) may engage in and enjoy tax benefits (or protections) associated with giving beyond the U.S. border.

Charitable Contribution

First, it is helpful to review the definition of a "charitable contribution" because the concept ebbs and flows throughout many situations of giving beyond the U.S. border.

For purposes of allowance of a charitable deduction under section 170 of the Internal Revenue Code, "charitable contribution" means contribution or gift to or for the use of – a corporation, trust or community chest, fund or foundation:

(A) organized in the United States or in any possession thereof, or under the law of the United States, any state, the District of Columbia or any possession of the United States;
(B) organized and operated exclusively for charitable purposes;
(C) no part of the net earnings of which inures to the benefit of any private individual; and
(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation or participating in elections for public office.[1]

Individual Donations

As defined, a "charitable contribution" does not include a gift made to a corporation, trust etc. organized in or under the laws of a foreign government or country not specified in section 170(c)(2)(A) of the code. Thus, and except in limited situations, individuals are not permitted to claim a charitable contribution deduction for donations made to foreign organizations, even if the organization is recognized as charitable under applicable foreign law.

There are, however, a few ways in which individuals may satisfy their urge to impact the world beyond the U.S. border and still obtain charitable contribution tax benefits.

For example, individuals may donate to a qualified U.S. charity that engages in charitable works beyond the U.S. border or that, as part of its overall charitable program, makes and has the human capital and financial wherewithal to administer charitable grants to foreign organizations. Also, an individual may donate to a foreign subsidiary of a U.S. charity – sometimes referred to as "friends of" organizations – provided that the U.S. charity in fact controls and oversees the foreign entity's administrative and other activities.

These opportunities are indirect means for an individual to touch the world on a global scale and still reap charitable contribution tax benefits. Moreover, the risk associated with the foreign contribution is likely reduced, and the likelihood that the contribution will benefit a charitable class or purpose is likely increased.

However, if a contribution has been earmarked for a foreign recipient, then the analysis goes beyond the immediate domestic recipient to determine whether the payment constitutes a deductible contribution.[2] For example, the domestic recipient cannot exist solely to funnel contributions to a foreign organization. Under section 170 of the code, no charitable contribution exists where the domestic organization serves solely as a nominal donee. Indeed, "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."[4]

Rather, the domestic charity must engage in sufficient charitable operations within the United States in order to qualify as a domestic charity to which charitable contributions may be made. Also, the contribution cannot be earmarked for submission to a specific foreign organization, and void of discretion and oversight of the receiving U.S. charity. The domestic U.S. charity must have and maintain control and oversight responsibility over the funds intended for or granted to the foreign organization.[5]

Essentially, the individual's contribution must be a gift to a qualified domestic charity; that is, a transfer of an asset with donative intent, disinterested generosity and with no return goods or services. If the domestic recipient exists for no other legitimate reason except to serve as a conduit for a foreign recipient, such services will essentially destroy the donative intent necessary to qualify a charitable contribution under section 170 of the code. The U.S. charity should have discretion and control over whether and how much of the individual's contribution may be delivered across the U.S. border, to whom it may be delivered, and how it may and must be monitored for advancement of qualified charitable purposes.

Private Foundations[6]

For private foundations, foreign grant-making entails the concept of taxable expenditures. Section 4945 of the code imposes an excise tax on a private foundation's "taxable expenditures," and the applicable tax may be assessed against the foundation, with an additional tax assessed against the foundation's managers who knowingly permit a taxable expenditure.[7] Thus, most private foundations (and their managers) usually try dearly to avoid taxable expenditures.

Briefly, a taxable expenditure includes "any amount paid or incurred" by a private foundation (1) for any purpose that is not a valid charitable purpose described in section 170(c)(2)(B) of the code (noted above), or (2) as a grant to an organization, unless (i) the grant is made to certain types of U.S. charities (or to a foreign equivalent of a U.S. public charity); or (ii) the foundation exercises expenditure responsibility according to subsection 4945(h) of the code.[8]

Thus, private foundations that desire to engage in grants beyond the U.S. border must engage in pre-grant efforts to qualify the foreign grant recipient, must exercise expenditure responsibility, or may execute a blend of both previous options without violating the requirements of either.

What is a 'Grant?'

First, the private foundation should determine whether the amount paid or incurred is a "grant." In this context, "grants" include amounts spent by a recipient organization to carry out a charitable activity; scholarships, fellowships, internships, prizes and awards; loans for charitable purposes described in section 170(c)(2)(B) of the code (noted above); and program-related investments.[9] Conversely, grants do not include compensation to the foundation's employees or payments to others for personal services in assisting the foundation in developing projects of foreign program activities.[10]

continued on next page

If the foundation determines that the amount to be paid to a foreign organization will constitute a grant, the foundation must decide whether it will exercise expenditure responsibility over the grant or will properly qualify the foreign organization as the equivalent of a public U.S. charity.

Expenditure Responsibility

The requirements of expenditure responsibility are too detailed to adequately describe in this article. However, the requirements may be summarized as follows:

(1) the granting foundation must screen the intended grantee before assets are contributed;
(2) the granting foundation and the recipient foreign organization must execute a grant agreement that describes, among other things, the charitable activity to be accomplished;
(3) the granting foundation must require and receive progress reports regarding the activities advanced by the grant; and
(4) the foreign grantee must provide (and make available upon request) financial books and records evidencing how the funds were spent.[11]

Pre-grant screening should include identity, past experience, management, activities and practices of the foreign organization.[12] The scope of the inquiry may vary from case to case depending upon the size and purpose of the grant, the period over which the grant is to be paid and the prior experience that the grantor had with respect to the capacity of the grantee to use the grant for the proper purposes.[13]

To meet the expenditure responsibility requirements, the grant must be made under a written grant agreement that prescribes the charitable purposes for the grant. The foreign organization must agree to repay any amount that is not used for the purposes of the grant, and to affirm that the grant will not be used to influence legislation, the outcome of any specific public election or any voter registration drive. The foreign organization must also agree to maintain records of receipts and expenditures, and to make its books and records available to the grantor foundation.[14]

Any diversion of grant funds for a use not specified in the grant agreement may result in that part of the grant being treated as a taxable expenditure to the grantor foundation. If a grantor foundation determines that any part of the grant has been used for improper purposes (and the grantee has not previously diverted grant funds) the foundation will not be treated as having made a taxable expenditure if the grantor: (1) exerts reasonable efforts to recover amounts not used according to the agreement; and (2) withholds further payments to the grantee, after being made aware that a diversion of funds may have occurred, until assurances are given that future diversions will not occur due to additional and extraordinary precautions engaged by the foreign recipient.[15]

Reports on the Expenditures to the IRS

To satisfy the report-making requirements involved in expenditure responsibility, a grantor foundation must provide the required information on its IRS Form 990-PF annual tax return as long as grantee reporting on that grant is required.[16] The reports must include:

(i) The name and address of the grantee.
(ii) The date and amount of the grant.
(iii) The purpose of the grant.
(iv) The amounts expended (based upon the grantee's most recent report).
(v) Whether the grantee has diverted any portion of the funds.
(vi) The dates of any reports received from the grantee.
(vii) The date and results of any verification of the grantee's reports undertaken by the grantor.[17]

If the grantor foundation fails to comply with the expenditure responsibility requirements, such as by failing to conduct a proper pre-grant inquiry, failing to use a proper grant agreement or failing to report properly to the IRS, the grant will likely constitute a taxable expenditure.

Foreign Equivalency Determination

If the private foundation does not desire to exercise expenditure responsibility, the foundation may seek to qualify the foreign organization as the equivalent of a public U.S. charity, unless the foreign grantee has a determination letter from the IRS. To so qualify a foreign grantee, the private foundation must make or receive a good faith determination that the grantee is the equivalent of an organization described in section 509(a)(1), (2) or (3) of the code, which, generally speaking, includes public charities, churches, educational organizations or any arm of the U.S. or any state political subdivision.

Revenue Procedure 92-94, 1992-1 C.B. 507, as amended by Treasury Decision 9740 (effective Sept. 25, 2015) provides procedures that a domestic foundation must use to determine whether a grant to a foreign organization may be treated as a grant to an organization described in section 509(a)(1), (2) or (3) of the code. The procedures allow a grantor to distinguish a qualifying distribution from a taxable expenditure under section 4945 of the code and they allow a useful path for private foundations to engage in international grant making.

Briefly, the foreign grantee organization will usually provide an affidavit (translated in English) that includes representations about how and why the organization qualifies as the equivalent of a U.S. public charity. The affidavit should be current (as described in T.D. 9740) and include verified copies of governing documents (translated) as well as a schedule of financial information to verify sufficient receipts from the donating public so as to qualify the organization as a public charity. Then, the grantor foundation, through a "qualified tax practitioner," makes a good faith determination on whether the foreign organization is qualified based on the information provided.[18]

Revenue Procedure 92-94 includes the requirements for the affidavit and provides sample language. However, Treasury Decision 9740 makes clear that grantor foundations should not rely solely on the sample affidavit completed by the foreign grantee. Rather, the grantor foundation should dive deeper into governance documents, program materials and other organizational and operational matters relevant to qualifying the foreign organization as the equivalent of a U.S. public charity. Essentially, a grantor foundation (or its qualified tax practitioner) is wise to scrutinize a foreign organization's request for funding in a manner similar to the scrutiny expected of the IRS in regard to its review of a domestic organization's Form 1023 Application for Recognition of Exemption Under Section 501(c)(3) of the code.

Grants to Foreign Governments

No equivalency determination or expenditure responsibility is required for grants to a foreign governmental unit.[19] Nonetheless, the granting foundation should document that the grantee is a unit of foreign government. Also, the grant arrangement must identify and advance a charitable purpose, as opposed to a purely governmental or political purpose. General support grants to foreign governments are not prohibited, but the granting foundation may have a difficult time accounting for the charitable purpose achieved by the grant. If a specific, charitable purpose is identified, the granting foundation may more easily monitor and account for the appropriateness of the grant.

Suspected Terrorists

At the risk of being obtuse, no funds should be granted to individuals or organizations designated as suspected terrorists by the U.S. Department of the Treasury or the U.S. Federal Government's Office of Foreign Assets Control (OFAC). OFAC publishes a list of individuals and companies owned or controlled by, or acting for, targeted countries, and OFAC also lists individuals, groups and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific, whose assets are generally blocked.

Links to these lists may be included in grant agreements, and foreign grantees may affirm that neither the grantee nor any of its officers, control persons, etc. are designated as suspected terrorists on the applicable lists.

Public Charities

The expenditure responsibility rules and foreign equivalency rules do not apply to domestic public charities. However, public charities must ensure that their assets are used exclusively to achieve or advance a charitable purpose. Thus, public charities should refrain from general support grants to foreign organizations unless the foreign organization has been qualified as the equivalent of a U.S. public charity. Without qualifying the foreign grantee, the domestic grantor will have great difficulty identifying the charitable purpose achieved with a general support grant, which could jeopardize the domestic charity's tax exemption.

A better approach is for the domestic public charity to engage in project-specific grants to foreign organizations. This allows the grantor charity the ability to identify a specific, charitable objective to be achieved with the grantor's assets. The grantor will be in a much better position to document and receive reports regarding the specific charitable objective achieved through the grant.

In any event, and especially if the grant is substantial, the domestic public charity should consider entering into a grant agreement with the foreign grantee. The agreement may identify the purpose of the grant, reporting requirements, protocol for disbursement of funds, repercussions for violating the agreement and affirmation that the foreign grantee is not a terrorist organization.

Closing Considerations

The foregoing constitutes some high-level concepts and tax issues to consider when charitable contributions or charitable assets are expected to cross the U.S. border. Domestic organizations may find that initial foreign grant programs are cumbersome and even administratively costly. However, through the development of a focused and compliant foreign grant program, the domestic organization will likely settle well into a manageable budget as well as the applicable tax regulations. By doing so, domestic organizations should be in a position to honor the privilege of tax-exemption and truly affect change on a global scale.

Footnotes

1. *See* 26 U.S.C. § 170(c)(2)-(2)(D).
2. *See* Rev. Rul. 63-252, 1963-2 C.B. 101; Rev. Rul. 54-580, 1954-2 C.B. 97.
3. *See* Rev. Rul. 63-252, 1963-2 C.B. 101.
4. *Id.* quoting *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938)).
5. *See* Rev. Rul. 75-65, 1975-1 C.B. 79.
6. *See* 26 U.S.C. § 170(b)(1)(A)(v), (c)(1) (setting forth defining characteristics of a private foundation).
7. *See* id. at § 4945(a)(1)-(2).
8. *See* id. at § 4945(d)(4), (d)(4)(B), (h)-(h)(3).
9. *See* 26 C.F.R. § 53.4945-4(a)(2).
10. *See id.*
11. *See id.* at § 53.4945-5(b)-(b)(iii).
12. *See id.* at § 53.4945-5(b)(2).
13. *See id.*
14. *See id.* at § 53.4945-5(b)-(b)(3).
15. *See id.* at § 53.4945-5(e)(1).
16. *See id.* at § 53.4945-5(d)(1).
17. *Id.* § 53.4945-5(d)(2)-(2)(vii).
18. A "qualified tax practitioner" includes certified public accountants, enrolled agents, as well as attorneys who are subject to the standards of practice before the IRS set out in Circular 230. *See* T.D. Cir. No. 230 §§ 10.2(a)(1), 10.2(a)(3).
19. *See and compare* 26 U.S.C. § 4945(d)(4) *and* 26 C.F.R. § 53.4945-5(a)(4)(iii) (noting that a grantee organization will be treated as a section 509(a)(1) organization if it is a foreign government, or an instrumentality thereof), *with* 26 U.S.C. § 170(b)(1)(A)(v), (c)(1) *and id.* at § 509(a)-(a)(4) (omitting foreign governments from the list of organizations to which a charitable contribution may be made).

Cory Halliburton is a shareholder attorney with Weycer, Kaplan, Pulaski & Zuber, P.C. He represents a wide array of public charities, private foundations, trade associations and other tax-exempt organizations. In his counselor role, he has been involved in many grants across the U.S. border, including organizations located in Africa, Asia, Australia, Europe, South America and the Middle East.

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2017 Outstanding Accounting Educator Nominations Due March 1

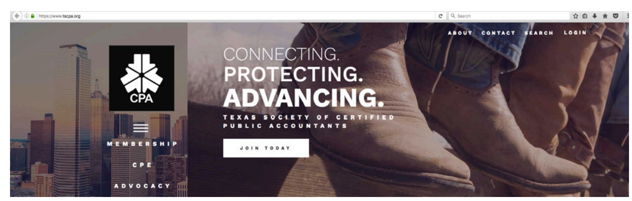
Do you know an accounting educator who deserves recognition? TSCPA is accepting nominations for 2017 Outstanding Accounting Educator Awards. This award recognizes Texas accounting educators who have demonstrated excellence in teaching and have distinguished themselves through active service to the accounting profession.

The award recipients will be honored during TSCPA's annual Accounting Education Conference, and each recipient will receive a $500 award, a recognition plaque and complimentary registration to the Accounting Education Conference. The deadline for nominations is March 1, 2017. For more information and to complete the nomination form, please go to the TSCPA website at https://www.tscpa.org/about-tscpa/awards/outstanding-accounting-educator-award or contact TSCPA's Catherine Raffetto at craffetto@tscpa.net or 800-428-0272, ext. 216 (972-687-8516 in Dallas) for more information.

Accountants Confidential Assistance Network

The Accountants Confidential Assistance Network (ACAN) is a peer assistance program that supports Texas CPAs, CPA candidates and/or accounting students who are addressing alcohol, chemical dependency and/or mental health issues. ACAN provides a confidential phone line at **1-866-766-ACAN** to help people who need assistance. You can also contact TSCPA's Craig Nauta at cnauta@tscpa.net.

To learn more about the program, please go to TSCPA's website at tscpa.org. Under the Resource Center tab, scroll down and click on Accountants Confidential Assistance Network.



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Have you checked out TSCPA's new and improved website? The user-friendly site gives you access to a variety of professional resources and features benefits that are only available to members, so you can access the information you need quickly and easily.

We hope you'll take a minute to click through our cleaner, fresher, mobile-friendly online environment designed especially for you. The website is available at www.tscpa.org. If you have trouble finding something within the new site, please don't hesitate to send us a message at membership@tscpa.net or give member services a call at 800-428-0272.

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Do you have expertise in a certain practice area that would be important to cover in ***Today's CPA*** magazine? The editors are currently seeking articles for consideration in upcoming issues. We are soliciting technical submissions in all areas, including taxation, regulation, auditing, financial planning, ethics and corporate governance, information technology, and other specialized topics.

The magazine features articles and columns that focus on issues, trends and developments affecting CPAs in all facets of business. If you would like to submit an article for consideration or to learn more, please contact managing editor DeLynn Deakins at ddeakins@tscpa.net or technical editor Brinn Serbanic at Brinn_Serbanic@baylor.edu.

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Disciplinary Actions

Membership Suspensions

The following people have had their membership in TSCPA suspended by the Executive Board for non-compliance with TSCPA *Bylaws* Article III, Section (4A)(1) for non-compliance with the Texas State Board of Public Accountancy's continuing professional education requirements.

Suspended for a period of three years –

- **Phillip S. Baker Jr., CPA, Houston**
- **Michael A. Lawanson, CPA, Houston**

As a result of a decision by the Executive Board of the Texas Society of CPAs, the following member had his TSCPA membership:

Suspended –

- **Mahesh K. Thakkar** of Frisco for a period of five years retroactive to April 6, 2016. The suspension is effective Dec. 8, 2016. The action was based on an Offer of Settlement through the Securities and Exchange Commission (SEC), whereby Thakkar was suspended from appearing or practicing before the SEC as an accountant for five years.

Members Expelled

The following people have had their membership in TSCPA expelled by the Executive Board under TSCPA *Bylaws* Article III, Section (4B). This action was a result of the revocation of their CPA certificate by the Texas State Board of Public Accountancy.

- **Fred H. Falls, San Antonio**
- **Bruce E. Koenig, Keller**
- **Robert D. Morris, Rockwall** ■

Remembering the Past, but Looking Ahead …

TSCPA's Long-time Executive Director/CEO John Sharbaugh is Retiring

By DeLynn Deakins, *Today's CPA* Managing Editor

When **John Sharbaugh**, CAE, started in his role as TSCPA's executive director/CEO in 2000, it was the beginning of a new millennium, the Internet was relatively unfamiliar to many people and the CPA exam was still paper and pencil. An association management veteran, he was uniquely qualified to lead the organization in the new century. He had held positions at the Florida Institute of CPAs, the North Carolina Association of CPAs and at AICPA.

Now, 17 years later, he is retiring from TSCPA. He took some time to talk with the *Today's CPA* managing editor about the Society's accomplishments over the years, the issues faced during his tenure, what he'll remember about his career and his future plans.

What are some of TSCPA's biggest accomplishments during your time here?

If you look back, a number of things have taken place. One of the biggest relates to technology. When I came on board, the Internet was really just getting started. Our first website was in development and now we're on our third iteration with the new website redesign we rolled out recently. So technology has had a tremendous effect on TSCPA, as well as everyone in society and all kinds of businesses and organizations.

We were doing things much differently 15 to 20 years ago than we are today. TSCPA and our members are now using technology extensively. The automation of many of our functions has changed pretty dramatically in how we operate from a business standpoint. I think all of that's good, because it allows us to respond more quickly when issues arise.

So the technology has been very positive for us and many others, but at the same time, it's been a challenge, since there's so much material readily available that information overload can become a problem. Members have access to volumes of information. One of the values that associations can provide is to help members cut through the information overload. What's relevant to CPAs and the profession? TSCPA can help CPAs get what they need more quickly. Implementing technology is one of those things where you're never done. We're on our third iteration of our website and of a database. That's just going to continue into the future. We'll be constantly upgrading as technology continues to evolve to stay ahead of the curve to best serve members.

One of the other things we've done during the time period I've been here is to add several new committees. The Professional Standards Committee and Federal Tax Policy Committee did not exist when I walked in the door and today, they're viable committees. They do a lot of good work commenting on proposed accounting standards and to the IRS on proposed regulations. They also communicate with elected officials about tax policy when it's appropriate. We're fortunate to have members who make a commitment to do the necessary work to comment intelligently as proposals and exposure drafts come out. Although the staff helps them, if we didn't have the volunteer base of committee members who are willing to do the reading and writing involved in issuing comments and responses, it would not happen. They're trying to represent the interests of the broader profession. It's been beneficial to our members to have other members who are trying to look out for their interests and provide input into the process. Not all state societies have effective committees like these.

We created a Young and Emerging Professionals Committee a few years back. This committee has been very active in soliciting input from the members of the Society who are younger. We want to make sure that we know the interests of the next generation in terms of what the Society is providing and how we operate. That has also transitioned to having some younger members involved in leadership positions, on the Board of Directors and on the Executive Board. This is helpful as the Society goes into the future, making sure that we're hearing from all the different segments of the membership.

We also developed a Leadership Development Institute (LDI) and I think that's been very valuable too. It's primarily for younger members, though any member can attend. The goal of the LDI is to assist younger members in developing leadership skills they can carry over into their careers. The hope is that they also choose to continue to develop those leadership skills by getting involved in TSCPA. We don't require that, but it's been a definite side benefit of the program. We looked at the statistics and found that the overwhelming majority of members who go through the program end up getting involved in TSCPA at the local level with the chapters or at the state level. The chapters have been very helpful in supporting it and providing candidates to attend. So it's been a win-win for the Society and the chapters.

Another thing I'm proud of is that the Society has made an effort to make sure all members understand that TSCPA is an inclusive organization. That means having members of all types involved. I think that anything we can do to have a broader representation of the different types of people we have in our membership actively engaged and serving in leadership positions, serving on the boards, serving on committees – that can only be a positive for the Society and its members. We're a member organization for all CPAs. We want to make sure we're in touch with all the different types of people we have as members and they see themselves as part of, and actively engaged in, the organization.

Another initiative over the last 15 years is to help the profession and members at large think about where the profession is going and how it needs to change and adapt to remain relevant as a profession for the public and the clients served. Most CPAs are busy day to day running their organizations, whether it's in an accounting firm if they work in public accounting or if they work in industry, they're working for the company that employs them. They don't have a lot of time to think about the profession at large, so that's a role the Society plays, to be a watchdog for the broader profession, take a look at the trends and consider how those trends are going to affect CPAs. Both TSCPA and AICPA have spent time trying to focus on where the profession is going. We've looked at what needs to be considered for the profession to continue to be relevant in the future.

What will you remember about TSCPA?

What I'll remember the most are the people I was able to meet and interact with, such as members, volunteer leaders, TSCPA staff, and colleagues from other state societies and AICPA. One of the benefits of having this type of job is that you get to meet a lot of different people. It's been a very positive experience for me and most of that is because I've gotten to work with many outstanding people.

I also think we have somewhat of a unique atmosphere here in terms of how members view TSCPA, especially the members who are actively involved. We must have one of the most active memberships in the country in that our members are willing to volunteer their time and the pride they take in the Society. It's easy for me to take pride in working for this organization. To also have members who take pride in the organization is somewhat of a unique situation. It's possibly unique to Texas and TSCPA, how our members are willing to contribute, participate and volunteer their time to do what's needed to support the profession and TSCPA. It's amazing to me how much time many of our

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WE MUST HAVE ONE OF THE MOST ACTIVE MEMBERSHIPS IN THE COUNTRY

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members are willing to devote to making this organization better and in turn, make their profession better. CPAs have to be some of the most committed professionals out there in terms of what they're willing to do to support and advance their profession.

What are some of the most memorable moments?

When I think about memorable moments, the professional issues webcasts come to mind. These webcasts make it more convenient for people to take training, since they can participate from their desk or home, wherever they have access to a computer and the Internet. When we first started producing the webcasts, we were using a tiny studio in the back of a tech company in Austin, so it was not a fancy studio by any means. It was just a small area that had all the computers and other equipment used to actually do the broadcasting over the Internet. Basically, the studio included a table and two folding chairs, and they would hang up a black cloth behind us on the wall.

Jim Smith was our chairman when we did the very first professional issues webcasts. I talked to him and said I thought this would be a good way for us to communicate out to members. It was a new technology and classically, Jim was all for it and he was a great chairman especially in terms of his ability to communicate. However, the first couple of years we were doing the webcasts, we felt like we were in a cave somewhere with a black cloth on the wall. The first time I wanted to bring someone else in other than the TSCPA chairman, we did not have room to have three people sitting at the table at the same time, so we had to figure out a way to shuffle people in and out to do the webcast, because the place was so tiny.

Then as we continued to do them, we did upgrade and eventually end up moving and doing them in a real studio here in Dallas. Now, we do them in a studio that our provider, ACPEN, has at their office. In the early days you probably could not tell from watching us on the computer screen, but the visual of what it looked like where we were actually doing these recordings from was not anything fancy.

As for other memorable moments, they were at some of our Board of Directors meetings. Going back to how passionate TSCPA members are, sometimes we would have issues for discussion that would turn into a longer-than-expected period of discussion. Many of our members are not bashful about going to the microphones and providing their input as we would have to deal with issues. But that's democracy in action. It was always a challenge going into a Board of Directors meeting to know exactly how the agenda was going to play out and how much time was going to be needed on any particular issue. Any time I thought I had that figured out, I would usually get surprised. Something I did not think would be controversial would end up becoming controversial.

What are some things you'll look back on in your career?

I really did not know anything about the field of association management until I started working with the Florida Institute of CPAs over 40 years ago. However, I was not in it very long until it really resonated with me. First of all, I began to understand and appreciate what associations are all about. I think associations play a valuable role in our society, not just TSCPA; it's all kinds of associations that represent all different kinds of interests. And I think that's one of the endearing traits of America that we allow people to come together, form common groups and work cooperatively to achieve things. Associations play a very valuable role in contributing to society.

The example here is that the forefathers of TSCPA not only created the Society, they created the CPA profession in Texas. It was that group of people who went to the Legislature, lobbied to get an accountancy law passed and got a State Board of Accountancy created. It did not just happen. They were people who were involved in the profession at that time who said “We need to get organized; we need to make this happen.” So that's one of the real values associations play. We continue to play that role today by speaking out on behalf of the profession and our members to the Legislature, and to represent them with the licensing board, the federal government, Congress and the regulatory agencies.

Also, I did not grow up thinking “I want to be an association executive.” And I think it's like that for many of the people in my field. You don't major in association management in college. Most people find their way into this line of work accidentally. I was just fortunate enough to find my way there early in my career right after getting an MBA and I never looked back.

What advice do you have for the profession as you contemplate what might be in store for it in the future?

My advice for the profession is to continue to do introspection, look out into the future and anticipate where the profession needs to go. I think CPAs must continue to have those kinds of conversations and the Society must help the profession prepare to deal with changes that are coming.

My other advice is to understand that the profession is going to continue to change and evolve. That's difficult for some members. They want things to stay the way they are and view any kind of change as a negative. The reality is that you can't stop change. Most of the time, it's driven by external forces that you don't have complete control over. So whether it's technology, globalization, the changing workforce – with all those kinds of things, you're not going to be able to continue to operate 10 to 20 years from now exactly as you operate today. TSCPA's role is to try to give them the information about how the world is changing and suggestions for how they can adapt to that change. As that takes place, the critical thing is to stay true to the core values and ideals of the profession. It will be challenging. If the profession as a whole can meet the challenge, it will continue to be successful, viable and a needed part of our society.

What are your future plans?

I have no real hard and fast long-term plans. I will be going to Austin to work in our governmental affairs department, taking over for **Bob Owen**,

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TSCPA's managing director of governmental affairs, who is stepping down. So at least during this next legislative session and for the next six to seven months, my focus is going to be on the Legislature, trying to accomplish the legislative agenda we've set out, monitor other things that might happen that could have an effect on our members, try to play defense as needed, and work with our State Board and any other governmental agencies in Austin. So that's the short-term plan that will take me into the summer.

After that, I'm not quite sure what I'll be doing. I know that I will enjoy spending more time with my wife and our new grandson who came into our lives this past year. I know I'm going to enjoy having the opportunity to spend time with my family and do family oriented kinds of things.

What are some things you'll miss about TSCPA and/or the CPA association world?

It goes back to what I said earlier – I'll miss the people. If you don't like people, you probably are not cut out for association management work, since what you're doing on a daily basis is interacting and working with different kinds of people. I find people fascinating, so I'll miss all the members I've gotten to work with, the staff, and other folks in my field with other state societies and AICPA. I was also fortunate enough to be involved with my professional associations, the American Society of Association Executives (ASAE) and the Texas Society of Association Executives. I've met so many great people who have been a great resource to me and have helped me do my job better by understanding the work at large and the world of associations.

In addition, I think I'll miss the intellectual stimulation that my job brings. As the CEO, I deal with a lot of different issues and need to be knowledgeable about them. I find that intellectually stimulating, so guess I'll need to create new problems to deal with in retirement! I'm looking forward to my retirement, but I'll definitely miss this organization and the exceptional people involved with it.

Editor's Note: Sharbaugh will be handing over the reigns to TSCPA's new Executive Director/CEO **Jodi Ann Ray,** CCE, IOM. She is an association and chamber of commerce management veteran. You can read more about her in the cover article of this issue of *Today's CPA* magazine. ■

CAPITOL INTEREST

Master of Advocacy

By John Sharbaugh, CAE | TSCPA Managing Director, Governmental Affairs

As we start another legislative session in Austin, there is one thing that is significantly different for TSCPA. This session, we will not see **Bob Owen**, CPA-Dallas, as our managing director of governmental affairs leading our advocacy efforts on behalf of the Society. Due to a health issue, Bob has had to step down from his duties. So for the first time in nearly 19 years, we will not have Bob around to represent TSCPA members in Austin. For those who know Bob, you understand what a huge hole this creates for our legislative and regulatory efforts.

To be successful in conducting advocacy efforts, you have to be viewed as credible and possessing integrity. The people you are communicating with (legislators, regulators, staff, members, etc.) have to believe that you are being honest and forthright in what you are telling them, and they can depend and act on the information you provide to the process. The first time they think you are not an honest broker, your ability to have influence is over. So the primary currency of advocacy work is your credibility and your reputation.

On these points, there was none better than Bob. He could always be counted on to explain the issue or the concern in an easy-to-understand way. To paraphrase an old TV ad, "When Bob spoke, people listened." This was especially true when it came to issues of controversy or potential controversy. Bob has a way of calming the waters with his ability to cut through the noise and frame a topic or issue. And of course, it helps that people saw him as someone of high integrity, which he is.

Another great trait that Bob possesses is a terrific sense of humor. I think that is another quality that is helpful to being a good advocator or a good leader. Good leaders know how to use humor to help ease the tension of a situation or convey a point in a unique way. It helps humanize them and helps in the communication process. Bob's ability to use humor in speaking and writing is a talent that served him well, and served our members well.

I know our members who got to work with Bob first hand will miss his leadership and talent. As CEO, I got to see it nearly every day. I also got to use his counsel to help me do my job on many fronts, not just advocacy. Bob is a great person to turn to for advice on any issue, again because of his ability to cut through the fog and help zero in on what is important.

This legislative session, I will be taking on the role of advocacy for TSCPA, having ended my run as executive director/CEO. Taking on these advocacy duties wasn't something I planned, but the circumstances of Bob's need to step down created a void to fill. I take on this new role with a fair amount of trepidation in knowing I have very big shoes to fill. But I will also be guided by how Bob carried out this role and I will be continuing to seek his advice as long as I can get it. If I can do half as good a job as Bob, I will be extremely happy. He was certainly the "master of advocacy." ■

John Sharbaugh, CAE is TSCPA's managing director of governmental affairs. Contact him at jsharbaugh@tscpa.net.

Incoming TSCPA Executive Director/CEO Says ‘Our Commitment is Serving our Members’

“The final test of a leader is that he leaves behind him in others the conviction and will to carry on.”

— Walter J. Lippmann

By Anne McDonald Davis

As the Texas Society of CPAs ushers in 2017, longtime Executive Director/CEO **John Sharbaugh**, CAE, retires and incoming Executive Director/CEO **Jodi Ann Ray**, CCE, IOM, looks forward to her role in the Society's continuing success. The two worked together throughout last fall to coordinate a smooth transition. Here's what Ray had to share about her career, family and life experiences, and what she sees ahead.

Q: You most recently were vice president of membership and volunteer experience at Meeting Professionals International (MPI), where you were responsible for governance and community development. Prior to joining MPI, you served as the CEO for chambers of commerce in Connecticut, North Carolina and Texas. How did you choose a career in association and chamber of commerce management?

A: I originally went to school for psychology and had gotten involved with the local Chamber of Commerce, the Greater Valley Chamber of Commerce in Shelton, Connecticut. There I took a job on staff in membership, my first association job. And I've stayed ever since.

Q: So that was a fit for you?

A: I just loved it and decided that's what I was going to do and how I would pursue my career.

Q: From Connecticut to North Carolina to Texas – that's a pretty interesting cross-section of the United States.

A: Well, what's been nice about it is I've gotten to work in three very distinct regions of the country and have really enjoyed experiencing the cultural differences, the different approaches to business. Spending 10 years in North Carolina was actually a great transition from the northeast to Texas.

Q: What are some of those differences?

A: The politics are different. The approach to planning is different. The approach to infrastructure, the pace of life – even social conversation and interaction is different.

Q: Perhaps your early training in psychology came in handy there?

A: *(laughs)* It has been a beneficial background.

Q: Clearly. What other training or experience have you found helpful?

A: I went through a program called Institutes for Organization Management, which was a six-year certification program at the time (it's four years now). I did specific training in the areas where I really needed to focus – advocacy being one of those, economic development another.

Q: As you progressed in your career, what has been most rewarding to you? Did anything make you think twice about what you were doing?

A: *(smiles)* I think everyone has those days, but not really. There has always been a new challenge. What I love about this work is no two days are ever alike, and there are so many different areas I'm engaged in. It's always interesting and compelling.

Q: The dynamics of coordinating a full-time association staff with a large, passionate volunteer base can certainly be a challenge.

A: Absolutely. It's a unique part of association management work, but it's also, I would say, the most rewarding. Not only do we have a fabulous staff team of folks who are experts in their field and have been doing this for a really long time, but the dedication, passion and commitment of the volunteers; this is always what drives me. It's what made me come to TSCPA, when I heard from the search committee just how much this organization meant to them.

Q: The CPAs who have made TSCPA their home feel deeply about their involvement. Why do you think that is?

A: It's been an integral part of their lives for a lot of years. The amount of time that they give to this organization because they love it and want to give back to their profession is really amazing. We have folks who have volunteered for us for almost their entire professional lives.

Q: And many TSCPA volunteers don't just volunteer for TSCPA; they seem to volunteer in other areas – communities, schools, churches.

A: That's right. These are people who volunteer and serve, the kind of people you want to surround yourself with. It's been amazing to me coming to this profession, not having worked in it before, that every single person I've met has said, "Welcome and how can I help you?"

Q: So you're looking forward to getting involved here?

A: Yes. And the opportunity that the board and search committee gave me for this transition is great. How many times do you get to really have some quality time with your predecessor so that we can make sure we have everything covered the way it should be? It's best for the organization going forward and best for our members.

Q: What are the similarities between TSCPA and the organizations where you worked previously?

A: Most everything we do is similar, as are the challenges. How do we continue to provide the services that members need, which changes

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over time? How do we adapt to technology? Associations in general face all the same issues no matter what – the only difference is the specifics of a particular industry. The issues that we will work on legislatively, for example, will be specific to the accounting profession in Texas.

Q: What overall issues do you see facing TSCPA in the next several years?

A: Well, I think the landscape for associations has changed and we need to be changing with it, and looking at what are the new and emerging expectations of our members.

We're looking closely at the demographics of our membership and how that's changing. We have 28,000 members. The member value proposition for all those folks isn't going to be the same. The demographics are different. The areas of practice are different. So we really need to make sure that we're carving out unique value propositions for different types of members.

We also need to look at continuing professional education. That's an important benefit and value that we provide to our members, but how should it look in five or 10 years? And we must continue to find the best ways to share the brain trust among our members, the opportunity for interaction that is so valuable. I'm not sure that the traditional models we've always used for that networking will necessarily be the same going forward.

Q: Well, it's always been a challenge in Texas for members to have in-person, face-to-face interaction, because it's such a big state. People just don't get on a plane as often as they used to.

A: Absolutely. *(laughs)* Except I feel like I'm on a plane a lot.

Q: Back to legislative and governmental affairs, what are the priorities going to be?

A: Well, this should be an interesting year at the federal level for tax reform. The chairman of the House Ways and Means Committee has told us that they hope to have some form of tax reform on the floor by mid-2017. Then at the state level, we are continuing our efforts to oppose any efforts to levy a sales tax on professional services. So far, there are no specific bills that we're aware of, but it's always a threat and something that we monitor closely.

We're also working to repeal the Texas exception to GASB Statement 45; hopefully, we'll be able to get that accomplished this session. And then there are a number of issues that would be better to hold off on until the Texas Public Accountancy Act undergoes sunset review, which is currently planned for 2019.

Q: What other types of activities are you involved in as a professional?

A: I wholeheartedly believe, not only professionally but personally, that you should be involved in industry associations. So I'm involved in ASAE (American Society of Association Executives). I will be involved in TSAE (Texas Society of Association Executives) and also the CPA SEA, which is the group for state society executives, because I think it's important to give back to your profession. You learn so much working with your colleagues that way.

Q: Tell us about your family and other interests. What are your activities when you're not working?

A: So I'm married. We have five children.

Q: Goodness.

A: *(laughs)* So if I'm not working, I'm usually going to a tumbling practice or a band lesson or a sporting event.

Q: What's the age range?

A: It's 10 to 17. So we have a senior this year – that's a whole new experience.

Q: Your husband is a CPA, yes?

A: I think during the search process, during one of the interviews, we had talked about my husband being a CPA and someone said, "Well, bless your heart." *(laughs)*

Q: That can mean one of two things in Texas, but I think they meant the good thing *(laughs)*. What else would you like to make sure we say to members?

A: I want everyone to know I recognize that TSCPA has a long tradition of service to our members and to the profession. Obviously, we're over 100 years old! So moving forward for me, it's most important to carry on that tradition, but also to look towards those opportunities to move us into the future. So first and foremost, our commitment will always be to serving our members and upholding the value of the profession.

Again, what that might look like in the future may change. We want to be able to help our members adapt to those changes so they can be the most successful. I know that our board and our entire team is 100 percent committed to members in everything we do. ■

Anne McDonald Davis, ABC is a freelance reporter, writer and editor based in Dallas, Texas.

The Fair Labor Standards Act's One-Two Punch

By Dustin A. Paschal, J.D.

The Fair Labor Standards Act (FLSA) has dominated legal updates and business alerts recently and likely has been the primary focus of many businesses. In spite of the recently issued nationwide injunction halting the regulatory changes related to overtime exemptions, it is the FLSA's one-two punch that is and always has been the most harmful to an employer if not properly addressed. What is the one-two punch? It is the "independent contractor vs. employee classification conundrum" and the "exempt vs. non-exempt classification challenge."

The one-two punch involves an extremely fact-intensive analysis that employers must conduct on a case-by-case basis for each individual or job position and as such, employers always should conduct that analysis with the assistance of legal counsel. That said, CPAs can and often do play an important role in the process. As employers' auditors, accountants and bookkeepers, CPAs often are the first people able to identify a likely problem and alert the employers about the need to address it. It is important, therefore, that CPAs have a basic understanding of the one-two punch so they can serve this important front-line role.

Independent Contractor vs. Employee

Any business with workers must classify those workers either as employees or independent contractors. The "employee" classification includes numerous responsibilities and requirements that the business must meet. These include the employer portion of federal employment taxes, Texas unemployment insurance taxes, the quarterly Form 941 (the Employer's Quarterly Federal Tax Return), the annual Form 940 (Employer's Annual Federal Unemployment Tax Return), the Texas Workforce Commission's (TWC) Unemployment Tax Services Employer's Quarterly Report, the USCIS Form I-9 (Employment Eligibility Verification), the Form W-4 (Employee's Withholding Allowance Certificate), the Texas Employer New Hire Reporting Form and the annual Form W-2 issuance. In addition and depending on the number of employees, various state and federal employment laws apply that govern minimum wage and overtime, medical leave, anti-discrimination and anti-harassment, insurance coverage under the Affordable Care Act, workers' compensation and workplace safety.

On the other hand, there are minimal responsibilities and requirements in place when a business classifies a worker as an independent contractor. The employer must complete a Form W-9 (Request for Taxpayer Identification Number and Certification) and annually issue a Form 1099 for payments made to the independent contractor. It is for this reason that many businesses seek to classify workers as independent contractors. In turn, this increased desire for the independent contractor classification has resulted in increased state and federal audits regarding worker classification.[1]

With that in mind, it is important to know how the state of Texas (TWC) and the U.S. Internal Revenue Service (IRS) determine a worker's classification. The TWC and the IRS utilize the same test but somewhat different factors, so it is critical to know and understand both approaches.

According to the IRS, a worker is an independent contractor if the payer (i.e., the business in most cases) has the right to control or direct only the result of the work, and not what will be done and how it will be done.[2] To make this determination, the IRS uses the common law control test to examine the relationship between the worker and the business. In doing so, the IRS examines the facts using three broad categories – behavioral control, financial control and relationship of the parties.[3] It is important to note that no single factor within the categories is determinative and the factors are meant to assist in determining the overall question of control and direction. That said, the more factors that favor an employee classification, the more likely it is the worker in question is an employee. The more factors that favor an independent contractor classification, the more likely it is the worker in question is an independent contractor.

1. Behavioral Control – Within the behavioral control category, the fact finder examines the business' right to direct and control what work is accomplished and how the work is accomplished, whether that is through instructions, training or other means.[4] The greater the business' right to direct and control what work is accomplished and how it is accomplished, the more likely this category favors an employee classification.

2. Financial Control – In this category, the fact finder examines the facts related to a business' right to direct or control the financial and business aspects of a worker's job. The areas of inquiry include: (a) the extent to which the worker has unreimbursed business expenses, (b) the extent of the worker's investment in the facilities or tools used in performing the work, (c) the extent to which the worker makes his/her services available to the relevant market, (d) how the business pays the worker and (e) the extent to which the worker can realize a profit or incur a loss.[5]

If the business reimburses the majority of the worker's business expenses and/or regularly reimburses the worker's business expenses, the fact finder should categorize that factor in favor of an employee classification. If a worker invests minimally in the facilities or tools used to perform his/her work, the fact finder should categorize that factor in favor of an employee classification. The third factor within this category favors an employee classification if the worker does not make his/her services available to the relevant market or at least highly minimalizes that availability. A common inverse example is a bookkeeper hired by a business to review and close the business' financial documents at year-end. If that bookkeeper makes such services available to other businesses as well, that factor favors an independent contractor classification.

With respect to how a business pays the worker, an hourly, weekly or monthly rate favors an employee classification, while a "per job" or flat rate favors an independent contractor classification. Finally, if a worker generally does not realize a profit or incur a loss in the business, the fact finder should categorize that factor in favor of an employee classification. Only independent contractors can realize a profit or incur a loss through the management of expenses and revenues (i.e., transportation costs, marketing expenses, payments to subcontractors, etc.). Employees simply are paid for services rendered.

3. Relationship of the Parties – Within this category, the fact finder examines the type of relationship the parties had. This includes examining (a) written contracts describing the relationship the parties intended to create, (b) whether the business provides the worker with benefits an employee typically receives, such as insurance, a pension and vacation and/or sick pay, (c) the permanency of the relationship, and (d) the extent to which the services the worker performs are a key aspect of the business' regular business.[6]

If the business and worker entered into a written contract in which it states the worker is an independent contractor, this factor favors an independent contractor classification. It is important to note, however, that a contract is not determinative and is merely one of many factors to examine. Furthermore, the parties' intent does not determine the worker's classification. With respect to the second factor, if a business provides a worker with benefits an employee typically receives, the fact finder should categorize that factor in favor of an employee classification. The factor addressing the permanency of the relationship sometimes can be confusing.

While Texas is an at-will employment state, meaning either the employee or the employer may terminate the employment relationship at any time and for any reason, this inquiry presumes that an employer-employee relationship is ongoing absent some reason to terminate. On the other hand, an independent contractor relationship typically is for a single job or project with no expectation of continuing work. As such, the more permanent the relationship, the more likely this factor favors an employee classification. The final factor in this category favors an employee classification when the services the worker performs are a key aspect of the business' operations and/or the business' success depends on the worker's services.

As this article mentioned previously, the TWC also utilizes the common law control test, which means a worker is an independent contractor if the payer (i.e., the business in most cases) has the right to control or direct only the result of the work, and not what will be done and how it will be done. To determine control, however, the TWC utilizes a 20-factor approach. As with the IRS approach, no single factor is determinative and the weight assigned any given factor can vary depending upon the specific facts. The factors can be found here: http://www.twc.state.tx.us/files/businesses/form-c-8-employment-status-comparative-approach-twc.pdf. While the factors vary slightly, most are found within the IRS approach and should be examined the same way.

Despite the extensive IRS and TWC tests, another government agency recently created more potential concern for businesses. In July 2015, the Department of Labor (DOL) administrator issued an interpretation memo regarding worker classification. The interpretation narrowed the DOL's definition of independent contractor so much that businesses should be extremely wary about classifying workers as independent contractors. Pursuant to the interpretation, the DOL moved away from the traditional control test and toward an economic realities test. That test examines each worker to determine if he/she is economically dependent on the business/employer or in business for himself/herself.

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"IT IS EXTREMELY IMPORTANT TO NOTE THAT SIMPLY PAYING AN EMPLOYEE A SALARY DOES NOT MAKE THAT EMPLOYEE EXEMPT FROM THE FLSA'S OVERTIME COMPENSATION REQUIREMENTS."

In conducting this test, the DOL utilizes the following six factors: (1) the extent to which the worker's work is an integral part of the employer's business; (2) the extent to which the worker's managerial skill affects his/her opportunity for profit or loss; (3) the worker's relative investment compared to the employer's investment; (4) whether the worker's work requires special skill and initiative; (5) the permanency of the relationship between the worker and employer; and (6) the nature and degree of the employer's control over the worker.[7] As with the IRS and TWC tests, no single factor is determinative.

While it can be more expensive and a larger administrative burden, classifying a worker as an employee rather than an independent contractor eliminates the misclassification risk. That said, if a business classifies a worker as an independent contractor, it should bear in mind that the analysis can change over time and a business regularly should monitor and evaluate the chosen classification.

Exempt vs. Non-Exempt

Once a business has determined that it has at least one employee, it most likely faces the "exempt vs. non-exempt classification challenge." If a business has annual gross volume of sales made or business done of $500,000 or more, that business' employees are covered by the FLSA.[8] Hospitals, businesses providing medical or nursing care for residents, schools and public agencies are subject to the FLSA no matter their annual gross volume of sales made or business done.[9] Furthermore, even if a business is not subject to the FLSA, individual employees may be covered if their work involves them in interstate commerce.[10] For example, making telephone calls and responding to email crosses interstate lines and implicates interstate commerce. As a practical matter, therefore, it is rare that a business has employees and those employees are not subject to the FLSA in some way. The focus of this article is the FLSA because the state of Texas has no added protection or requirements beyond those the FLSA imposes.

The FLSA delineates two broad categories of employees – those exempt from the law's minimum wage and/or overtime requirements and those who are not exempt. An employee who is exempt from the overtime requirements need not be paid time and one-half the employee's regular rate of pay for every hour worked in excess of 40 in a workweek. While the FLSA identifies 48 exemptions from the law's overtime requirements, 43 are industry-specific or job-specific exemptions that do not apply to most employers.[11] Five of the exemptions, however, are general exemptions, three of which are known as the "white collar" exemptions and are available to the vast majority of employers.

These exemptions are the executive, administrative, professional, computer and outside sales exemptions. With the exception of the computer exemption and the outside sales exemption, these exemptions require that the employer compensate the employee on a salary basis at a rate not less than $455 per week ($23,660 annually).[12] With respect to the computer exemption, employers also have the option to compensate the exempt employee on an hourly basis equal to $27.63 per hour.[13] There is no salary or hourly pay requirement for the outside sales exemption.

After a court-issued injunction in November 2016, this salary requirement remained unchanged and pending further court order, will remain unchanged. The term "salary basis" is a term of art within the DOL regulations. Pursuant to the regulations related to these exemptions and subject to some exceptions, an exempt employee must receive the full salary for any week in which the employee performs work, regardless of the number of days or hours worked.[14] The exemption is lost for any week in which the employer makes improper deductions.

There is one final note regarding the salary requirement. The DOL regulations permit employers to satisfy 10 percent of the required salary using nondiscretionary bonuses and incentive payments as long as employers pay those bonuses and incentive payments on at least a quarterly basis.[16]

It is extremely important to note that simply paying an employee a salary does not make that employee exempt from the FLSA's overtime compensation requirements. The exemptions discussed above also have required duties tests. In order to be exempt, therefore, an employee must earn the previously discussed required compensation and perform the required duties. These duties are as follows.

Executive Exemption – The employee's primary duty must be managing the enterprise or managing a customarily recognized department or subdivision of the enterprise; the employee must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent and the employee must have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.[17]

Administrative Exemption – The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers; and the employee's primary duty includes the exercise of discretion and independent judgment with respect to matters of significance.[18]

Learned Professional Exemption – The employee's primary duty must be the performance of work requiring advanced knowledge, defined as work which is predominantly intellectual in character and which includes work requiring the consistent exercise of discretion and judgment; the advanced knowledge must be in a field of science or learning; and the advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction.[19]

Creative Professional Exemption – The employee's primary duty must be the performance of work requiring invention, imagination, originality or talent in a recognized field of artistic or creative endeavor.[20]

Outside Sales Exemption – The employee's primary duty must be making sales, or obtaining orders or contracts for services or for the use of facilities for which a consideration will be paid by the client or customer; and the employee must be customarily and regularly engaged away from the employer's place or places of business.[21]

Computer Exemption – The employee must be employed as a computer systems analyst, computer programmer, software engineer or other similarly skilled worker in the computer field performing the duties described in the subsection. And the employee's primary duty must consist of the application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software or system functional specifications, the design, development, documentation, analysis, creation, testing or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications, the design, documentation, testing, creation or modification of computer programs related to machine operating systems; or a combination of the aforementioned duties, the performance of which requires the same level of skills.[22]

The DOL regulations further define specific phrases and terms within these duties tests, including primary duty, management, customarily and regularly, discretion and independent judgment, matters of significance and others. These explanations could themselves be the subject of an entire article but for purposes of this article, they can be found in Title 29 of the Code of Federal Regulations, Subtitle B, Chapter V, Subchapter A, Part 541, Subpart H, Sections 541.700 through 541.710.[23]

It is important to note that job titles do not determine exempt or non-exempt status and job descriptions in and of themselves do not determine exempt or non-exempt status. Rather, exempt or non-exempt status is determined by the actual duties the employee at issue performs. That said, a written job description can and should assist in determining an employee's exempt or non-exempt status.

One other exemption merits discussion here. The highly compensated employee exemption provides an exemption for any employee who performs office or non-manual work and earns at least $100,000 per year (which must include at least $455 per week paid on a salary basis) if that employee customarily and regularly performs at least one of the duties of an exempt executive, administrative or professional employee.

The purpose of this information is vital to any business or employer to avoid liability, but what is at risk? Since these areas of inquiry are related, a business or employer can face liability for one or both depending on how they classified the worker (i.e., whether the worker was classified as an independent contractor or employee and if classified as an employee, whether the worker was classified as exempt or non-exempt).

As an example, suppose a business wrongly classifies a worker as an independent contractor and following an audit by the DOL and the IRS, the worker is classified as a non-exempt employee. The business could be liable for back taxes to the state and federal government, as well as penalties related to the I-9, the Texas Employer New Hire Reporting Form and the Affordable Care Act. In addition, the business could be liable for two to three years of unpaid overtime compensation, penalties and interest. The dollar amount could be staggering. While an audit is dangerous enough, the situation is worse if the worker at issue decides to file a lawsuit as a collective action (i.e., a term of art for a class action lawsuit under the FLSA) and seeks unpaid overtime compensation, penalties (which includes a doubling of unpaid overtime wages), interest and attorney's fees for himself/herself and several other workers.

It is for all these reasons that businesses and their advisors must recognize potential issues involving the "independent contractor vs. employee classification conundrum" and the "exempt vs. non-exempt classification challenge." Once recognized and ideally with the assistance of legal counsel in some manner, businesses should carefully and thoughtfully ensure their workers are properly classified. In doing so, they can minimize risk and liability.

Footnotes

1. Wood, Robert W. "IRS Inspector Urges Crackdown on Mislabeling 'Independent Contractors'" *Forbes.com. Forbes*, 30 July 2013. Web. 22 Aug. 2016.
2. https://www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-defined
3. https://www.irs.gov/taxtopics/tc762.html
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21. https://www.dol.gov/whd/overtime/fs17e_computer.pdf
22. http://www.ecfr.gov

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Amendment to Gross Versus Net Revenue Recognition

Curriculum: Accounting and Auditing

Level: Basic

Designed For: CPAs in public practice and CPAs in public or private companies

Objectives: To clarify the amendment to Topic 606 (revenue recognition) in gross versus net revenue recognition

Key Topics: Principal, agent and gross versus net revenue recognition

Prerequisites: None

Advanced Preparation: None

By Josef Rashty

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606). In June 2014, FASB and the International Accounting Standards Board (IASB) announced the formation of Transition Resource Group (TRG) for revenue recognition. TRG does not issue any authoritative guidance, but makes recommendations about potential implementation issues on the new revenue recognition standards to both boards. In May 2016, FASB issued ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net) under Topic 606 based on TRG recommendation.

In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with corresponding offset to cost of sales. Thus, FASB provides for an alternative method of revenue recognition on a net basis (i.e., recognizing as revenues only the fee or commission that an entity receives as a reward for its participation in the transaction process). For example, in case of a travel agency that sells airline tickets to customers on behalf of an airline company for a commission, the travel agency recognizes its net amount of revenue (i.e., its commission).

Nevertheless, regardless of the method of accounting (i.e., gross versus net), the amount of net income remains the same under either of the two acceptable accounting methods.

However, in certain circumstances, the stock market and investors may judge the performance of a company based on its top line (i.e., gross revenues) instead of net income and as a result, reporting revenues on gross versus net methods becomes important.

This article will discuss the new revenue guidance and its amendment for recognition of revenues for principals (on a gross basis) versus agents (on a net basis) and compares the new revenue guidance (ASC 606 as modified by ASU 2016-08) with the existing revenue standard (ASC 605).

Existing Guidance (ASC 605)

ASC 605-45-45-10 states that it is a matter of judgment whether the entity should recognize revenues as the gross amount billed to a customer or the net amount retained (the amount billed to the customer less the amount paid to a supplier).

ASC 605 has the following indicators for gross revenue reporting:

- The entity is the primary obligor in the arrangement (ASC 605-45-45-4).
- The entity has general inventory risk (ASC 605-45-45-5).
- The entity has the latitude to establish the price of transaction (ASC 605-45-45-8).
- The entity is primary responsible for fulfillment and can change the product or perform part of services (ASC 605-45-45-9).
- The entity has discretion to select the supplier for fulfillment of customer order (ASC 605-45-45-10).
- The entity is primary responsible or involved in the determination of specifications for a customer order (ASC 605-45-45-11).
- The entity has the risk for the physical loss of inventory after customer order or during shipping (ASC 605-45-45-12).
- The entity carries transaction's credit risk (ASC 605-45-45-13).

Additionally, ASC 605 has the following three indicators for net revenue reporting:

- Suppliers, rather than the entity, have the primary obligation to fulfill the contract (ASC 605-45-45-16).
- The amount that the entity earns is fixed (ASC 605-45-45-17).
- The suppliers, rather than the entity, have the credit risk (ASC 605-45-45-18).

Topic 605 did not specifically address the principle underlying these indicators. However, since Topic 605 is a risk and reward model, we can fairly assume that these indicators use the same framework.

The boards brought forward these indicators more or less unchanged to ASC 606, but the new guidance is based on control rather than risk and reward, and that contributed to confusion on gross versus net revenue reporting under Topic 606. TRG made recommendations for clarification of the standard and FASB issued ASU 2016-08 based on those recommendations.

Effective Date of Amendment

The effective date for ASU 2016-08 is the same as the effective date for ASC 606; that is, ASU 2016-08 is effective for public business entities (PBEs) for annual reporting periods after Dec. 15, 2017 (i.e., 2018 for calendar year PBEs and interim periods therein).

Non-PBEs will be required to adopt the standard for annual reporting periods beginning Dec. 15, 2018, and interim periods within annual reporting periods beginning after Dec. 15, 2019.

All entities are permitted to adopt the standard as of the original PBEs' effective date (i.e., annual periods beginning after Dec. 15, 2016 and interim periods therein). Earlier adoption prior to that date is not permitted.

New Guidance (ASC 606)

The revenue recognition model has changed from a risks and rewards model to a model based on control (ASC 606-10-55-37). ASC 606-10-55-39 identifies the following indicators that enable the company to exercise control over the specified goods or services before they are transferred to customers:

- **Fulfillment responsibility** – The entity is primary responsible for fulfilling the promise to provide the specified goods or services to customers.
- **Inventory risk** – The entity has inventory risk before the specified goods and services are transferred to customers.
- **Price determination** – The entity has discretion in establishing prices for specified goods and services.

ASU 2016-08 Specific Clarifications

ASU 2016-08 amended ASC 606 and clarified the following, regarding principal versus agent classification:

Unit of Accounting – ASU 2016-08 has clarified how an entity should identify the unit of accounting for the principal versus agent evaluation. The unit of accounting refers to "specified goods or services" as distinct goods and services (or distinct bundle of goods and services) to be transferred to customers. Thus, for contracts involving more than one specified good or service, an entity could possibly be designated as a principal for certain goods and services and as an agent for others.

The unit of accounting for principal basically identifies the performance obligation in the contract. Significant amount of judgment is required to determine whether the specified goods or services are the underlying goods or services or rights

continued on next page

to obtain such goods or services. Once the unit of accounting is identified, it is easier to determine the party that exercises control over the contract.

Control Principle – ASU 2016-08 has clarified how the control principle applies to transactions. The objective is to determine the party that controls the specified goods and services before being transferred to customers.

ASC 606-10-55-37A clarifies that an entity is considered a principal if it controls any of the following:

- A good or another asset from a third party that gets transferred to customers.
- A right to a service performed by a third party for customers.
- A good or service from a third party that is embedded with entity's own goods and services provided to customers.

The meaning of control under the principal versus agent guidance is consistent with its meaning under ASC 606-10-25-25, which states that control of an asset refers to the ability to direct the use of an asset and obtain substantially all of the remaining benefits from it. Control includes the ability to prevent other entities from directing the use of asset and obtaining any benefits from it.

ASC 606-10-55-37B states that an entity is principal and recognizes revenue in the gross amount of consideration if it satisfies performance obligation, and on the other hand ASC 606-10-55-38 states that an entity is an agent and recognizes revenue in the net amount if the entity's performance obligation is to arrange for another entity to render goods and services.

Indicators – ASU 2016-08 revised the indicators such that focus would be on identification of principal:

- Reframed the indicators to reflect that the principal controls specified goods and services before transfer.
- Added guidance to explain how each indicator supports the assessment of control (ASC 606-10-55-39 discussed earlier).
- Removed the indicator related to the form of consideration.
- Removed the indicator related to credit risk exposure.
- Clarified that these indicators are not an exhaustive list.

FASB did not intend to establish bright lines for identification of principal versus agent. Management exercises significant judgment in each instance to identify the principal in each transaction.

Examples

FASB added a few examples and illustrations to clarify the concept of principal versus agent.

Example 45 – In this example, FASB clarifies that simply arranging to provide goods and services is not enough to make an entity principal. FASB describes an entity that operates a website for commission based on sales price. This website enables customers to purchase goods from a number of suppliers. The suppliers control the price of goods and services that they provide.

FASB concludes that the entity is an agent in this scenario since suppliers have the fulfillment responsibility and inventory risk, and also determine the price, thus having control over the specified goods and services. The website operator in this example is an agent.

> “IN CERTAIN REVENUE ARRANGEMENTS, AN ENTITY MAY NOT NECESSARILY PERFORM ALL THE REVENUE-RELATED TASKS TO BE ABLE TO RECOGNIZE THE WHOLE SALES PRICE AS REVENUES ON A GROSS BASIS WITH CORRESPONDING OFFSET TO COST OF SALES.”

Example 46 – An entity enters into a contract with a customer for certain custom designed equipment. The customer and entity together design the equipment and agree on the price of equipment. The entity communicates the specifications to suppliers to manufacture and deliver the equipment directly to customers.

FASB concludes that the entity controls the specialized equipment before the equipment gets transferred to customers and is the principal. Although the entity has subcontracted the manufacturing of the equipment to suppliers, it remains responsible for the overall management and performance of the contract. Thus, it has the ultimate fulfillment responsibility and control over the price of goods and services. It may have limited inventory risk but nevertheless that by itself is not a strong enough indicator to exclude it as principal in this example.

Example 46A – An entity enters into a contract with a customer to provide office maintenance services. The entity usually outsources the maintenance services for this and other similar contracts to sub-contractors. Nevertheless, the entity remains responsible for the fulfillment of the contract and determines the price with customers and remains responsible for the payment settlement with the third party subcontractors regardless if it gets paid by its customers.

FASB concludes that the entity is the principal since it has the fulfillment responsibility, and has control over the price of goods and services even though it has limited inventory risk.

Example 47 – In this example, FASB distinguishes between having responsibility for fulfillment and control over specified goods and services versus having rights on specified goods and services. An entity negotiates with major airlines to purchase tickets at reduced rates to sell them to the public.

FASB concludes that the entity is principal because it is obligated to pay for the tickets whether it can sell them to the public or not (inventory risk); it determines the price of the tickets sold to the public (price determination); it obtains control of a right to fly (it can transfer it to a customer) once it obtains the ticket from the airlines (fulfillment responsibility).

However, if the entity was simply facilitating the sale of airline tickets to the public for a percentage of selling prices as commission, it had the rights to sell the tickets, but did not necessarily control the specified goods and services. FASB concludes that the airline company has the performance obligation and as a result, the entity is an agent and must record the revenue transaction in the net amount (i.e., its commission).

Example 48 – An entity sells vouchers to customers that entitle them to receive significant discounts for future meals at specified restaurants. The entity does not purchase or make commitments for the purchase of vouchers. The entity and restaurants together determine the price of vouchers and the entity receives a commission for the sale of vouchers.

FASB concludes that the entity is an agent in this scenario since it does not have any fulfillment responsibility or inventory risk. It controls the price partially, but that is not enough to be designated as principal.

Example 48A – An entity provides recruiting services to customers. Customers as part of the contract with the entity obtain a license to access a third party's database for recruiting information. The entity invoices the customer for both recruiting services and database license.

FASB concludes that the entity is a principal regarding the recruiting services since it has the fulfillment responsibility and determines the price. However, it is an agent in relation to services related to database since the entity does not have any control over the database, does have any fulfillment responsibility and does not determine the price.

Illustration

An entity acquires an airline ticket from an airline company for $1,000 and sells it to a customer for $1,100. The airline company's cost of sales for the ticket is $700.

The following illustration is based on Example 47 where the entity is principal:

<u>Entity's Books (Principal)</u>

Cash	$1,100	
Revenues		$1,100
Cost of sales	$1,000	
Cash		$1,000

<u>Airline's Books (Agent)</u>

Cash	$1,000	
Revenues		$1,000
Cost of sales	$700	
Cash		$700

An entity sells an airline ticket for an airline company for $1,000 and receives $100 commission. The airline company's cost of sales for the ticket is $700.

The following illustration is based on Example 47 where the entity is agent:

<u>Entity's Books (Agent)</u>

Cash	$100	
Revenues (Commission)		$100

<u>Airline's Books (Principal)</u>

Cash	$1,100	
Revenues		$1,100
Cost of sales (Commission)	$100	
Cash		$100
Cost of sales	$700	
Cash		$700

In both of these scenarios, the net income of the entity remains at $100 and the net income of the airline company remains at $300.

Final Remarks

FASB's guidance on gross versus net revenue recognition has changed since the new revenue recognition model is no longer a rule-based risk and reward model, but instead is a principle-based control model. ASC 606, as modified by ASU 2016-08, provides certain indicators to distinguish principals from agents; however, these indicators should not be viewed as bright lines and an exhaustive list. Management exercises significant judgment on each transaction to determine if the revenue transaction should be recorded at gross versus net. ■

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By Josef Rashty

Amendment to Gross Versus Net Revenue Recognition

1 The article argues that under either gross or net revenue recognition:
- **A.** Revenue remains the same
- **B.** Cost of goods sold remains the same.
- **C.** Gross margin remains the same.
- **D.** Net income remains the same.

2 The article claims that ASC 606 (the new revenue recognition guidance) is based on a:
- **A.** Risk and reward model.
- **B.** Control model.
- **C.** Both (a) and (b).
- **D.** Neither (a) nor (b).

3 For calendar year PBEs, the new revenue recognition guidance is effective in:
- **A.** 2018
- **B.** 2017
- **C.** 2019
- **D.** None of the above.

4 ASC 606 identifies the following indicators for exercise of control over the specified goods or services before they are transferred to customers:
- **A.** Fulfillment responsibility.
- **B.** Inventory risk.
- **C.** Price determination.
- **D.** All of the above.

5 The article claims that for contracts involving more than one specified good or service, an entity can be designated as a principal:
- **A.** For all the goods or services.
- **B.** For none of the goods or services.
- **C.** Possibly for some of the goods or services.
- **D.** None of the above.

6 The new guidance has revised the indicators such that the focus would be on identification of:
- **A.** Principal.
- **B.** Agent.
- **C.** Both (a) and (b).
- **D.** Neither (a) nor (b).

7 The article claims that FASB did not intend to establish bright lines for identification of principal versus agent.
- **A.** True.
- **B.** False.

8 The article claims that management exercises _______ judgment in each instance to identify the principal in each transaction.
- **A.** Little.
- **B.** No.
- **C.** Some.
- **D.** Significant.

9 FASB added a few examples and illustrations to clarify the concept of principal versus agent.
- **A.** True.
- **B.** False.

10 FASB's new guidance on gross versus net revenue recognition in ASC 606 has _______ as existing ASC 605 guidance.
- **A.** Remained exactly the same.
- **B.** Remained more or less the same.
- **C.** Has not remained the same.
- **D.** None of the above.

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Answers to last issue's self-study exam: **1. A 2. C 3. D 4. B 5. B 6. C 7. D 8. A 9. A 10. A**

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Course	Date	City
Financial Forecasting and Decision Making	February 9	Dallas
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U.S. GAAP: Review for Business & Industry	February 14	Houston
Identity Theft: Preventing, Detecting and Investigating	February 14	Dallas
Transforming Your Role as Controller to Business Partner	February 16	San Antonio
Transforming Your Role as Controller to Business Partner	February 17	Austin
Financial Forecasting and Decision Making	February 17	Houston
Personal and Professional Ethics for Texas CPAs	February 21	Dallas
Transforming Your Role as Controller to Business Partner	February 21	Houston
Current Economic Issues and Their Impact on the CFO/Controller	February 22	Houston
Advanced Controller and CFO Skills	February 22	Fort Worth
Transforming Your Role as Controller to Business Partner	February 22	Dallas
Personal and Professional Ethics for Texas CPAs	February 23	Houston
Current Economic Issues and Their Impact on the CFO/Controller	February 23	Dallas
Advanced Controller and CFO Skills	February 23	Houston
Personal and Professional Ethics for Texas CPAs	February 27	Fort Worth
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$842,000 gross. Central TX CPA firm. Accounting (21%), tax (65%), audit/review/consulting (21%), continued staff and owner involvement to ensure client retention. TXC1060

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$100,000 gross. Weatherford CPA firm. Tax (90%), accounting/bkkpg (10%), loyal client base, experienced staff in place. TXN1391

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$250,000 gross. Van Zandt Co. tax and accounting firm. Stable, loyal client base, primarily tax but plenty of expansion opportunity. Ideal starter practice. TXN1418

$178,000 gross. Allen CPA firm. 90% derived from monthly bookkeeping and accounting services, year-round cash flow, quality client base. TXN1419

$633,000 gross. N. Dallas CPA firm. Accounting (34%), tax (64%), strong fee structure, cash flow near 50%, staff in place, capacity for growth. TXN1423

$160,000 gross. Jefferson CPA firm. Tax 45%, accounting 44%, high-quality client base, solid fee structure and tenured staff in place. TXN1424

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$1,081,000 gross. W. of Ft. Worth CPA firm. Business tax and accounting 70% of revenues, 60% of total from bkkpg, P/R and misc. svs., cash flow near 50%. TXN1432

$240,000 gross. Keller CPA firm. 61% tax, 37% accounting, knowledgeable staff in place, turn-key starter practice primed for growth. TXN1433

$182,000 gross. Ft Worth CPA firm. Tax (48%), bookkeeping (36%), reviews (16%), strong cash flow over 60%, high-quality client base. TXN1434

$650,000 gross. Addison CPA firm. 50% tax/compliance, 40% accounting, 10% consulting/tax planning, excellent cash flow approx. 60%, turn-key. TXN1435

$380,000 gross. Wood Co. CPA firm. 78% tax, 22% accounting, good fee structure and knowledgeable staff in place, well positioned for additional growth. TXN1436

$383,000 gross. N. suburb of Ft. Worth firm. (53%) tax, (47%) bookkeeping, quality client base, good fees yielding strong cash flow, primed for growth. TXN1437

$960,000 gross. Dallas area property tax consulting firm. Cash flow about 75%! Strong fees per engagement, minimal overhead costs, tenured staff. TXN1438

$149,214 gross. East Texas CPA firm. Tax (69%), accounting (31%), quality client base and staff available to assist with smooth transition. TXS1161

$365,800 gross. Near downtown Houston accounting firm. Tax (39%), bkkpng (37%), payroll (11%), other (13%), flexible transition. TXS1174

$226,000 gross. Orange Co. CPA firm. Tax 70%, bkkpng 20%, reviews/consult/payroll 10%, support staff in place and seller available to assist with transition. TXS1180

$604,000 gross. Sugar Land-Richmond Rosenberg CPA firm. Tax (70%), accounting (27%), consulting (3%), well-trained long-term staff in place, turn-key. TXS1182

$32,600 gross. Corpus Christi accounting firm. Accounting 74%, tax 26%, part-time operation, low overhead expenses, portable within Corpus or nearby. TXS1184

$73,150 gross. Houston CPA audit firm. Six audit types include three GAAS and three 133, high cash flow, minimal expenses. TXS1188

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