MARCH/APRIL 2017

Today's CPA

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Connecting for Business and Industry Professionals

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

In this issue of *Today's CPA* magazine, we would like to focus on TSCPA's programs and efforts to serve members in business and industry (B&I). In increasing numbers, CPAs are choosing careers in B&I or making the switch from public practice. Nearly 40 percent of our current members are working in the B&I sector. They have different needs than public practitioners for education, networking opportunities and remaining current on professional issues.

Working outside of an accounting firm requires CPAs to have access to their own continuing professional education (CPE). TSCPA offers hundreds of high-quality CPE opportunities in a variety of formats throughout the year, including seven industry-specific conferences. The high-quality CPE webcasts available through the Industry Institute are designed to meet the specific needs of CPAs who work in business and corporate environments.

Networking is also a career necessity for CPAs who don't have the built-in colleagues found when working at an accounting firm. TSCPA and the chapters offer various networking events throughout the year, bringing together CPAs who work in similar positions and industries.

Each year, TSCPA designates the month of April as B&I month. During the month, the Society hosts events in the large chapters and company tours with presentations to provide members with networking and educational opportunities. In addition, we are looking forward to recognizing the winner of the first-ever B&I award, which will be announced in April this year. The award honors and pays tribute to the professional accomplishments of CPAs who have spent their careers in B&I, and have made significant contributions and recruited others to the CPA profession.

TSCPA is an excellent source of news and information. The online Business & Industry Center is a customized online communications hub. The center was refreshed and updated with the redesign of TSCPA's website last fall. TSCPA provides a targeted e-newsletter, which is called B&I E-ssentials. Members can also keep informed through the Viewpoint e-newsletter, *Today's CPA* magazine and various social media channels.

A series of member profiles titled "A Day in the Life" is posted on the B&I LinkedIn page and in the B&I Center, and is featured in the B&I E-ssentials newsletter. Each profile explores a "normal" day of a member to highlight the diversity of our B&I population by the industries they work in and the jobs they do. These profiles have proved to be fascinating and we've learned more about the challenges facing our B&I members, as well as being impressed with what they manage to accomplish in a typical day.

Bill Schneider, CPA-Dallas, authors the *Industry Issues* blog. Schneider is a member of TSCPA's Business & Industry Committee, and he shares his thoughts on critical issues and opportunities facing the profession. *Industry Issues* also features guest bloggers from TSCPA's chapters. Schneider brings a perspective to the blog that can only be obtained from a member who has "been there, done that." His postings are an interesting and enlightening read!

TSCPA works with AICPA to encourage members to acquire and maintain the Chartered Global Management Accountant (CGMA®) designation. This was a strategic initiative that TSCPA joined in response to the needs of accountants working in the B&I sector who want, and need, a professional designation. AICPA and the Chartered Institute of Management Accountants (CIMA) created the CGMA designation. AICPA and CIMA members approved a proposal to form a new, international accounting association that integrates operations of both organizations, while preserving the existing membership bodies. The new organization that began on January 1st is now called the Association of International Certified Professional Accountants and represents more than 650,000 members and students in management and public accounting. It advocates for the public interest and business sustainability on current and emerging issues in the United States and worldwide.

In the rest of this *Today's CPA* issue, you'll find articles and columns on topics that are relevant to B&I members. The cover article discusses how internal auditors can use data analytics tools. As a former chief audit executive at UT Tyler, your TSCPA chairman can vouch for the increased need to utilize data analytics in internal auditing. There are also articles on companies using corporate inversions and accounting for workers' compensation costs. We also highlight a member who works in a government role and the Chapters column spotlights three current chapter presidents who work in areas other than public practice. We hope you enjoy reading this special B&I issue of *Today's CPA*. ■

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An Update on International Tax Enforcement

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

International tax enforcement remains one of the nation's top tax priorities. Indeed, a number of important developments over the past year signal that offshore enforcement issues remain firmly in the government's crosshairs. Notably, the past year saw the Treasury Department implement several key regulations that impose new reporting obligations, and that are designed to increase transparency and promote its ability to exchange information under the nation's tax agreements – agreements like the Foreign Account Tax Compliance Act (FATCA). Data leaks, such as the infamous Panama Papers scandal, provided a reminder that privacy is being supplanted by transparency in this age of information and globalization, and sparked new insights into the soft spots in our system.

The past year also saw the government continue to capitalize on information it has received from initiatives like the Offshore Voluntary Disclosure Program (OVDP), the streamlined filing compliance procedure and the Swiss Bank Program – programs that have been instrumental in the government's offshore tax compliance initiative, but have uncertain futures. And, in large part due to these developments, recent statistics indicate that international compliance rates are significantly increasing, signaling a growing awareness of filing obligations.

FBAR Filings are on the Rise

The number of FinCEN Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR) filings has been on the rise in recent years. More than a million FBARs are now being filed annually and the number of FBAR filings has grown an average of 17 percent per year over the past five years. Those are astounding figures for a reporting requirement that has been around since the 1970s.

The increase in the number of FBAR filings is an indicator that taxpayers and tax professionals are increasingly becoming better educated about their filing obligations. The trend is the product of several initiatives over the past few years that have raised taxpayer awareness – perhaps most prominent among them, FATCA and the OVDP.

How Much Longer will the OVDP Be Around?

The IRS' OVDP has perhaps been the primary offshore initiative responsible for increasing awareness of filing obligations. The OVDP is a program that the IRS offers to qualifying non-compliant taxpayers that allows them to come forward proactively and disclose their prior foreign reporting deficiencies in exchange for reduced penalties and criminal amnesty. In addition, the IRS introduced a streamlined filing compliance procedure, a sort of adjunct to the OVDP, allowing qualifying non-compliant taxpayers whose prior reporting deficiencies were not willful to correct those deficiencies at a significantly reduced cost (and without penalty in some cases). Both the OVDP and the streamlined procedure are open-ended initiatives that could end at any time.

In October of 2016, the IRS issued new statistics indicating that 55,800 taxpayers have now come into the OVDP, paying in more than $9.9 billion in taxes, penalties and interest since its adoption in 2009. In addition, another 48,000 taxpayers have used the streamlined filing compliance procedures since their adoption in 2012 (the vast majority of them since the procedures were expanded in 2014), paying in approximately $450 million.

All told, these figures represent major milestones with more than 100,000 taxpayers coming into compliance and the government collecting more than $10 billion. However, perhaps the most interesting aspect of these figures is their year-over-year changes. The OVDP, it turns out, experienced markedly slowed growth: a year before these statistics were released, 54,000 taxpayers had come into the OVDP, implying that there have only been 1,800 new entrants in the past year. The streamlined procedures, on the other hand, grew rapidly, with approximately 18,000 new entrants. In light of past IRS signals, these statistics could indicate that the OVDP's days are limited.

The Swiss Bank Program Reaches Resolution with Final Swiss Banks

In August of 2013, the Department of Justice instituted the Swiss Bank Program. The program provided eligible Swiss banks with the ability to resolve potential criminal and civil exposure by fully cooperating with the United States' ongoing investigations into the use of foreign bank accounts to facilitate tax evasion. This unique, landmark initiative has been incredibly successful. In roughly a year, the program led to non-prosecution agreements with some 80 Swiss banks and the collection of more than $1.3 billion in penalties. The final Swiss bank resolutions under the program were inked in late 2016, bringing that portion of the program to a close. The greatest fruits of the program, however, have been the vast amounts of data and information obtained from cooperating banks. Indeed, the government has now entered a phase of digesting and mining that data. This "legacy" phase, as the government has referred to it, is likely to produce a wave of new examinations and investigations.

In addition, the past year saw the Department of Justice's first criminal convictions of non-Swiss financial institutions (Cayman National Securities Ltd. and Cayman National Trust Co. Ltd.) for conspiring with U.S. taxpayers to evade tax. This movement outside of Switzerland, and the winding down of the Swiss Bank Program, indicates that the government is now turning its attention more and more towards other "trouble" jurisdictions. This is likely to be a

trend. We may even ultimately see similar programs – programs built on the Swiss Bank Program model – instituted in other countries.

FATCA Spurs New Regulations Seeking Increased Transparency

Under FATCA, foreign financial institutions are generally required to report accounts held by U.S. customers on an annual basis or face a 30 percent withholding tax on certain U.S.-source income. The United States now has FATCA-related intergovernmental agreements (IGAs) with more than 100 partner countries. The effort has been a phenomenal success in terms of fostering and promoting global transparency and the exchange of information among taxing authorities.

However, as this author and other commentators have noted, U.S. law has hindered the Treasury's ability to fully comply with the information-exchange obligations under its FATCA IGAs. Perhaps most notable has been the Treasury's inability to provide partner countries with information about underlying beneficial owners of U.S. entities. Prominent data breaches and leaks, such as the Panama Papers leak, have exposed these shortcomings and created political pressure to address them.

In reaction to these factors, the Treasury has enacted several new regulations that are part of a multipronged effort to increase financial transparency and improve the IRS' access to tax information. For instance, the Treasury finalized regulations under section 6038A of the code, providing that domestic disregarded entities that are wholly owned by a foreign owner will now be required to obtain an EIN and to file Form 5472, *Information Return of a 25 Percent Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, to report certain transactions. Prior to these new regulations, such entities generally did not have tax filing obligations. This will be a major change that goes into effect in 2017.

The section 6038A regulations bolster Treasury regulations that were introduced during 2016 under the Bank Secrecy Act and that impose new customer due diligence requirements on certain financial institutions, requiring the collection of information about the identity of beneficial owners of legal entities. The Treasury, recognizing that "information held by banks and other financial institutions about the beneficial ownership of companies can be used to assist law enforcement in identifying the true owners of assets and their true tax liabilities," adopted the rules in large part, it said, to promote compliance with "international standards for transparency and information exchange [and] to combat cross-border tax evasion and other financial crimes." In particular, the Treasury noted that the new rules will promote its ability to comply with FATCA agreements with partner countries. In this respect, the customer due diligence regulations will work hand in hand with the section 6038A regulations.

Another important FATCA-related reporting regulation also took effect this past year. The Treasury enacted final regulations under section 6038D of the code, which was enacted as part of FATCA, that require certain "specified domestic entities" to file a Form 8938 to report certain foreign assets, a requirement that had previously only applied to individuals. The requirement extends to certain closely held U.S. entities that are "formed or availed of" to hold, directly or indirectly, specified foreign financial assets. These new reporting regulations, combined with already increasing levels of compliance, will surely increase the flow of offshore-related information to the government.

A High Priority

International tax enforcement will remain high on the nation's list of priorities for tax administration in the coming years and it is, perhaps, positioned better than it has ever been to enforce such reporting requirements. An array of new reporting obligations will impact many taxpayers with foreign assets and holdings.

In addition, developments with several key offshore initiatives show signs that they may significantly change the landscape. For instance, as the Swiss Bank Program enters its "legacy" phase, the government is likely to expand its focus into new "trouble" jurisdictions. This may raise the stakes for many taxpayers who have thus far stayed off the radar, as it is quite possible that the OVDP, with its slowed growth, could be narrowed or even closed. Any such changes would represent major shifts in the offshore tax compliance initiative.

Jason B. Freeman, JD, CPA is the managing member of Freeman Law PLLC, based in the DFW Metroplex, and an adjunct professor of law at Southern Methodist University's Dedman School of Law. He can be reached at Jason@freemanlaw-pllc.com.

Finance and Legal – An Inextricable Link

By Mano Mahadeva, CPA, MBA | Column Editor

"A trusted partner who can scale the business." "A confident communicator who drives improvement initiatives." These attributes describe the expanding requirements of finance leaders in today's business environment. This is quite a change from finance executives who began their careers as bean counters, crunching numbers, preparing financial statements and helping to develop budgets.

Global economic challenges, financial crises and technological innovations have reshaped our roles in unforeseen ways. In the 1990s, companies recruited finance leaders who excelled in strategic vision. Enron's collapse in 2001 reshaped the position, shining a spotlight on the importance of ethics and integrity. The collapse of the global markets in 2008 caused another shift, which keyed on specifics of restructuring, turnarounds and cost cutting. Improved efficiencies led to lean companies with cash rich balance sheets. Traditional finance work that was transactional in nature became automated or outsourced, creating new opportunities. The opportunities on the horizon are unlimited for those who have the passion, energy and an innate desire to learn. The finance profession of today offers numerous career benefits to the professional and long-term value for employers like never before.

One significant area of benefit is assisting in the development of legal strategy while controlling its legal spend. This is especially impactful for small to mid-size companies. Here is the rationale – many think of legal fees as a necessary "cost" and something not as a "value" proposition. Therefore, when a contract or agreement comes by, a person may forward it to his/her external counsel for a review, as an outsourced job and without any input. That may end his/her participation in the process, as the counsel becomes the principal negotiator for the company.

Don't miss your chance to add value! Instead of passing the agreement on, become a key participant in this strategic discussion with your counsel. Do not leave your counsel to negotiate key elements of an agreement without insider input. You may forfeit potential strategic gains in a myriad of areas including, but not limited to, service offerings, pricing structure, long- and short-term tax planning, partner obligations, insurance coverage provisions, termination rights, and many operational aspects of up time on machinery, hours of service, performance guarantees and a host of others! Often times, there is a blurring between legal and business issues, with one affecting the other, so it is critical to have finance and operations involved in negotiating terms and working together.

Critical agreements you should be familiar with include the following.

A non-disclosure or confidentiality agreement needs to be signed by both parties before the exchange of information. If the company is in the business of patient care, an additional document called a Business Associate Agreement (BAA) needs to be signed when the definitive agreement is signed. Both need to have the appropriate and correct organizational names and addresses and be signed. A non-disclosure agreement protects sensitive information that is shared so that it will not be improperly used or further disclosed. The BAA protects health information in accordance with specific federal and state requirements.

A service level agreement is signed between a provider of services and a client. The agreement will state the level of service that is expected from the provider, with defined expectations and metrics to be received by the client. An ambiguous definition will result in an unmeasurable measurement. This is a very critical document, as it covers basic recitals (such as parties, duration, commencement date, etc.), as well as the scope of the work, governance (such as roles and responsibilities and dispute resolution), finance (such as pricing and cost), performance (such as performance targets, measurement and reporting) and implementation elements (such as milestones, transition and training).

A management service agreement in a broad sense is between a company and a manager who performs certain services for the company. The agreement sets out the specific services to be performed, types of supplies needed, the standard of performance and the term of the agreement. This document will cover sections like responsibilities, the nature of the relationship, term, termination, representations and warranties, compensation, insurance provisions, indemnifications, assignment and governing law.

Having outlined some of the key agreements above, questions arise – so when an agreement such as a lease stipulates insurance, do we go back to our policies to confirm coverage? When we negotiate a capital lease, do we review our credit agreements and forecast covenant compliance? When we design joint venture agreements, do we have an eye on proposed tax structure to gain a better position? These are examples of questions that need to be answered with great insight and thought.

By writing this column, I do not propose that the reader practices law, but instead reads and understands the agreements, and provides critical insight to an in-house or external counsel to help create a strategic advantage in the negotiations. This can be done by being familiar with all areas of operations. There is no one-size-fits-all approach to optimize value, as every agreement has a nuance or twist that may be different. So here is an opportunity to make a meaningful contribution to your company and help propel your career forward! ■

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.

FASB Clarifies Definition of a Business

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

On Jan. 5, 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-1, *Business Combinations (Topic 805): Clarifying the Definition of a Business*. The objective of the new ASU is to assist companies and other reporting organizations with evaluating whether sales transactions of productive assets should be accounted for as acquisitions (or disposals) of businesses or merely assets.

What's the Issue?

What difference does it make in a sale (or purchase) transaction whether the object of the transaction is an asset or a business? The answer is that it can make quite a difference on the seller's financial statements in reporting gains or losses on such transactions, and on the purchaser's financial statements as to whether goodwill (and thereafter, subsequent impairment) is recorded, as well as whether the rules for consolidations might apply while the set of assets is held.

For example, on the sell side, if the transaction is accounted for as an asset sale, gains and losses on such sales are combined for reporting purposes with other gains and losses in income from operations. If the transaction is accounted for as a sale of a business, it is often presented as a separate line item on the income statement, net of tax effects, and may later be excluded on a pro-forma basis in reporting earnings from ongoing operations (non-GAAP measures).

Accounting for Business Combinations is covered in Topic 805 of the Accounting Standards Codification (ASC). Under this topic, there are three elements of a business – inputs, processes and outputs. While an integrated set of assets and activities, a "set," that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a "set" are not required if market participants can acquire the set and continue to produce outputs, for example, by integrating the acquired set with their own inputs and processes.

A post-implementation review of this topic by FASB revealed that many stakeholders believed Topic 805's definition of a business was applied too broadly, resulting in many transactions being reported as business acquisitions when, in fact, they were more akin to asset acquisitions. Many stakeholders stated that analyzing transactions under the existing definition is difficult and costly. In addition, the scope of Subtopic 610-20, *Other Income – Gains and Losses from the De-recognition of Nonfinancial Assets*, raised questions about the interaction of the definition of a business and the term "in-substance non-financial asset" as used in that subtopic.

What's the Effect of the New ASU?

ASU 2017-1 provides a more robust framework to use in determining when a set of assets and activities constitutes a business. Thus, the new framework should provide more consistency in applying the definition and reduce the cost of implementation. The new framework sets up a screen to determine when a set is not a business. The screen requires that when substantially all the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business. If a transaction is caught by the screen, then to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output.

The new standard removes the evaluation of whether a market participant could replace the missing elements of the set. The new standard provides a framework to assist entities in evaluating whether both an input and a substantive process are present. This framework includes two sets of criteria to consider that depend on whether a set has outputs. Although outputs are not required for a set to be a business, they are generally a key element of whether a business exists. The new ASU includes more stringent criteria for a set without outputs to be classified as a business. In addition, the ASU narrows the definition of the term output to be consistent with the definition of the term used in updated ASU section 606 on revenue recognition.

When is the New Standard Effective?

For public companies, ASU 2017-1 is effective for annual periods beginning after Dec. 15, 2017, including interim periods within those periods. For all other companies and organizations, the effective date is annual periods beginning after Dec. 15, 2018, and interim periods within annual periods beginning after Dec. 15, 2019.

For a full reading of ASU 2017-1, see www.fasb.org.

C. William Thomas, CPA, Ph.D. is the J.E. Bush professor of accounting in the Hankamer School of Business at Baylor University in Waco. Thomas can be reached at Bill_Thomas@baylor.edu.

Chapter Presidents Thrive in Diverse B&I Arenas

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

Current chapter presidents who work in areas other than public practice will be highlighted in this issue of *Today's CPA*. They are in widely varied fields: one is with a multinational corporation providing communications services, one is a practicing attorney and one is a faculty member at a public university.

Those participating are, in alphabetical order:
Nikki Laing, CPA-Texarkana;
Kelly Noe, CPA-East Texas; and
Bill Schneider, CPA-Dallas.

Nikki Laing
CPA-Texarkana

Kelly Noe
CPA-East Texas

Bill Schneider
CPA-Dallas

CPA Career, Job Responsibilities

Reflecting the adaptability required of CPAs, there is tremendous range in the size and scope of employers for which these individuals have worked, from a nine-person office to a multinational corporation of 250,000 employees. Only one person has worked in public accounting at some point since being licensed as a CPA.

Bill Schneider works at a multinational corporation. During his 25 years there, he has held a number of positions, including corporate books manager, external reporting manager, director over SOX compliance, controller for three different subsidiaries and a current position as accounting policy director.

Schneider served on a team that created a shared service center for the predecessor corporation, including developing an entirely new accounting system. He said: "I can still remember the conference room pilots with foam bricks we could throw at fellow participants if they said why we couldn't do something rather than stating the issue and asking how we could deal with it. My recent work on the new revenue standard has taken me around the country to discuss issues with other companies in my industry. Seeing so many people who care about doing things right really has reinforced my belief in the good our profession does for all stakeholders in our businesses."

As a CPA/attorney, Nikki Laing's areas of practice are estate planning, probate, fiduciary litigation support, business transactions and taxation. Her focus is on providing guidance with trust administration and advising personal representatives in the probate and administration of decedents' estates, as well as drafting estate planning documents. For business clients, she helps with entity formation and drafting documents, such as shareholder agreements, employment agreements, leases and general contracts. The tax practice is focused primarily on the federal estate, gift and GST tax, corporate tax, state sales tax and state franchise tax.

Kelly Noe is a faculty member in the school of business at a public university. She explained that work compression comes during semester-end at universities. Final papers are due and exams must be prepared and graded. She said, "That's when students really get involved in academics."

At the corporation, the busy times are at month-end, quarter-end and year-end close. At the law firm, things tend to get hectic in the estate planning, taxation and business transaction areas toward the end of the calendar year. According to Laing: "For example, at the end of 2012, when it looked like the gift tax exemption could be reduced by millions of dollars in 2013 if Congress didn't act, many taxpayers chose to make gifts before the year ended to take advantage of the then-current exemption. Practitioners saw a similar push to get gifts made at the end of 2016 due to the concern over the proposed Section 2704 regulations that threaten to significantly reduce or eliminate some valuation discounts in the context of intra-family transfers."

Chapter Involvement

The conversation turned to the skills that have helped in the volunteer arena. Chapter involvement has come in a variety of ways. Noe worked at the university with longtime TSCPA and chapter volunteer **Treba Marsh**, CPA-East Texas, who encouraged Noe to serve on the student scholarship committee. Attorneys at Laing's firm are encouraged to get involved with the community, so when she was looking for ways to connect locally, the CPA chapter was a natural fit. Schneider was heavily involved in his chapter and state society in Georgia. When he moved to Texas, joining TSCPA and participating in the chapter were among the first things he did.

Most have become more deeply involved in their chapter through the encouragement of a specific person, such as **Sarah Berry**, CPA-Texarkana, **Kelly Birdwell**, CPA-Texarkana, and **John Perkins**, CPA-Dallas.

Career Rewards and Challenges

When the conversation shifted gears to the most rewarding aspect of their careers, there were varied responses. Laing enjoys working with clients to find creative solutions for financial and legal issues. Schneider appreciates helping people he has worked with as they progress in their career and likes the feeling that he might have had a little something to do with their success.

Noe talked about the thrill of helping students academically, as well as getting them on the CPA career path. She explained, "I show them the variety of opportunities in the accounting profession and get them to recognize that they can have many options." She went on to say, "I see relief on students' faces when they learn that I haven't worked in public practice and I understand there is a different route to success as a CPA." She remembers a student who was a political science major, but took a beginning class in accounting and showed a knack for it. Noe explained to her the benefit of changing her major in case she didn't get into law school, so that she would have an option to fall back on. After helping her get an accounting position at a large oil and gas company, where she now is a senior accountant and does their SEC reporting, Noe has learned that the company will pay for her to add a law degree to her toolkit.

Like other professionals, those in the group face career challenges. Noe works to get students from all different levels, who come from very different backgrounds, prepared for the CPA exam. "Sometimes you have to convince them that this world is for them," she says. Many had not pictured themselves in such an esteemed profession.

Laing deals with ever-changing laws, especially in the area of federal estate tax and the inability to predict what Congress will do from year to year. She said: "Practicing in that area is a never-ending roller coaster of amended statutes, new regulations and IRS interpretive guidance. It can be challenging to help clients navigate the uncertainty of how tax laws might change in the future and how those changes could affect their estate plans or businesses."

Schneider said: "I've had to learn to pace myself. There will always be another issue to tackle or another problem to solve."

The Next 10 Years for CPAs Working in Business and Industry

Turning to the future, the group considered the big thing in the next 10 years that will be a game-changer for CPAs working in business and industry. The participants expect:

- increased automation and/or outsourcing of activities that are not required to be conducted onsite,
- artificial intelligence to change the face of the profession,
- changes that impact revenue recognition, leasing and financial instruments,
- business and industry employers to move to a requirement that eligible workers get the CPA license to prove adherence to best practices, and
- the ability to accept – and work with – new and better ways of doing things will be the key to a long-lasting career.

Advice to Students Considering a Career in Accounting

To close the discussion, the group was asked what advice they would give to students who are considering a career in accounting.

"This is a great profession that gives you an opportunity to go in many different directions," said Schneider. "I can't think of a better, more useful base of knowledge if you have a desire to be successful in the business, not-for-profit or governmental world."

Laing suggests: "In addition to obtaining a strong foundation in substantive accounting principles, students must hone their writing skills and work on becoming proficient communicators. It doesn't matter how smart or talented one is, or how brilliant a solution to a problem is, if one cannot communicate that solution effectively to management or clients."

"You don't have to start over with each new position you take; your skills are recognized," according to Noe. "It's a career with fantastic security. After becoming a CPA, I have always had a job."

Are you a business and industry member? Contact your chapter president or executive director to see how you can become involved in a committee or in community service projects.

City Limits

CPA Follows Winding Path to Career in Government

By Anne McDonald Davis

Olivia Riley, CPA-Austin/Dallas, made two decisions in college that would steer her future down an adventurous and circuitous road: she was going to marry the Cal-Tech physics student she'd known since she was 12 years old and she was going to become an accountant.

Enrolled at nearby Cal-Poly, Riley's field of study promised to provide her with the career flexibility she was going to need in order to travel with her husband to the various universities where he would complete his education, and continue his research and related business ventures. In addition to zigzagging the United States from California to South Carolina to New Mexico to Texas, the Rileys would even spend four years in France.

"Our second child was born in Annecy, not far from Lyon," she recalls and adds with a chuckle, "Lyon's where all the good food comes from, such as beef bourguignon and au gratin potatoes." Through it all, the CPA was able to keep working and honing her own career interests, which turned to governmental accounting during recent years in the Austin area.

Riley explains: "Most of my work had been in public accounting – auditing, tax management. Then in 2009, I got a call from one of the cities I'd audited – Cedar Park."

The city's "project" ended up spanning three-plus years, at which time it turned out the nearby city of Round Rock was facing similar issues. By last year when she discovered that the town of Addison was in the market for a CFO, Riley was hooked. "When I get the opportunity to learn something new, I'm fascinated," she enthuses. "And city government is unique. There aren't exactly handy accounting reference guides on how to master that process."

One issue, Riley describes, is that city government has to effectively serve its larger public, more than just the people who actually live there. In fact, depending on the locale, the residential populace may be significantly smaller than the sum of its business owners, hospitality attractions and attendant customers. For instance, the town of Addison has about 15,000 residents and yet services closer to 100,000 people in some capacity on any given day.

Giving Back

Born in Mexico, Riley was three when her family came to California. Her Latina heritage is a motivating factor in her future volunteer aspirations. As she completes her year as the TSCPA Austin Chapter president, she hopes to become even more active in directed student outreach.

"I would like to be involved in local schools, going out and making sure that especially the Latino young women and men understand that it's possible to have this career (in accounting), to mentor them about going to college," Riley projects. "I want to say to them: There are so many possibilities for people to guide you. There's financial help for someone who shows that they're dedicated and invested in pursuing an education in accounting. Those are two big holdbacks for minorities – they don't know how to find a mentor and how to pay for higher education. They're lost. This is their chance at a good life, getting an accounting degree."

Even as she adds support staff in her new position with the town of Addison, Riley has found opportunities to mentor. Two of her new accounting hires now have plans to pursue their CPA licenses.

She beams: "For me, that's what I enjoy, going to colleges, speaking to the students, putting together panels so they can ask working CPAs how they made it to college, through college, through the exam. One of the misconceptions I hear is that you have to be some kind of cookie-cutter person to be a CPA. I tell them that it takes all kinds."

Riley says she's been active in CPA societies since college. "They pretty much promoted it at Cal-Poly. After all, CPA societies defend our licenses! And we have so many rules and guidelines to follow; we were encouraged to stay in touch with our societies to make sure we were informed.

"First thing I did when I got to Austin was join TSCPA and the chapter. Being 2016-17 (Austin) Chapter president has been very fulfilling. I got to look at the whole state and what other areas of Texas are doing. I really like **Bill Schneider** (Dallas Chapter president) and look forward to working with him."

Personal Thoughts

When possible, Riley enjoys the quiet introspection to be found in reading and walking. One of her personal philosophies of life is embodied in a quote from M. Russell Ballard: "It may not always be easy, convenient or politically correct to stand for truth and right. But it is the right thing to do. Always." She observes, "Ethical behavior is central to being a CPA."

As of Jan. 1, Riley was still juggling her latest career move with life back in Austin where she serves as chapter president through May and where her husband maintains his business. Riley smiles, "The reason I've gotten to do everything that I love about my profession is my supportive husband, Steven, and three wonderful children – Paul, Nicolas and Ruth."

Next stop, Addison, Texas. ■

CGMA® Designation: Next Testing Window for the Exam

The Chartered Global Management Accountant (CGMA) designation was created by AICPA and the Chartered Institute of Management Accountants (CIMA) to recognize U.S. CPAs and CIMA members who work in management accounting roles. The designation is a respected complement to your CPA license.

Candidates for the CGMA designation must pass a strategic and comprehensive examination. It is a computerized case study exam that tests a candidate's readiness to apply management accounting knowledge in real-world business situations. The exam is available four times a year during five-day testing windows. Candidates must register before the registration deadline for each testing window.

The next testing window is May 23-27, 2017, with a registration deadline of May 8, 2017. To learn more about the program and register for the exam, go to the Become a CGMA section of their website at cgma.org. ■

TSCPA Awards Nominations Due April 28

Do you know a young CPA who deserves recognition? Is there someone who is working to promote the accounting profession or making a difference in your chapter or local community? Be sure to nominate them for an award. TSCPA's Awards Committee is seeking nominations for Meritorious Service to the Profession, Distinguished Public Service, Outstanding Chairman, Honorary Fellow, Honorary Member and Young CPA of the Year. All criteria details are available online.

For more information, go to TSCPA's website at www.tscpa.org/about-tscpa/awards or contact Melinda Bentley at mbentley@tscpa.net; phone 800-428-0272, ext. 279 or 972-687-8579 in Dallas. **Nominations are due April 28, 2017**. ■

Accountants Confidential Assistance Network Seeks Volunteers

The Accountants Confidential Assistance Network (ACAN) program befriends a number of CPA candidates around the state as part of the ACAN peer assistance program. ACAN supports Texas CPAs, CPA candidates and/or accounting students who are addressing alcohol, chemical dependency and/or mental health issues.

Can you help? If so, please contact Craig Nauta at 800-428-0272, ext. 238; 972-687-8538 in Dallas; or at cnauta@tscpa.net. ■

Succession Planning Resource for TSCPA Members

TSCPA offers the Practice Management Institute to assist members with their firm management and practice management needs. Developed in partnership with the Succession Institute, LLC, the Practice Management Institute provides TSCPA members with free material and content on succession planning. There are also CPE self-study course offerings available at a discounted rate for those who would like to receive CPE credit. To learn more and utilize this members-only resource, please go to the CPE section of the TSCPA website at tscpa.org, click on Partners and then on Practice Management Institute CE. ■

Disciplinary Actions

Membership Suspensions

As a result of a decision by the Executive Board of the Texas Society of CPAs, the following members had their TSCPA memberships:

Suspended –

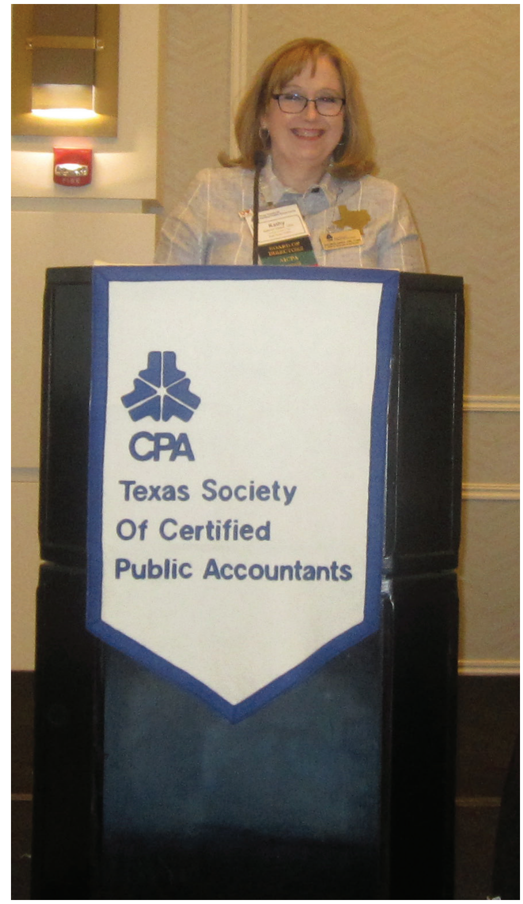
- **Christopher M. Bauer of Austin** and **Jeffrey W. Jamieson of Dallas** for a period of one year retroactive to Nov. 21, 2016. The suspensions were effective March 1, 2017. The action was based on an Offer of Settlement through the Securities and Exchange Commission (SEC), whereby Bauer and Jamieson were suspended from appearing or practicing before the SEC as accountants for one year. ■

Submit an Article to *Today's CPA* Magazine

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. ■

TSCPA Midyear Board of Directors Meeting



By Rhonda Ledbetter, Chapter Relations Representative

Members of the TSCPA Board of Directors met in Austin on Feb. 1 to conduct Society business and obtain profession information.

Chairman's Report

Kathy Kapka,CPA-East Texas, CGMA, shared information about TSCPA's work during the first few months of the fiscal year. There are a number of projects to recruit and serve members. They include:

- continued emphasis on educating students about the benefits of a career as a CPA and on recruiting them into TSCPA membership;
- introducing new CPAs to the Society and providing them with automatic free membership for the fiscal year in which they are licensed;
- a targeted recruitment campaign to reach those who became CPAs before the automatic membership program was launched and who have not joined;
- phone calls to non-renewing CPA members as a follow up to email and mail communications sent to them;
- a group billing program that offers firms and companies the option of receiving a single renewal invoice for all of the members in their organization, which is a great service to the employer and the member;
- special services focused on members who work in business and industry (B&I), such as CPE and networking events for them, April designated as B&I month, a dedicated issue of *Today's CPA* magazine and communications to connect this group with TSCPA and each other;
- a focus on the needs of young CPAs and emerging professionals, with a conference held to bring them together for networking and education;
- the opportunity for members' involvement in their communities through the CPA Month of Service; plans being made to hold it again during November of 2017; and
- Rising Stars in the profession being selected and recognized.

At this meeting, there was a special emphasis on governmental affairs. Advocacy Day included presentations by individuals involved in the legislative process and member visits to the Capitol. For

continued on next page

Figure 1. TSCPA Leaders for 2017-18

Terms begin June 1, 2017

Chairman-elect: *(Chairman in 2018-19)*
Stephen Parker *(Houston)*

Treasurer-elect: *(Treasurer in 2018-19)*
Ben Simiskey *(Houston)*

Secretary: *(Beginning June 2017 and expiring May 2018)*
Diane Terrell *(Abilene)*

Executive Board (Three-Year Term):
(Beginning June 2017 and expiring May 2020)

Michele Heyman *(Austin)*
Susan Roberts *(Fort Worth)*

Director at Large (Three-Year Term):
(Beginning June 2017 and expiring May 2020)

Wayne Barton *(East Texas)*
Anne Carpenter *(Panhandle)*
Caitlin Chupe *(Corpus Christi)*
Phil Davis *(Permian Basin)*
Sheri DelMage *(Southeast Texas)*
Jose Luna *(Dallas)*
Misty Mata *(Corpus Christi)*
Jay Neukomm *(Victoria)*
Norm Robbins *(Fort Worth)*
Joan Schwartz *(San Angelo)*
Sean Skellenger *(Austin)*
Sally Wolfe *(Central Texas)*

Committee on Nominations:
(Beginning June 2017 and expiring May 2018)

Brandon Booker (*Fort Worth*)
Kristy Everitt *(East Texas)*
Renee Foshee *(San Antonio)*
Jimmy Hudson *(Permian Basin)*
Kelly Hunter *(Houston)*
Josh LeBlanc *(Southeast Texas)*
Adelaide Odoteye *(Abilene)*
John Perkins *(Dallas)*
Kate Rhoden *(Austin)*

As immediate past chairman of TSCPA, Kathy Kapka *(East Texas)* will automatically serve as the Nominating Committee chair. Michael Brown *(Central Texas)* was appointed as vice chair.

The following names will be submitted to the AICPA Nominating Committee as recommendations from Texas to serve on the **AICPA Council:**

Three-Year Terms: *(Beginning 2017 and expiring 2020)*

Kathy Kapka *(East Texas)*
Jerry Spence *(Corpus Christi)*
Jeannette Smith *(Rio Grande Valley)*

One-Year Designee: *(Beginning 2017 and expiring 2018)*
Michael Brown *(Central Texas)*

Chairman-elect Appointees *ratified by vote of the Board of Directors at this meeting*
(One-year term – 2017-2018)

Executive Board
Wendi Christian *(Southeast Texas)*
Angela Ragan *(Central Texas)*
Bill Schneider *(Dallas)*

Committee on Nominations: Jeff Gregg *(Wichita Falls)*

Figure 2. CPA-PAC Awards

The following awards were presented to chapters for their work encouraging members to donate to the CPA-PAC.

Highest Percentage of Fund-Raising Goal
Large Chapter – Austin
Medium-sized Chapter – South Plains
Small Chapter – Rio Grande Valley

Highest Percent Increase in Members Contributing
Large Chapter – Austin
Medium-sized Chapter – Panhandle
Small Chapter – Rio Grande Valley

information about TSCPA's ongoing work in this area, read the Capitol Interest article in each issue of this publication.

TSCPA is active in the regulatory arena. The Federal Tax Policy (FTP) Committee was recognized by National Taxpayer Advocate Nina Olson in the 2016 Annual Report to Congress and in the 2017 Objectives Report to Congress. Representatives of the FTP Committee testified in San Antonio at the National Taxpayer's Public Forum on the IRS future state plan. The FTP and Business Valuations, Forensic and Litigation Services committees sent a joint letter to the Treasury and the IRS on proposed regulations for IRC section 2704 regarding family owned entity valuation discounts. The FTP Committee and the Texas State Bar Tax Section's Committee on Governmental Submissions issued a joint letter to the IRS commissioner about the shift in policy pertaining to in-person appeals conferences.

The Professional Standards Committee has issued several responses to the standards-setting bodies, including:

- FASB exposure draft – *Simplifying the Accounting for Goodwill Impairment;*
- GASB exposure drafts – *Omnibus 201X and Certain Debt Extinguishment Issues;*
- PCAOB requests for comments regarding *Post-Implementation Review: Auditing Standard No. 7;* the *Auditor's Report on an Audit of Financial Statements*; and *Proposed Amendments Relating to the Supervision of Audits*; and
- AICPA Ethics Exposure Draft – *Omnibus Proposal*.

Work is in progress to address the rapidly changing continuing professional education landscape. A virtual conference was developed on the topic of accounting in agriculture. The new Audits of Employee Benefit Plans Conference was held in partnership with the San Antonio Chapter and a new Fraud and Enterprise Risk Conference will be held in Austin in the spring. A new event, the Cowboy Cluster, will be offered this summer in the Dallas/Fort Worth area. Members who attend all three days of the new program will earn up to 24 hours of CPE credit.

To put TSCPA's resources at members' fingertips, a new website was launched at tscpa.org. As would be expected, the site was built to be accessed on mobile devices. Content is organized into three main sections: membership, CPE and advocacy. Logging in gives access to a member landing page that features profile details, upcoming events, transactions, registrations, chapter details, committees, the directory of members and a link to pay dues. The CPE section includes new search filters that allow course listings to be browsed by city, date, number of hours, topic, format and location. The second phase of improvements will include an "Amazon" model of suggested courses based on previous registrations. Also, all online courses from the CPE Foundation's vendors will be added to the catalog so that members see a more comprehensive list of options.

Look for a comprehensive report in the "Year In Review" article in the upcoming May/June issue of *Today's CPA*.

CEO/Executive Director's Report

Jodi Ann Ray, IOM, said that work has begun on the development of an updated three-year TSCPA Strategic Plan. She showed the elements of the organization's strategic path, explaining that to know where it's going, there must be a foundation based on where it has been. If everyone involved has a shared strategic vision, there will be even more success than in the past.

A CPE Task Force has been at work for several months and will report recommendations to the Executive Board this spring. One focus will be to provide additional support to chapters.

There are numerous forces affecting the accounting profession at this time. Key among them is the pipeline of future CPAs. Another is the Chartered Global Management Accountant (CGMA®) designation partnership. There are three entry points to the designation, with CPAs at the highest level. There is progress in moving the program forward. The plan is for all three phases of the CGMA learning program to be available by the end of 2017.

In the area of peer review, there are proposed changes as part of the Enhancing Audit Quality Initiative. The objective is to improve audit performance by increasing the consistency, efficiency and effectiveness of peer review program administration. Responses to the AICPA draft are due by June.

Washington Update

AICPA's Executive Vice President – Advocacy, **Mark Peterson**, touched on results from the 2016 presidential and congressional elections and what they mean for the CPA profession. The elections reflect a populist wave being felt worldwide. Republicans now control both the White House and Congress. That is smoothing the way for agreement on government funding. A regulatory and federal employee hiring freeze has been approved. The 2 for 1 Regulatory Executive Order requires departments and agencies to identify two regulations to eliminate for each new one proposed.

CPAs hold 10 seats in the House, including two from Texas. There are 62 freshmen who entered Congress. The profession can serve as a credible resource to the new members, especially when discussing tax and financial legislation.

One of the legislative issues to be dealt with is budget reconciliation. The process has been used for spending cuts in the 1980s, welfare reforms in 1996, and tax cuts in 2001 and 2003. It was used in 2010 to help pass the Affordable Care Act (ACA) and is being considered during this term as a vehicle to repeal elements of the ACA. Other issues are tax reform and changes to the Dodd-Frank Act.

AICPA issued a compendium of tax legislative proposals to correct technical problems or simplify existing provisions. It is developed for the incoming Congress every two years.

A continuing issue is mobile workforce legislation related to state personal income tax treatment of nonresidents. It has an historic amount of support by cosponsors, thanks to letters from state CPA societies. Efforts will continue.

Regulatory issues include Department of Labor changes to overtime rules and Equal Employment Opportunity Commission revisions to the EEO-1 filing form. Work on regulation of tax preparers continues. AICPA is involved on Capitol Hill regarding the aftermath of the Supreme Court case affecting state licensing boards, and is working with state CPA societies and the National Association of State Boards of Accountancy to ensure strong coordination throughout the profession. The Financial Action Task Force has focused on the role of CPAs in anti-money laundering and counter-terrorist financing initiatives after the Panama Papers leak.

Peterson closed by stating that, now more than ever, grassroots participation in government is important. CPAs must be involved in addressing issues that have a real-life impact.

85th Session of the Texas Legislature

After hearing presentations as part of Advocacy Day, members visited the state Capitol to meet with legislators and staff. For more information, see the Capitol Interest article in this issue of *Today's CPA*.

Other Business

The treasurer's report was made by **Jerry Spence**, CPA-Corpus Christi. A motion was passed for a $5 dues increase for CPA members who pay the full dues amount.

The Annual Meeting of the Accounting Education Foundation was conducted and trustees with terms beginning June 2016 were elected. **Frank Arnold**, CPA-San Antonio, was recognized as the newest Kenneth W. Hurst Fellow.

The results of TSCPA's electronic election were announced. Also, there was a vote to ratify the chairman-elect's appointees. (See Figure 1.) A report on the CPA-PAC was given. Fundraising awards were presented to chapters. (See Figure 2.)

Upcoming Events

The 2017 Annual Meeting of Members will be held in Colorado Springs at the Cheyenne Mountain Resort June 30-July 1. The Omni Corpus Christi Hotel is the site for the next Midyear Board of Directors Meeting, Jan. 26-27, 2018. ■

Report on the Texas Legislative Session in Austin

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

TSCPA Advocacy Day a Success

At the TSCPA Advocacy Day and Midyear Board of Directors Meeting, a couple hundred TSCPA members came to Austin to help us carry our message to Texas legislators. Our program was a success and even the unpredictable Texas weather cooperated, making it a beautiful day for CPAs to trek to the Capitol for personal visits with their elected representatives and senators.

At our Advocacy Day, attendees got to hear from a variety of speakers on topics ranging from what's likely to happen in the current legislative session to how to effectively communicate and establish relationships with legislators.

Rep. Angie Chen Button, Rep. John Frullo and Senator Charles Perry, all CPAs, served on a panel moderated by former Rep. John Otto, CPA, now a TSCPA lobbyist, to discuss their take on the current legislative session and a variety of topics. It was a lively session with the panelists providing very frank comments and responding to a number of questions from attendees.

Rep. Button shared that earlier on Tuesday morning, she had sponsored a resolution on the House floor acknowledging TSCPA's CPA Day at the Legislature and the important work that Texas CPAs do for the public. You can read the resolution on the TSCPA website.

All in all, it was a great meeting and we thank all of the TSCPA members who traveled to Austin to help us communicate with Texas legislators and form effective relationships with them. Members are the "heart" of our grassroots program and without them, we could not effectively represent the interests of Texas CPAs. So thanks to all who help us in this effort.

State of the State

While TSCPA Advocacy Day was the big event in January in our CPA world, in the world at large another event was also taking place. That was the governor's State of the State address. In it, Governor Greg Abbott laid out his agenda and vision to the Legislature and to the citizens of Texas.

The governor named four emergency items in his address to lawmakers, including: reforming Child Protective Services, banning sanctuary cities, implementing meaningful ethics reforms and passing a resolution calling for a convention of states. Naming these as "emergency items" means the Legislature can take immediate action on them by passing legislation in the first 60 days of the session or before March 10. Otherwise, all legislation is barred from being passed before this two-month mark.

Abbott opened his speech talking about how the state of Texas is exceptional. He noted that since his first State of the State address two years ago, more kids are graduating from high school, Texas doubled the number of tier one universities and more Texans have jobs today than ever before. Last year when oil hit bottom, Texas still added more than 200,000 new jobs. He stated that our national and international rankings continue to rise. Texas is now second in the number of *Fortune 500* companies. He also noted that if Texas were its own country, we would now be the 10th largest economy in the world. Our economy is larger than Australia, Canada and even Russia.

Following the speech, the office of the governor released a web video highlighting the governor's legislative priorities. You can view it on their website at http://gov.texas.gov/. Or you can read the speech in its entirety at http://gov.texas.gov/news/speech/20659.

The speech was not all good news, however, and in it the governor also announced he was directing state agencies to impose a hiring freeze as a way of dealing with the state's tight budget. He said the move would free up about $200 million in the current budget. He also took a dig at legislators saying the Legislature spends too much on itself. With the economy still recovering from an oil-drilling slowdown, Abbott noted that it's "a time for addressing essential needs and eliminating the nonessential wants."

Abbott earned his loudest applause from legislators when he said this session will be the one in which lawmakers ban "sanctuary cities," places where local officials do not fully cooperate with federal immigration authorities. Since his speech, the Texas Senate passed Senate Bill 4, commonly known as the "anti-sanctuary cities bill." If enacted, it would punish local government entities and college campuses that refuse to cooperate with federal immigration officials or enforce immigration laws. The bill was sponsored by Senator Charles Perry, CPA (R-Lubbock). Its fate in the Texas House is unclear.

Also since the governor's speech, the Senate unanimously passed Senate Bill 14, legislation that requires elected officials to disclose their government contracts, prevents lobbyists from concealing which legislators they wine and dine, and targets corruption by revoking pensions of elected officials convicted of felonies related to their office. The legislation also requires legislators to disclose bond counsel work and legal referral fees above $2,500 if they are not involved in the case, and eliminates the "revolving door" that allows former legislators to immediately become lobbyists. The House must now take up the legislation for consideration and vote.

Bill to Eliminate the Franchise Tax

In February, legislation was filed to abolish the state's business franchise tax over the next decade. Senate Bill 17 would reduce the franchise tax every year that the comptroller of public accounts certifies that the state will experience at least 5 percent revenue growth.

Introduced by Senate Finance Chair Jane Nelson (R-Flower Mound), she noted that based on current estimates it would mean an end to the hated business tax in 10 years. While conservative groups applauded the proposal, saying it will help grow Texas' economy, the measure falls short of a faster repeal that has been advocated by other leaders. Nelson's bill is expected to get the issue on the table for discussion with a phase-out plan rather than an immediate cut in the tax and is expected to pass in the Senate. It is not clear where the House is on this issue, but with the financial challenges of the current budget, it may not play as well in that body.

Fiscal Challenges

The biggest issue in the 2017 legislative session, bar none, is the lack of funds for the Legislature to spend. This is in stark contrast to two years ago when the state was flush with money and tax cuts were all the rage. While everyone knew it was coming, the bad news was officially delivered by State Comptroller Glenn Hegar on Jan. 9, 2017, the day before the Legislature convened. That's when he provided his revenue estimate for the biennial budget. The number came in at $104.87 billion, a 2.7 percent decrease from his estimate two years ago. However, his revenue estimate does not cover the scope of the entire Texas budget. Instead, it sets a limit on the state general fund, the portion of the budget the Legislature has the most control over. The state general fund typically covers about half of the total budget. Adding in federal funds and other revenue sources, the comptroller estimated that there will be $224.8 billion in total revenue for the 2018/19 biennium, which starts in September. That's almost $4 billion more than two years ago when it was estimated at $221 billion.

Exacerbating the fiscal problem is that in 2015, the Legislature moved to dedicate up to $5 billion in sales tax revenue every two years to the state's highway fund, rather than making it available to spend on other priorities. Folks knew this day of reckoning was coming and back in July, Texas' top elected officials (governor, lieutenant governor and speaker) directed state agencies to scale back their budget requests by 4 percent.

The comptroller estimated the state's Rainy Day Fund (derived largely from taxes on oil and gas development) will have a balance of $11.9 billion at the end of the next two-year budget, up slightly (.8 billion) from two years ago, assuming legislators don't tap that savings account this session. Generally speaking, in order to use the Rainy Day Fund, the Legislature requires a two-thirds vote. And legislators are typically not crazy about raiding the fund, so we will see if that is an option they choose.

Those in the know say the amount of general revenue available for lawmakers is in the neighborhood of $5-6 billion less than what is required to cover the current services of the state when you factor in inflation and the growth of the state. This financial challenge is going to be the number one issue in the current session.

House and Senate Far Apart on Budgets

In January, the Senate and House issued their initial "markers" on the budget by introducing base budgets to establish the state's funding priorities for the next two years. The two chambers are very far apart in their plans.

The Senate budget allocates $103.6 billion of the $104.9 billion the Legislature will have available and includes additional resources for transportation, Child Protective Services and other priorities. It eliminates one-time expenditures from the previous budget, includes many agency recommendations for 4 percent savings, reduces funding for non-educational higher education initiatives and calls for a 1.5 percent across-the-board budget reduction, exempting the Foundation School Program.

The initial 2018-19 budget introduced by Texas House leadership puts additional resources into public education, child protection and mental health while increasing state spending by less than 1 percent without raising taxes. It appropriates $108.9 billion in general revenue. It reduces funding for administrative costs and discretionary programs across state agencies. It eliminates one-time funding provided by the last Legislature, such as completed capital and information technology projects. It also includes cost-containment efforts to reduce spending in Medicaid by $100 million.

The House budget provides funding to pay for expected enrollment growth of about 165,000 students over the next two years. It also includes an additional $1.5 billion for public education that is contingent upon the passage of legislation that reduces recapture and improves equity in the school finance system.

The Legislative Budget Board has the fine print of both the House and Senate plans, which you can find at http://www.lbb.state.tx.us/.

TSCPA Legislative Agenda

TSCPA's limited legislative agenda for 2017, approved by our Legislative Advisory Committee (LAC) and Executive Board, includes the following items.

TSCPA is seeking to repeal Chapter 2266 of the Texas Government Code relating to the acceptable financial accounting and reporting standards for use by state and local governmental entities. This chapter gives governmental entities in Texas the ability to opt out of following GAAP as it relates to other postemployment benefits and use a statutory modified accrual basis of accounting.

In February, Senator Charles Perry, CPA, filed a bill requiring state and local governments to follow GAAP. It is SB 753 and you can read it here: http://www.legis.state.tx.us/tlodocs/85R/billtext/pdf/SB00753I.pdf#navpanes=0. It states that a regulation adopted under this section may not be inconsistent with generally accepted accounting principles as established by the Governmental Accounting Standards Board. Rep. John Frullo, CPA, introduced a bill in the House. It is HB 1930. We are hopeful we will see this legislation passed in this session and have gotten good feedback about support from our members who conducted visits with their legislators during TSCPA Advocacy Day. Our thanks to Senator Perry and Rep. Frullo for sponsoring the legislation.

Other items on TSCPA's legislative agenda include:

- TSCPA is seeking to obtain an exemption from the insurance services sales and use tax for licensed CPAs who work in a licensed CPA firm.
- TSCPA will continue opposition to any attempt to tax professional services. We don't expect anything on this front, but one never knows what can happen.
- TSCPA will stay alert to all franchise tax legislation hoping to provide reliable input to legislators interested in franchise tax reform and provide recommendations developed by the TSCPA State Taxation Committee for improving the franchise tax.

We will also be watching all legislation filed to determine any effect it may have on the profession. At press time, we do not have bill numbers on our legislative proposals, but are working on those and hope to see legislation introduced and passed before the session ends.

You can keep up with on-going legislative activity by reading our blog at http://tscpaatthecapitol.com or by following me on Twitter @jsharbaugh.

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Accounting for Accrued Workers' Compensation Costs:

Recognizing Incurred but Not Reported Accounting Liabilities

By Alan Reinstein, CPA, DBA; Avinash Arya, Ph.D.; and Natalie Tatiana Churyk, Ph.D., CPA

Workers' compensation costs represent a major portion of many manufacturing companies' production costs, which like other incurred but not reported (IBNR) liabilities are difficult to measure. While companies can self-insure or pay insurance companies to satisfy such liabilities, measuring such costs remains problematic, because the periods when the employee's output (during one's working life) often do not match easily with the ultimate workers' compensation payments. Moreover, such factors as changing state statute of limitation laws and companies idling plants due to mergers, acquisitions and other business interruptions add complexity to measuring such liabilities. This article summarizes this matter and provides examples and references of how companies and their auditors can better grasp workers' compensation concepts.

Workers' compensation insurance reimburses medical costs and lost income for workers becoming ill or injured on the job. The Bureau of Labor Statistics[1] finds the manufacturing (service) sector spending 2.1 percent (1.3 percent) of total employee costs on workers' compensation – representing 23 percent (15 percent) of legally required benefit costs. Such costs affect many industries when office workers claim they experience chronic and debilitating illnesses such as carpal tunnel syndrome and chronic fatigue, or when truck drivers and construction workers claim spinal injuries. Claims often increase with announcements of expected workforce reductions, complicating the estimation of future workers' compensation costs.[2] Per the National Academy of Social Insurance, in 2012, U.S. employers paid $83.2 billion in workers' compensation costs.[3]

In measuring workers' compensation costs, employers must estimate potential claim liabilities that exceed insurance coverage. Per the Financial Accounting Standards Board (FASB) in Accounting Standards Codification (ASC) 450-20-25-2 and 720-20-25-14, entities must accrue "probable and estimable losses" as liabilities for IBNR[4] claims and incidents, and record a corresponding expense. While guidance related to insurance costs exists,[5] little guidance exists for calculating workers' compensation IBNR. Calculations become uncertain, and potential costs and accrued liabilities may change substantially, due to such factors as:

- claims often lag the injury causing the claim,
- current claims often grow over time (e.g., sprains worsen with repetitive motion),
- external events can trigger unexpected claims (e.g., plant closings, mergers, restructurings),
- changed calculation inputs (e.g., experience rating, reportable and non-reportable conditions, severity and frequency of prior and expected claims, legislation changes), and
- laws against denying coverage based upon pre-existing medical conditions.

Auditors should diligently examine client inputs to assess the calculations' accuracy, also considering the factors discussed in this study.

In this article, we analyze workers' compensation expenses and accruals to help CPAs present and auditors attest to financial information accurately and reasonably. This includes calculation of workers' compensation insurance premiums, examples of workers' compensation calculation changes in known entities and a discussion of Texas workers' compensation.

Determining Workers' Compensation Insurance Premiums[6]

Insurance premiums fundamentally equal rate times payroll. Rate reflects expected losses and the insurance company's markup. To estimate expected losses, the National Council on Compensation Insurance (NCCI) collects insurance company data for claims filed and amounts paid for each claim under each employer's policy. It then groups employers by industry or occupational classification and state to calculate average cost or expected loss rate (ELR) by dividing total losses by total payroll for each industry/state combination. ELR is typically higher for hazardous industries, such as roofing or logging, than for low-risk industries, such as clerical or restaurant; rates increase for states with "plaintiff-friendly" legislation (e.g., legislation that grants long periods of statute of limitations to file claims).[7] Such rate determinations are also called "manual rating," which vary significantly among states.

To tailor premiums to individual employer risk characteristics, NCCI uses an Experience Rating Plan.[8] The plan uses the most recent employer three-year history of actual loss and payroll data. Based on the frequency (number of claims filed) and severity (dollar amount of lost wages or medical costs) of claims over this time relative to average or expected losses, the NCCI determines an employer's experience rating modification (Mod). Employers receive Mod calculations for each employee occupational classification and for each state where the employer operates.

The NCCI derives loss development factors (LDF) to help smooth employers workers' compensation premiums (e.g., cases where workers claim that the injury has worsened or new health problems arise). The NCCI LDF factors consider the employers' claim histories, job classifications, and states where they do business. Small changes in LDF can cause wide disparities in IBNR estimates, because companies must multiply the LDF by the entire payroll. Thus, management accountants and external auditors must carefully review this potentially high-risk account.

Examples of Workers' Compensation Calculation Changes in Known Entities

Workers' compensation often represents a large liability. Target's $467 million 2013 long-term workers' compensation liability equaled 29 percent of its total other non-current liabilities.[9] The U.S. Postal Service (USPS) had a $16.2 billion long-term 2012 workers' compensation liability.[10]

Example: IBNR Liabilities for Workers' Compensation

We now present Company X's IBNR liabilities example, using an actual engagement – but with some simplified assumptions and disguised rounded balances. Table 1 contains Company X's 2000-2014 loss data, including a $500,000 catastrophic claims deductible insurance policy. Catastrophic claims exceeding incurred losses represent amounts accrued for claims originating in those years. For example, for claims filed for 2013 injuries, the company recorded $2.2 million of actual losses. However, the accrual, as described below, will differ.

In earlier years (2000-2002) presented in Table 1, Company X's LDF is 1.000 since those years' claims were fully settled. Multiplying "incurred losses" times LDF represents estimated total losses. LDF increases for later years, indicating that much of the payout is unpaid. For example, a company has actual liabilities of $2.2 million in 2013. The LDF indicates that total estimated loss is expected to be $3,152,600 ($2.2 million x 1.433). Since claims arose recently, much of the payout will occur over several future years. The next column indicates company claim payments made. The last column indicates

continued on next page

Table 1: Loss Data for Use in Calculations

Year	Incurred Losses	Loss Development Factors [LDF]	Estimated Total Losses	Actually Paid Losses	Required Reserve as of December 31, 2014 (Undiscounted)
	A	B	C = AxB	D	E = C-D
2000	$1,310,000	1	$1,310,000	$1,300,000	$10,000
2001	1,350,000	1	1,350,000	1,300,000	50,000
2002	940,000	1	940,000	933,000	7,000
2003-2012	.	.	.	.	.
2013	2,200,000	1.433	3,152,600	1,400,000	1,752,600
2014	870,000	2.512	2,185,440	380,000	1,805,440
Total	**$32,120,000**		**$36,507,240**	**$29,499,000**	**$7,008,240**

Table 2: Employer's Payout Schedule

Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Total
2000	$10,000	$0	$0	$0	$0	$0	$0	$0	$0	$0	$10,000
2001	20,000	30,000	0	0	0	0	0	0	0	0	50,000
2002	0	0	7,000	0	0	0	0	0	0	0	7,000
2003-2012	.	.	.	.	.	.	.	.	.	.	.
2013	100,000	110,000	120,000	130,000	140,000	150,000	160,000	87,600	755,000	0	1,752,600
2014	110,000	120,000	130,000	140,000	150,000	160,000	170,000	180,000	201,440	444,000	1,805,440
Total	**$493,000**	**$833,800**	**$843,000**	**$632,300**	**$716,300**	**$708,200**	**$897,000**	**$484,200**	**$956,440**	**$444,000**	**$7,008,240**

the company's probable accruals, which for 2013 equals $3,152,600 less $1.4 million of actual paid losses – or $1,752,600.

Next, Table 2 details the time periods that the company expects to settle the claims from Table 1. The payout pattern considers the nature of individual claims, past experience of similar injuries and NCCI data. For example, for claims arising in 2002, the company expects to pay $7,000 in 2017. Total (undiscounted) payout for claims for current (2014) and prior years is $7,008,240 – as also shown in the right most cells of Tables 1 and 2.

Using a 4 percent discount (among options in Table 3, Panel A), Company X should accrue a $5,690,676 total liability. Sensitivity analysis (Table 3, Panel A) shows that expected inflation rates can significantly impact the liability. A 2 percent discount rate reduces the liability by only 10.1 percent, from its undiscounted level while a 6 percent discount rate reduces it up to 26.3 percent. Assuming Company X's opening liability per its balance sheet was $2,837,500 and $380,000 in paid 2014 claims, its accrued IBNR financial statement liability is $3,119,676 (Table 3, Panel B).

Results of Changes in Actuarial Calculations

Changing actuarial calculations affect IBNR liabilities (e.g., Los Angeles International Airport's medical expense component of workers' compensation grew 59.6 percent from 2011 to 2012).[11] Thus, changes outside of a company's control can dramatically impact recorded liabilities. In Table 1, for example, the LDF grew substantially from 2013 to 2014 due to the company expecting to receive many more 2014 claims compared to earlier periods.

Differing Discount Rates

Long-term liabilities appear at discounted amounts. Discount rate changes can greatly affect the related expense and liability. In 2012, the USPS used a 2.1 percent discount rate and increased the 2013 rate to 3 percent, lowering its 2013 workers' compensation expense by $2.7 billion.[12] Ace Limited's 2012 Form 10-K Report stated that a 1 percent change would cause a projected net loss and loss expense reserve change of about $344 million; a 9.4 percent change.[13] Companies generally face similar challenges in properly reporting workers' compensation liabilities given many factors to consider, such as LDF discount rates, state where the claims arose, plus the number and severity of claims.

Texas Workers' Compensation

Texas is the only state not requiring workers' compensation insurance, thereby allowing employees to sue their employers in the courts with no limit for workplace injuries.[14] However, building or construction employers contracting with governmental entities must provide such coverage for each employee working on the public project. [15] Texas entities should use State Department of Insurance Rate Guides[16] to compare workers' compensation coverage using (1) the Texas workers' compensation classification relativities established by the insurance commissioner; (2) its own independent company-specific relativities; or (3) NCCI loss costs. Companies using the loss costs must file a loss cost multiplier that considers other associated expenses; e.g., agents' commissions and company profits. Employers may be able to negotiate their experience modifier downward for improved loss ratios or implemented safety programs. Companies can also use optional rating plans, such as different deductibles or retrospective ratings, to reduce premiums.

A Focus on Process and Reasonableness

Companies performing workers' compensation calculations in-house must measure, by location, these factors: numbers of employees and workers' compensation claims, and estimated time-off, medical costs per claim and estimated duration for such claims. They must also estimate the long- and short-term components, noting that short-term claims often accumulate less often than long-term claims. Calculations become more complex for companies operating in multiple states, with different laws related to workers' compensation calculations.

Given the size of workers' compensation balances in calculating IBNR, accountants and their auditors should carefully review the underlying assumptions and resultant calculations. Importantly, in *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1231 (2d Cir. 10/1/1991), cert. denied, 112 Second Circuit, 1671 (1992), the court held that generally accepted

Table 3: Calculation of Incurred but not Reported (IBNR) Liabilities

Panel A: Expected Future Payments of the $7,008,240 total Liability on Discounted Basis

Discount Rate:	Present Value*	% of Required Reserve
2.00%	$6,299,611	89.90%
4.00%	$5,690,676	81.20%
6.00%	$5,164,719	73.70%

*Assumes payments for each period are made at the end of the year as shown in Table 2.

Panel B: Unreported Workers' Compensation Liability

Accrued liability discounted at 4%, 12/31/2014:		$5,690,676
[Given] Workers' Compensation Liability Balance @ 1/1/2014	$2,837,500	
Add: Interest Expense 4% (assuming a discounted beginning balance)	113,500	
Subtotal:	2,951,000	
Less: [Shown in Table 1] Workers' Compensation paid during 2014	-380,000	
Workers' Compensation Liability to be Accrued		$2,571,000
Estimated Incurred But Not Reported (IBNR) Workers' Compensation Liability		**$3,119,676**

accounting principles (GAAP) require reinsurers to estimate reasonable IBNR liabilities – but need not use a "precise actuarial method." The court stressed that all actuarial methods are somewhat inaccurate and require conjecture, especially because no one can estimate accurately the number or amounts of future claims. Thus, it focused on the calculations' process and reasonableness – rather than on their exactness.

The above complexities should help company accountants and their auditors grasp how to measure and account for workers' compensation expenses. This process often involves considerable study or outside expertise.

Footnotes

1. See Employer Costs for Employee Compensation Survey, June 2013 (Table 5), Bureau of Labor Statistics, U.S. Department of Labor.
2. Krueger, A. B., & Meyer, B. D. (2002). "Labor Supply Effects of Social Insurance." *Handbook of Public Economics*, 4, 2327-2392).
3. The most recent year for costs relate to 2012, which was published in 2014. See National Academy of Social Insurance, *Workers' Compensation: Benefits, Coverage, and Costs*, http://www.nasi.org/sites/default/files/research/NASI_Work_Comp_Year_2014.pdf
4. IBNR is the term for calculating potential claims by covered employees.
5. See, for example, ASC 720-20 and ASC 340-30.
6. See "ABC of Experience Rating" published by The National Council on Compensation Insurance (NCCI), https://www.ncci.com/documents/abc_Exp_Rating.pdf. The NCCI collects and analyzes employer and insurance company workers' compensation claim data to make its insurance rates recommendations.
7. The statute of limitations time periods for the respective states can be found at http://injury.findlaw.com/accident-injury-law/time-limits-to-bring-a-case-the-statute-of-limitations.html.
8. NCCI-calculated Experience Rating Plans, which face state approval, are mandatory plans affecting all employers that meet a state's premium eligibility criteria. Employers paying premiums below this threshold face an effective Mod of 1. Plans do not apply to California, Delaware, Michigan, New Jersey or Pennsylvania. North Dakota, Ohio, Washington and Wyoming administer their own plans and rates.
9. http://corporate.target.com/annual-reports/2012/10-K/10-K-part-II/Item-8-Financial-Statements-and-Supplementary-Data.
10. http://about.usps.com/who-we-are/financials/10k-reports/fy2013.pdf.
11. http://www.lawa.org/uploadedFiles/Investors/LAWA%20CAFR%20FY%202013%20Final.pdf.
12. http:/t.usps.com/who-we-are/financials/10k-reports/fy2013.pdf.
13. http://insurancenewsnet.com/print.aspx?id=373734&type=newswires.
14. See Texas Department of Insurance, Workers' Compensation Insurance (May 2014) http://www.tdi.texas.gov/pubs/consumer/cb030.html.
15. https://www.tdi.state.tx.us/pubs/factsheets/employerrr.pdf.
16. https://www.tdi.state.tx.us/wc/.

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The Tidal Wave of Corporate Inversion

By James G. S. Yang, M.Ph., CPA, CMA; Jason Z.-H. Lee, Ph.D.; and Li-Chun Lin, Ph.D.

There is a detrimental corporate movement currently occurring in the United States referred to as corporate inversion. Many U.S. multinational corporations are moving their domicile abroad. They renounce their U.S. legal status and become foreign corporations, taking their tax base away with them.

As a consequence, the U.S. government has lost a tremendous amount of tax revenue. The situation has been deteriorating rapidly and more seriously during the past decade.

What is a Corporate Inversion?

The U.S. government has tax jurisdiction over a U.S. corporation, but not a foreign corporation. When a multinational corporation derives income from not only the United States but also a foreign country, should the U.S. government impose taxation on both sources of income? If the answer is affirmative, it inevitably encourages a multinational corporation to develop a strategy to avoid taxation on its foreign-sourced income. If the tax rate in a foreign country is lower than that of the United States, this strategy can become quite beneficial. A "corporate inversion" is a strategy to carry out this purpose.

Changing the Tax Domicile

The strategy of corporate inversion takes many different forms. In the simplest form, a multinational corporation may just move its tax domicile from the United States to a lower-tax country, but leave all its operations intact. In other words, its headquarters address is changed to a foreign country, but all its production and sales activities remain in the United States.

As before, it has the same income from the United States and the same income from a foreign country. By doing so, this multinational is no longer a U.S.-registered corporation; it's a foreign country registered one. The U.S. government no longer has the authority to tax this foreign country registered corporation. The U.S. government can still impose tax on the U.S.-sourced income, but not on the foreign-sourced income. As a benefit, it has saved this multinational corporation from being taxed twice on its foreign-sourced income. This is an advantage of corporate inversion.

Creating a Foreign Corporation

In a more complicated form of a corporate inversion, a U.S.-parent corporation may have earnings from a foreign-controlled corporation. Both earnings are subject to U.S. taxation. To avoid taxation on the part that is foreign-sourced income, the U.S. parent corporation may form a new foreign corporation, issuing stock to both the U.S.-parent corporation and the foreign corporation it controls. The new foreign corporation now owns both the U.S.-parent corporation and the controlled foreign corporation. The new foreign corporation becomes the parent company of the U.S. parent corporation. The parent-subsidiary relationship between the U.S. parent corporation and the new foreign corporation is now flipped around. As a result, the distribution of the controlled foreign corporation's earnings to the new foreign corporation is not subject to taxation by the U.S. government, because the new foreign corporation is not a U.S. corporation. This is the advantage of employing a foreign corporation as a vehicle to avoid U.S. taxation.

There are other variations on this theme. All of these corporate inversion strategies have the primary objective of saving U.S. tax. The U.S. government stands to lose its tax revenue from foreign-sourced income.

In fact, up to 2016, 76 U.S. corporations have inverted to 14 foreign countries.[1] It has caused the U.S. Treasury Department to lose $19.5 billion in tax revenue.[2]

Factors Influencing Inversion

The rash of corporate inversions did not occur without a good reason. There may be three identifiable causes. They all are rooted in features within U.S. income tax law, as will be discussed below.

Tax Rate Differential

More often than not, the tax rate is one of the most important factors in deciding where to locate a business. The U.S. federal corporate income tax rate is 35 percent maximum.[3] By comparison with other industrialized countries, it is almost the highest. Here are some examples. At the higher end, Japan is at 37 percent, France at 34.4 percent, Brazil and India at 34 percent, Italy at 31.4 percent, Germany at 30.2 percent, Australia and Mexico at 30 percent, and Spain at 29.2 percent. At the lower end, China is at 25 percent, the United Kingdom at 20 percent, Poland at 19 percent, Canada at 15 percent and Ireland at 12.5 percent. In many tax shelter countries, there is no income tax at all, such as Bermuda, the Bahamas and the Cayman Islands.[4]

The above facts clearly demonstrate that the driving force behind the current tidal wave of corporate inversion is undoubtedly the high U.S. tax rate in contrast to those other countries.

Taxation on Worldwide Income

If a corporation is taxed on both domestic income and foreign-sourced income, it is known as the "worldwide income tax system." Whereas, if it is taxed only on its domestic income, but not on foreign-sourced income, it is termed the "territorial income tax system."

Throughout the world, 26 countries adopt the former, while only eight the latter.[5] The United States is one of the countries that adopted the worldwide income tax system.[6]

Following is an example to illustrate the difference between the territorial income tax system and the worldwide income tax system. A Canadian corporation earns $100 million income from Canada and an additional $20 million income from the United States. What is its taxable income in Canada? The answer is $100 million. The $20 million of income from the United States is not taxable in Canada, though it is still subject to taxation in the United States, because Canada adopts the territorial income tax system.

In another example to the contrary, a U.S. corporation earns $100 million income from the United States and an additional $20 million income from Canada. What is its taxable income in the U.S.? The answer is $120 million. The $20 million income from Canada is not tax free in the United States, because the United States adopts the worldwide income tax system. Nevertheless, the $20 million income from Canada is still subject to taxation in Canada, but the tax paid to the Canadian government can be claimed as a tax credit against the United States tax liability.

This tax advantage has motivated U.S. multinational corporations to move to Canada. In fact, out of 76 corporate inversions, five chose Canada.

Allowing Deferred Tax on Foreign-Sourced Income

Notwithstanding the detrimental nature of United States tax law, there is a rather intriguing tax loophole. Although foreign-sourced income is taxable in the United States, the tax payment can be deferred until cash dividends are remitted back to the United States. In other words, the tax liability is based on the foreign-sourced income earned, but the tax payment depends on cash dividends received. It implies that if no dividends are remitted back to the United States, no tax liability shall occur. This tax loophole practically neutralizes the ill effect of the worldwide income tax system; essentially, it becomes the same as the territorial income tax system. A great many multinational corporations take advantage of this tax loophole by setting up a controlled foreign corporation.

Here is how it works. A U.S. multinational corporation earns $100 million income from Canada, but remits only $80 million cash dividends back to the United States. What is its tax liability and tax payment, respectively, assuming its tax rate is 35 percent? The tax liability is $35 million ($100,000,000 x 35%), while the tax payment is $28 million ($80,000,000 x 35%). The deferred tax liability is $7 million ($35,000,000-28,000,000). The untaxed foreign income is $20 million ($100,000,000-80,000,000). If this multinational corporation never remits this $20 million income back to the United States, it will never incur any tax payment. As a result, the tax liability would be the same as that under the territorial tax system, i.e., $28 million ($80,000,000 x 35%).

The amount of untaxed foreign earnings still sitting abroad is not small. It now amounts to $2 trillion, resulting in $20 billion of losses in tax revenue in 2012 alone. In practicality, this tax deficiency is another form of a corporate inversion. A multinational corporation can earn income from abroad, but if it never remits cash dividends back to the United States, it never pays income tax.

Purposes of a Corporate Inversion

It should be noted that a multinational corporation can earn profits abroad. However, as long as these earnings are earned by a controlled foreign corporation and not distributed back to the United States, no tax will be paid on the earnings. By the 1980s, these undistributed earnings have been accumulating to an amount that was astronomic, as discussed above. There was an urgent need to distribute these earnings back to the United States without paying tax.

The strategy was to create a new foreign corporation to serve as a vehicle to enable a controlled foreign corporation to shift its earnings to this new foreign entity. It then avoided paying tax.

Escaping United States Tax on Foreign-Sourced Income

Another purpose of a corporate inversion exploits the difference in tax rates. The U.S. corporate tax rate has remained unchanged throughout its long history. By simply changing its headquarters' address from the United States to a foreign country, a corporation has legally changed its tax domicile.

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However, this strategy only escapes tax on foreign-sourced income and not the U.S.-sourced income, because this income is always taxed in the United States. If the difference in tax rates between the United States and a foreign country is large, the tax savings can be very substantial. Most of the corporate inversions in recent years belong in this category.

"ALL OF THESE CORPORATE INVERSION STRATEGIES HAVE THE PRIMARY OBJECTIVE OF SAVING U.S. TAX."

Actual Cases of a Corporate Inversion

Corporate inversion is not a new phenomenon. It started in 1982. To date, a total of 76 corporations have done so. Each one is unique, with its own purpose. Which companies have actually inverted? They can be classified into the two groups as outlined above. Following are examples of some major ones.

In 2015, Medtronic was a U.S.-registered corporation in the medical technology industry. It accumulated $13 billion from earnings in many foreign countries. It merged with Covidien, another medical concern, in Ireland. Medtronic renounced its U.S. citizenship and moved its tax domicile to Ireland. The use of the $13 billion fund in Ireland or even in the United States would not trigger the U.S. tax.[7]

Pfizer was a U.S.-registered corporation in the pharmaceutical industry. It sells its medical products around the world. In 2015, it was holding $74 billion untaxed earnings in many foreign countries. A distribution of those earnings within the U.S. would entail a tax payment of $21 billion. It merged with Allergan in Ireland in a whopping $150 billion deal. By moving its tax domicile to Ireland, it escaped the huge tax bill.[8] Unfortunately, on April 4, 2016, the Treasury Department issued new rules on corporation inversion that take effect retroactively, back for three years. As a result, the Pfizer-Allergan deal was cancelled immediately thereafter.

Coca-Cola Enterprises is a U.S.-registered corporation in the bottling business, selling its products around the world, including Spain, Germany and Great Britain. In 2015, it acquired both Coca-Cola Iberian Partners of Spain and Coca-Cola Erfrischungsgetranke of Germany, but it moved its tax domicile to Great Britain. As a benefit, its earnings from Spain, Germany and Great Britain are no longer subject to U.S. taxation. In one move, it has covered three foreign countries.[10]

All of these companies share the same purpose: Avoid U.S. tax by forming a new foreign corporation or by moving their tax domicile to a foreign country. This is the essence of a corporate inversion.

Regulations Under IRC §7874

In 2004, Congress enacted Internal Revenue Code (IRC) §7874.[11] IRC §7874 provides that only when a foreign corporation derives at least 25 percent of its revenue from a foreign country of incorporation can it be treated as a foreign corporation.[12] If not, and only if the United States shareholders own less than 60 percent of the total stock, can it also be treated as a foreign corporation? If the U.S. shareholders own at least 60 percent, but less than 80 percent, it would be treated as a "surrogate foreign corporation," which means all restrictions in this section will apply.[13] If the ownership is least 80 percent, the entire combined corporation must be treated as a U.S. domestic corporation.[14]

If the foreign corporation attempts to dilute the U.S. shareholders' ownership by issuing more stock to the open market, this additional stock does not count toward the calculation of the ownership.[15]

Restrictions Under Notice No. 2014-52

Over the next 10 years, the corporate inversion problem became worse. On Oct. 14, 2014, the Internal Revenue Service (IRS) issued Notice No. 2014-52.[16] It concerns the transactions between a controlled foreign corporation and the U.S. parent corporation that may attempt to evade tax. For example, a foreign corporation may give an inter-company loan to the U.S. corporation. In substance, it is not a loan, but a distribution of earnings from the controlled foreign corporation to the U.S. parent corporation, so is taxable.

Example: The U.S. parent corporation may set up a new foreign corporation that in turn owns the controlled foreign corporation and the U.S. parent corporation. The controlled foreign corporation can now distribute its dividends to the new foreign corporation without going through the U.S. parent corporation. The new foreign corporation can then use the funds to purchase assets or stock from the U.S. parent corporation. Nonetheless, this distribution is taxable in the United States.

Example: To circumvent the 80 percent criterion mentioned above, before a merger, the foreign corporation may intentionally acquire a great deal of nonessential assets such as cash, marketable securities or passive assets so as to reduce the U.S. shareholders' relative ownership of the foreign corporation. This transaction is void.

Example: Concerning the 80 percent ownership, before a merger, the foreign corporation may deliberately distribute a large amount of dividends to the shareholders. This has the effect of reducing the U.S. shareholders' weight within the combined corporation. This transaction is ignored.

The IRS notice imposes restrictions on these transactions for the purpose of curtailing the potential abuses of a corporate merger.

Additional Restrictions Under IRS Notice No. 2015-79

In another attempt to tackle the problem, on Nov. 19, 2015, the IRS issued Notice No. 2015-79.[17] It imposes three additional restrictions, as follows.

Under IRC §7874, to be qualified as a foreign corporation, it must derive at least 25 percent of its business operations from the country of incorporation. This notice reiterates that the foreign corporation must be a resident of the country of origin.

Also under IRC §7874, there was a concern that a U.S. corporation may just change its tax domicile to a foreign country by merging with a foreign corporation. It provides that if the U.S. shareholders still own at least 80 percent of the combined corporation, it will be treated as a U.S. domestic corporation. There might be an attempt to circumvent this 80 percent criterion by issuing more stock to foreign shareholders. This notice reiterates that the additional stock does not count on the denominator in calculating the ownership.

Further, under IRS Notice 2014-52, there was a concern about the U.S. shareholders' ownership. A foreign corporation may expand its size by issuing more stock for nonessential assets such as cash, marketable or passive assets. These are called "nonqualified assets." This notice expands "nonqualified assets" to include all assets.

The Latest New Regulations on Corporate Inversion

Pfizer's attempt to engage in a merger triggered the Treasury Department to issue new regulations on April 4, 2016, under TD-9761.[18] It contains, among others, two essential points.

First, under §7874, after the merger, if the U.S. shareholders still own at least 80 percent of the combined corporation, this combined corporation will be treated as a U.S. domestic corporation. It will lose the benefit of being a foreign corporation. There may be an attempt to circumvent this rule by issuing more stock to the foreign shareholders for cash before the merger. It has the effect of reducing the ownership by the U.S. shareholders. This strategy is known as "cash box." The new regulations provide that, if this transaction occurred three years before the merger, it is now disregarded in the denominator in calculating the said ownership.

Second, the merger between the U.S. corporation and a foreign corporation may give rise to a situation where the former becomes a subsidiary corporation while the latter the parent corporation. It may serve as a vehicle to shift the U.S. income to a foreign country. For example, a foreign corporation may provide a loan to the U.S. corporation. The latter would pay interest to the former. It has the effect of decreasing the U.S. corporation's taxable income and at the same time increasing a foreign corporation's taxable income, as well. U.S. income now becomes foreign income. This strategy is known as "earning stripping." The new regulation would treat this loan as a stock equity instead of debt instrument. The interest payment from the U.S. corporation to a foreign corporation becomes a stock dividend payment rather than an interest expense. The purpose of the loan is then nullified.

Curtailing Abuses

This article discussed the issues related to corporate inversions. It pointed out that it is a strategy to avoid U.S. tax by moving a tax domicile to a foreign country. It can also be done by setting up a controlled foreign corporation. This article also covered three factors in the U.S. tax law influencing inversion – high tax rate, worldwide income tax and deferral of tax payment – and presented actual cases of corporate inversions. In addition, the article explained the actions taken by the IRS to curtail the abuses of a corporate inversion. ■

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By Dr. Kamala Raghavan, CPA, CFF, CGMA, CFP

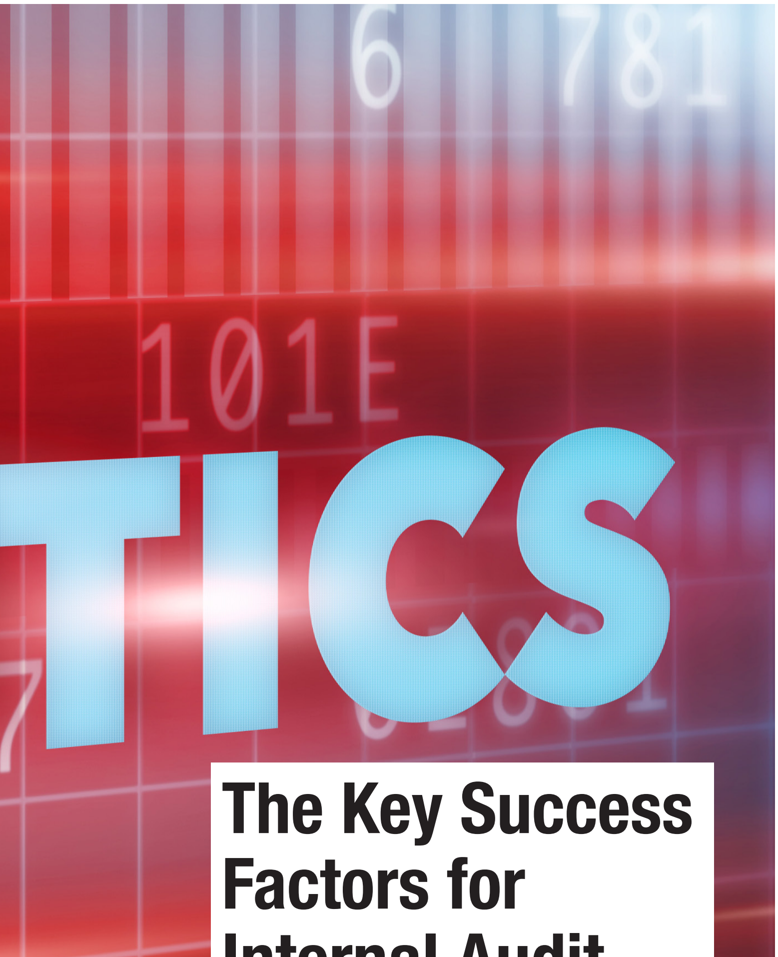
Internal auditors are dealing with competing demands of increased compliance workload due to regulations such as the Dodd-Frank Act, health care reform, anticorruption regulations, payment card industry regulations, the updated COSO internal control framework and strategic risk management responsibilities. However, many of them feel that the regulations have had positive impact on their companies and improved the governance and testing rigor, and are looking for ways to improve efficiency and emphasize value-added activities by using technology and data analytics, according to a Grant Thornton survey.

By strategically using the additional resources made available for meeting regulatory compliance challenges, internal auditors can add value by contributing to strategic, operational and financial risk management, promoting discussion across compliance functions at organizational units, upgrading staff skills, and utilizing technology and data analytics. The major findings from recent surveys can provide a road map for internal audit managers and educators to use in developing the future workforce. The following sections of this article outline the current state of data analytics used by internal auditors, its potential future applications and real-life case studies of data analytics tools used by businesses.

Current State

The Grant Thornton survey respondents felt that the regulations have had positive impact on their companies, and improved the governance and testing rigor. The same sentiment was echoed by management and audit committee respondents of an Institute of an Internal Auditors (IIA) survey. They offered suggestions to use compliance activities to strengthen the strategic risk management functions of internal auditors. Some of their recommended areas for improvement are:

- Staff skills – 40 percent of the IIA survey respondents felt that the available internal audit talent should be enhanced by conducting a skills gap assessment, providing the necessary training and/or acquiring the specialty skills.
- Technology – 33 percent of the respondents said their companies are using governance, risk and compliance-specific (GRC) technology to manage their departments and report audit plans and results, but are not effectively leveraging the technology.



The Key Success Factors for Internal Audit

- Data analytics – 60 percent of survey respondents are using data analytics and cited the top four benefits as increased efficiency; quick identification of patterns, trends and relationships; increasing internal audit coverage; and improving the strategic value of internal audit function.

The white paper "Reimagining Auditing in a Wired World" published by the Emerging Assurance Technologies Task Force of the AICPA Assurance Services Executive Committee (ASEC) explored the use of data analytics technology in future audit environments and recommended that the profession needs to achieve a "quantum leap" to redesign audit processes using today's technology, and that existing auditing standards and audit procedures should be modified to incorporate the concepts of "Big Data" (standard financial, operational and transactional data, and "unstructured" data such as tweets, social media and emails) and "continuous auditing."

Audit regulators are watching the technological developments to ensure that auditing standards facilitate improvements in auditing rather than being an obstacle to progress. The changes in audit approach needed to take advantage of the new environment will be ad-hoc and evolutionary, and audit practices will change in response to corporate processes. AICPA's Enhancing Audit Quality (EAQ) initiative is attempting to move the profession to using new audit technologies and methodologies that will facilitate continuous assurance and timely and relevant audit reporting. ASEC has also established audit data standards to identify key information and provided a common IT framework for audits.

The Institute of Chartered Accountants of England and Wales (ICAEW) issued the Program for Reform of Financial Disclosures in late 2015, and recommended changing disclosure requirements and rules to enable companies to "report separate information sets to different users, as long as all the information is available somewhere (e.g., online)."

In a business world with rapid changes and access to an unlimited supply of data, companies need to proactively anticipate and mitigate risks, and data analysis using real-time data that enhances the control environment is becoming an integral part of the process. Internal auditors are leveraging data to drive the scope and types of audits and risk assessment processes by using continuous auditing and continuous monitoring to provide more value to their employers. In continuous auditing, the internal audit staff uses technology to analyze data frequently for early identification of outliers and focus its resources. In continuous monitoring, analytics on key performance metrics are set up for management to review in real time and act on when necessary. These methods can enhance the timely, ongoing review of financial data and internal control at an organization.

Most financial professionals are limited by training and inclination to working with "structured" data that can fit readily into tables, Excel spreadsheets and financial statements, but the future may be dominated by "unstructured" data such as emails, social media messages and text, tweets, videos, photographs and the vast amounts of text floating free on the internet. Such unstructured data also includes the text found in the Management's Discussion and Analysis (MD&A) sections of company 10-Qs and 10-Ks, and in corporate press releases and interviews with corporate executives.

Use of Data Analytics Tools

Data analytics uses both traditional "structured" and "unstructured" data. An example of using analytics by a bank's call center is the technology called "natural language processing," which enables a computer to read millions of transcripts of phone calls and "diagram" sentences and phrases in mathematical terms. Companies are using data analytics in risk management by looking for patterns in their internal emails, internal audio files and on social media to spot and avert a plethora of potential risks.

The explosion of data being collected by companies of all sizes across industries and sectors has encouraged many high-profile data thefts, and has caused the corporate focus to shift from benefits of vast data in marketing to the risks of securing sensitive data. Massive thefts of data (names, credit card numbers, email addresses, passwords, etc.) beginning with the breaches of Target and Adobe

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Systems back in 2013, are continuing on a daily basis. Companies have begun to understand that data can be both a source of risk and a tool to manage the risk.

One example of assessing the data in both capacities is the "data-flow analysis," which involves tracing the location of data at different times during a business process. This method can be useful in detecting attacks on retail point-of-sale devices that copy debit or credit card data to an internal server and allows hackers to steal the credit card numbers at night from the server. Company risk managers can deploy data-flow analysis to detect an abnormally large number of queries being made on a specific aspect of a store's database during the week and compare it to normal trends. Observing an unusual number of queries can trigger a risk prevention response from the company. Another modeling technique used by credit card companies to find potential fraud is called "outlier analysis."

> "IN A BUSINESS WORLD WITH RAPID CHANGES AND ACCESS TO AN UNLIMITED SUPPLY OF DATA, COMPANIES NEED TO PROACTIVELY ANTICIPATE AND MITIGATE RISKS."

In addition to credit card transactions and other forms of "structured" data residing in spreadsheets or formal database records, a company's data also resides in "unstructured" form, such as the human speech used in natural language processing, chat rooms and email, and can play a role in increasing the risk. Risk managers are finding that technology to analyze unstructured data can provide them the ability to act almost immediately to avert hazards. Using unstructured data can limit the risks posed by the collection of more structured information, such as the items in the handwritten inventory lists traditionally employed by retailers. Among the vast array of sources of unstructured data that impact corporate risk, email ranks highest as the primary target of evidence collection for fraud examinations and in the context of lawsuits and regulatory investigations. Risk managers are finding that the unstructured data has a very rich layer of metadata revealing potential risks.

At Deloitte, email monitoring is an important part of the accounting firm's efforts to prevent the release of restricted information to the public, either accidentally or on purpose. Similarly, Dun & Bradstreet (D&B) has expanded the use of federal government compliance data culled by the credit-risk analysis firm to broader risk management purposes. Both D&B and Deloitte make use of information gleaned from the panoply of websites and applications, chat rooms, blogs and video-sharing systems collectively called social media. As the volume of messages on social media proliferate, many more companies will likely be engaged in efforts to avert the negative as much as accentuate the positive about themselves.

Future Trends

When combined with traditional auditing techniques, data analytics can provide internal auditors the ability to do continuous auditing and continuous monitoring to identify risks and anomalies as part of their system of internal control. Technology provides the opportunity to improve audits by testing complete sets of data, improve risk assessment through identification of anomalies and trends pointing auditors toward items they need to investigate further, and providing audit evidence through comprehensive analysis of companies' general ledger systems. Increased use of data analytics to aggregate data and provide information in auditing will complement the traditional skills of auditors to review, analyze and determine if the information is consistent with the auditor's expectations.

Some benefits realized by using data analytics in financial statement audits are in the audit planning and procedures to identify and assess risk by analyzing data to identify patterns, correlations and fluctuations from models. The use of such analytics is helping auditors to obtain better and new forms of audit evidence for their audit opinions and to understand fundamental causes of restatements, fraud and going-concern issues. Routine audit procedures such as bank confirmations, analytical procedures and journal-entry testing are being performed remotely, thereby freeing up auditors to focus on higher-risk and fraud testing.

The benefits derived from applying data analytics to auditing practices can far outweigh the costs by providing better risk analysis and management, a more efficient audit cycle, access to real-time data and more collaboration across units in the organization. Continuous auditing and continuous monitoring are providing benefits to be realized throughout the audit life cycle by multiple beneficiaries, including ethics and compliance, enterprise risk management and IT security functions. The real-time continuous monitoring process compresses the dynamic of audit identification and problem-solving so that the solution and status can be reported to the board along with the problem encountered.

Key Success Factors and Impact of Data Analytics

Crafting and implementing a big data and advanced analytics strategy demands the involvement of experienced managers who can apply institutional knowledge, navigate organizational hazards, make tough tradeoffs, provide authority when decision rights conflict and signal that leadership is committed to a new analytics culture. The key success factors for data analytics implementation are developing new mindsets, defining a strategy, determining what to build versus buy, securing analytics expertise, mobilizing resources, building frontline capabilities and putting leadership capacity where needed.

To be able to use the analytical tools, accounting students and professionals must become skilled in areas such as information technology, statistics and modeling. Universities are offering new courses and majors, but face resistance from the existing rigid accounting curricula. AICPA conducted a practice analysis research study to define the content of the CPA examination in 2017, and revised the CPA exam to test candidates on skills in the areas of analysis, interpretation and defense of auditors' positions, and additional emphasis on professional skepticism, data analytics, critical thinking and the integration of topics.

Real-Life Corporate Experiences

KPMG: Global audit teams can now share information across borders and with clients in a secure environment. Data analytics software has enabled the auditors to review large amounts of data points simultaneously, identify risks, provide robust audit evidence and gain broader business understanding, enabling them to ask more meaningful questions and focus on high-risk areas.

HP: When HP managers were concerned about the frequency and volume of manual journal entries, the internal audit function initiated a dashboard to enable ongoing evaluations. HP adopted a continuous auditing and continuous monitoring approach to identify the root cause of such transactions, to enable better decisions through standardized entries made under improved controls. The findings resulted in reduction of the number and risk of journal entries. The company has used continuous auditing and monitoring to make improvements in several areas. Internal auditors performing traditional field work were asked to identify three to five leading and lagging indicators in the areas they were auditing that would sustain remediation and provide new metrics to monitor, and they are planning collaboratively with the risk/compliance function to adopt a strategic and future-focused approach.

Paychex: Payroll-services company Paychex uses data analytics to improve efficiency in its internal audit operations. Internal auditors worked with the information technology department, and data analytics is benefiting the company to grow and mature.

Auspicium: This construction auditing consulting company uses data analytics on a regular basis for recalculations and trend analysis. Data analytics tools have helped find misdeeds such as collusion and bid rigging, find missing data, validate efficient controls and effectively navigate around complex issues.

Trax: A Singapore-based firm, Trax provides an image-recognition app that gathers data from photos taken of shelves at retail stores. Analytics are used to measure patterns in its website use, and the analysis enabled the business to trim its headcount costs and capital spending.

An Opportunity for Internal Auditors

The combination of explosive growth in the volume of structured and unstructured data and data analytics technology presents internal auditors with an opportunity to gain a better understanding of their organization's business units, improve the internal control processes and add value in strategic risk management processes. Data analytics will give auditors new insights about the entity's risk environment and improve analytical procedures. Auditing standards and procedures need to be updated to get the maximum benefit from the available technology.

Accounting curricula need to be restructured to include analytics, data management and critical thinking skills so that audit professionals and aspirants can keep up with needed skills and take advantage of available technological tools. Companies of all sizes and industries spend significant resources to capture and store data. Internal auditors must learn to enhance their skills at using this data for analysis to enhance strategic risk management and improve the value of the organization. ■

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Inbound Tax Planning:

What Your Clients Need To Know Before Immigrating

Part 2 – Wealth Transfer Tax Planning

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

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. Part 1 of this series, published in the January/February 2017 issue of *Today's CPA*, addressed the income tax aspects of the immigration process. In this Part 2, we will address planning for the estate tax, gift tax and generation-skipping transfer tax.

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.

As with income tax, U.S. citizens and residents are subject to worldwide taxation by the three wealth transfer taxes: the estate tax, gift tax and generation-skipping transfer tax. Nonresidents are only subject to wealth transfer taxation on their U.S.-situs assets. So, while these taxes are different from the income tax, the principle that nonresidents are taxed only on assets that are located in the United States is similar to the principal in income taxation that the United States only taxes income that is connected with the United States.

Domicile, Not Residence

Although the income tax uses an objective test to determine residence, the domicile test for the wealth transfer taxes is subjective and can produce a different result. The test is satisfied if a person is domiciled in the United States at the time of either his/her death or transfer by gift. A person acquires U.S. domicile by residing in the United States for any period of time, no matter how brief, with no definite present intention of leaving.[1] Absent that intention, a person will not acquire domicile for the purposes of wealth transfer taxation. As a result, the determination of domicile for wealth transfer tax purposes requires a determination of an individual's state of mind at the requisite moment. Once determined to be a resident under this subjective test, a resident is required to file

Forms 709 to report lifetime gifts, or the resident's estate must file a Form 706 if required to do so.

A person who is not a U.S. citizen or who does not have a U.S. domicile is a "nonresident not a citizen of the United States" for wealth transfer tax purposes.[2] For simplicity in this article, a "nonresident not a citizen of the United States" will be referred to as a "nonresident." Because this test is different than the residence test for income tax, it is possible for an individual to be a resident for income tax purposes without being a resident for wealth transfer tax purposes and vice versa.

Generally, a person's domicile continues to be the place of birth until it is affirmatively shown that the person acquired a different domicile. A person who resides in the United States without knowing when he/she will return home will not acquire a U.S. domicile. For example, a person who moved to the United States in 1940 from The Netherlands to escape the Nazis and intended to return home when it was safe did not acquire a U.S. domicile.[3] If doubt exists as to whether a new domicile has been acquired, it is likely that the person's domicile has not changed.[4]

Estate Tax

The United States only imposes the estate tax on U.S.-situs assets of nonresidents, though the estate tax is computed in the same manner as U.S. citizens and residents. As a result, the nonresident's estate tax will be equal to the excess of the taxable estate plus any adjusted taxable gifts over the tentative tax on the amount of the adjusted taxable gifts.[5] Two important differences in this calculation (but not the only differences) for the nonresident are the assets included in the estate and the availability of deductions.

A nonresident's estate will be subject to the estate tax only on U.S.-situs assets. For example, real property and tangible personal property located in the United States are included in the nonresident's estate.[6] But leases are generally not included in the gross estate.[7] Stock in corporations organized under U.S. law, but not the underlying assets, are included in the nonresident's estate.[8]

Although U.S.-situs property is included in a nonresident's gross estate, several classes of assets are excluded from the gross estate. For example, real property and tangible personal property located outside the United States are excluded from the gross estate.[9] To encourage nonresidents to loan works of art to U.S. museums, works of art owned by a nonresident are excluded if they are, at the time of death, on loan or exhibition in the United States, even though they are located in the United States.[10] Shares of stock in a corporation organized and incorporated under the laws of a foreign country are excluded.[11] The proceeds of a life insurance policy on the life of a nonresident are also excluded from the gross estate, regardless of the situs of the company that issues the policy.[12] Also exempted are debt obligations issued by a U.S. corporation and deposits with a U.S. bank if the interest would be treated as foreign source income, or would be exempt from tax as portfolio interest or the rules applicable to interest paid on deposits with U.S. banks.[13] And deposits with a foreign branch of a U.S. commercial bank will be excluded from the gross estate.[14]

Because fewer assets are included in the nonresident's gross estate for estate tax, a nonresident decedent only receives a $13,000 estate tax credit (effectively a $60,000 exemption amount),[15] as opposed to the $5,490,000 estate tax exclusion amount available for U.S. citizens and residents in 2017.[16] The nonresident decedent estate tax credit is not adjusted for inflation.

> **"A NONRESIDENT'S ESTATE WILL BE SUBJECT TO THE ESTATE TAX ONLY ON U.S.-SITUS ASSETS."**

Beyond a limited estate tax credit, nonresidents may only claim limited deductions for estate tax purposes. For example, a nonresident may deduct general expenses of administration, debts, taxes, funeral expenses and losses of the worldwide estate as a U.S. citizen or resident would.[17] However, the amount of the deduction is limited to the ratio of U.S. taxable property to worldwide assets. Additionally, it does not matter if the amounts to be deducted were incurred or expended within or without the United States.[18] To obtain these deductions, the nonresident's estate must disclose the decedent's worldwide estate on the estate tax return. No deduction will be allowed unless the value of the decedent's entire gross estate is disclosed in the estate tax return.[19] Thus, an estate must balance the ability to claim these deductions against the need to disclose.

So, if a nonresident decedent had a worldwide gross estate valued at $10,000,000, of which the U.S. gross estate is valued at $1,000,000, only 10 percent of their debts, taxes, and funeral and administration expenses would be deductible, regardless of whether they are directly attributable to the administration of the U.S. estate. Before claiming any deductions, the estate would need to report the entire $10,000,000 estate, even though only $1,000,000 would be subject to the estate tax.

Regardless of a decedent's residence, the unlimited marital deduction is not available for assets that pass to a surviving spouse who is not a U.S. citizen.[20] But the marital deduction can be obtained by using a qualified domestic trust (QDOT). An additional estate tax is imposed on distributions of corpus from the QDOT during the surviving spouse's lifetime and on the value of the QDOT corpus on the date of death of the surviving spouse.[21] The additional estate tax is generally equal to the tax that would have been due if the property had been included in the decedent's estate. The trustees are personally liable for this tax.[22]

A charitable deduction is allowed for the full amount of all bequests, legacies, devises or transfers to certain domestic recipients.[23] Generally, the recipient must be the United States;

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any U.S. state or any political subdivision or a U.S. state; the District of Columbia; any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary or educational purposes; or a trustee or trustees, or a fraternal society, order or association operating under the lodge system.[24] Unlike administrative expense and loss deductions under Code § 2106(a)(1), the charitable deduction is not proportionate to the ratio of U.S. and worldwide property. But like deductions under Code § 2106(a)(1), the charitable deduction is only allowed if the executor discloses the worldwide gross estate.[25] Again, the nonresident's executor must choose between disclosing worldwide assets and foregoing the charitable deduction.

Gift Tax

Nonresidents are subject to the gift tax on all transfers.[26] Like the estate tax, the gift tax only applies to a nonresident's gifts of U.S.-situs property and not worldwide transfers.[27] Because fewer assets have a U.S. situs for the gift tax than the estate tax, the gift tax presents less of an issue for nonresidents than the estate tax. Generally, real property and personal property physically located in the United States are subject to the gift tax.[28] So, if a nonresident were to gift $50,000 in jewelry while standing on Miami Beach, the gift would be subject to gift tax. However, if that nonresident and donee boarded a boat and headed into international waters, the same transfer would not be subject to gift tax.

A nonresident is not subject to U.S. gift tax on a transfer of property not located in the United States. Transfers of intangible property by a nonresident are not subject to the gift tax.[29] Bank deposits or Treasury bills are generally considered intangible property for gift tax purposes.[30]

Although a nonresident is not granted any lifetime exemption from gift tax, a nonresident gets many of the same deductions and exemptions as a U.S. citizen or resident. A nonresident receives the same per donee annual exclusion ($14,000 per donee in 2017) that is granted to U.S. citizens and residents on transfers of U.S.-situs assets.[31] As with U.S. citizens and residents, the payment of qualified educational and medical expenses by a nonresident is excluded from the gift tax.[32]

Generation-Skipping Transfer Tax

In addition to the estate tax and gift tax, nonresidents are generally subject to the generation-skipping transfer tax (GST tax) if the transfer is otherwise subject to the estate tax or gift tax.[33] The GST tax serves as a backstop to the estate tax and the gift tax by taxing transfers that "skip" a generation (e.g., a gift from a grandparent to a grandchild) if the transfer is subject to either the estate tax or gift tax. Although nonresidents receive GST exemption, it is not clear if that amount is $1,000,000[34] or $5,490,000 (the amount granted to U.S. citizens and residents in 2017).

Avoiding the Tax Traps

Even this brief introduction to the wealth transfer taxes shows the varied rules, exceptions, requirements and exemptions that apply to both U.S. residents and nonresidents. When combined with the income tax planning discussed in Part 1 of this series, a complex web of rules presents many traps for the unwary. The increased amount of investment in the United States 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. ■

Footnotes

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4. *Estate of Khan v. Comm'r*, T.C. Memo 1998-22 (citing *Weis v. Comm'r*, 30 B.T.A. 478, 487 (1934)).
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6. Treas. Reg. § 20.2104-1(a)(1)-(2).
7. *Estate of de Perigny v. Comm'r*, 9 T.C. 782 (1947).
8. Code § 2104(a).
9. Treas. Reg. §§ 20.2105-1(a)(1), (2).
10. Code § 2105(c).
11. Treas. Reg. § 20.2105-1(f).
12. Code § 2105(a).
13. Code §§ 2104(c); 2105(b)(1) and (3).
14. Code § 2105(b)(2).
15. Code § 2102(b)(1).
16. Code § 2010; Rev. Proc. 2016-55, Sec. 3.35, 2016-45 IRB.
17. Code § 2106(a)(1).
18. Treas. Reg. § 20.2106-2(a)(2).
19. Treas. Reg. § 20.2106-2(b).
20. Code § 2056(d)(1).
21. Code § 2056A(b).
22. Code § 2056A(b)(6).
23. Code § 2106(a)(2).
24. Code § 2106(a)(2)(A)(i)-(iii).
25. Treas. Reg. § 20.2106-1(b).
26. Code § 2501(a)(1).
27. Code § 2511(a).
28. Treas. Reg. § 25.2511-3(b)(1).
29. Code § 2501(a)(2).
30. Treas. Reg. § 25.2511-3(b)(4).
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32. Code § 2503(e).
33. Treas. Reg. § 26.2663-2(b)(1).
34. Treas. Reg. § 26.2663-2(a).

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Considering the Alternative Entity Structure of an LLC Taxed as an S-Corp

By Joseph Struble, J.D., and Katherine E. David, J.D.

Curriculum: Tax

Level: Intermediate

Designed For: Business and industry, tax practitioners

Objectives: To provide business owners and tax practitioners the necessary knowledge to consider the ramifications of setting up a business as an LLC taxed as an S-Corp

Key Topics: Taxation and other organizational aspects, including creditor protection, operational flexibility and legal ramifications of setting up businesses as LLCs taxed as S-Corps

Prerequisites: None

Advanced Preparation: None

The S-Corporation (S-Corp) is the most popular form of taxation for business entities in the United States.[1] Traditionally, most S-Corps are organized as state-law corporations. Many business owners are unaware that a limited liability company (LLC) has the ability to elect its taxation structure and may choose to be taxed as an S-Corp, a C-Corporation or a partnership.

Typically, it is most advantageous to operate a small to mid-sized business through an LLC that is taxed as a partnership. This structure provides the governance flexibility of an LLC and the tax benefits of a partnership. Compared to the S-Corp tax classification, the partnership tax classification allows for a wider range of owners,[2] special allocations of profits and losses to the members who do not match their underlying ownership percentages, [3] allocations for debt,[4] non-taxable property distributions[5] and inside basis step-ups on ownership transfers.[6] With that said, S-Corps are very popular and in some cases, business owners and their advisors prefer the S-Corp structure to a partnership. For those business owners who already use S-Corps or who are considering organizing a new business as an S-Corp, it may be worthwhile to consider the advantages of forming the S-Corp as a state-law LLC rather than as a state-law corporation.

An LLC taxed as an S-Corp can be used to combine the tax benefits of an S-Corp with the legal and liability benefits of an LLC. This article will explore the legal benefits and drawbacks of a Texas LLC taxed as an S-Corp compared with a traditional Texas corporation taxed as an S-Corp and provide an overview of some considerations to take into account in an LLC company agreement for an LLC taxed as an S-Corp. In addition, this article will briefly touch on the major considerations for a business owner contemplating a conversion from an existing corporation taxed as an S-Corp to an LLC taxed as an S-Corp.

Benefits of an LLC Versus a Corporation

While the LLC is still in its relative infancy compared to the corporate form, Texas law has recognized LLCs for 25 years and it is a well-known form of entity.[7] The original Texas LLC statute was proposed with the goal of combining pass-through taxation with the limited liability protection accorded to the shareholders of the corporation in a new entity structure that provided greater management flexibility.[8] One of the foundations of the LLC structure is that an LLC company agreement is a creature of contract.[9] LLC owners are permitted more flexibility in structuring their internal economic and governance structure than the shareholders of a corporation.[10] To achieve some

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of the same flexibility granted to LLCs, a corporation would have to extensively modify its governing documents. The following is an overview of some of the structural advantages that an LLC has over a corporation from an entity standpoint.

Creditor Protection

Under Texas law, a judgment creditor of a member of an LLC who is seeking to reach the assets of an LLC may only receive, as its exclusive remedy, a charging order against the member's LLC interest.[11] A charging order is like a lien, but with no corresponding right to foreclose upon the underlying property interest.[12] The charging order provides a creditor with the right to receive the distributions of profits from the LLC, but does not provide any right to the underlying assets owned by the LLC or control over management of the LLC.[13] If the LLC does not distribute any profits, the creditor receives nothing.[14]

In contrast, a judgment creditor of a corporate shareholder may seize the debtor's shares in the corporation and sell them at public auction.[15] Stock in a corporation is the debtor's non-exempt personal property that can be subject to levy, garnishment and turnover.[16] The ability of a creditor to seize a debtor shareholder's stock in the corporation allows the debtor to wrest both economic and voting rights away from the shareholder.

When faced with the choice of (a) retaining ownership of the underlying equity interest and management of an entity and ceding a distribution of profits or (b) giving up both ownership and voting control, almost all business owners and investors would choose the former. The ability to limit a creditor's remedy to a charging order on distributions of profits is a distinct advantage that an LLC enjoys over a corporation.

Flexibility in Organizational Control

Another benefit of an LLC over a corporation is greater flexibility in organizational control and management. By default, a Texas corporation has a tiered entity structure with a board of directors controlling the direction of the corporation, officers managing the day-to-day business operations and shareholders owning the shares.[17] In contrast, an LLC may be organized as manager or member managed.[18] In the member-managed structure, the members as the owners of the LLC take direct management control over the decisions of the LLC.[19] In a manager-managed LLC, the manager is a distinct position separate from the members, who own the equity in the LLC.[20] In this respect, a member-managed LLC is more akin to a true partnership and a manager-managed LLC is similar to a corporation.

To achieve the same level of direct owner management that a member-managed LLC enjoys, a Texas corporation would need to adopt a shareholders' agreement ceding management to the shareholders[21] or elect to be treated as a close corporation managed by the corporation's shareholders.[22] Both processes are complex endeavors that require coordination between multiple governing documents and filing instruments to create a corporate structure that would not exist otherwise.

Fewer Documents, Fewer Formalities

An LLC has the advantage of having all of the company governance and economic structure contained in a single company agreement. The company agreement is a contract between the members and the LLC that governs the LLC's internal structure, operation and the parties' relationship with one another.[23] In comparison, a corporation will need special provisions in the certificate of formation, bylaws, shareholders' agreement and stock certificates to accomplish the same purposes.[24] For clients and their advisors, maintaining consistency across a broad set of corporate documents can pose a challenge, especially when years have passed since the documents' initial drafting and the owners have changed. An LLC company agreement that is searchable, streamlined and well organized has the advantage of having everything in one place for easy reference and analysis.

In addition to fewer documents, an LLC has the benefit of having fewer formalities. A Texas corporation has numerous formal requirements, including:

- a required annual meeting,
- annual director elections,
- a requirement that a majority of the board of directors and two-thirds of eligible shareholders approve of fundamental actions (e.g., a merger or sale of substantially all assets),
- required unanimous written consent for board or shareholder action taken without a meeting,
- formal proxy voting rules and a right to dissent, and
- appraisal for dissenting shareholders in fundamental transactions.[25]

In contrast, an LLC has:

- no annual meeting requirement,
- no limit on the length of a manager's term,
- less formal proxy requirements,
- a lower threshold for managers and equity owners' approval of fundamental business decisions,
- fewer restrictions for action by written consent and no right to dissent, and
- appraisal for dissenting members in fundamental transactions (unless specifically included in an LLC's governing documents).[26]

Built-in Transfer Restrictions

By default, shares in a Texas corporation are freely transferrable.[27] In contrast, LLC interests may be freely transferred, but the transferee is treated as an assignee, unless admitted as a member.[28] An assignee of an LLC interest has a right to receive the economic distributions and company information, but does not have the voting and control rights accorded to a member of the LLC.[29] For both LLCs and corporations, these are default rules and can be modified. An LLC's statutory, built-in transfer restriction provides an additional mechanism by which economic benefits are separated from entity management, permitting flexibility for estate and succession planning, and business purposes.

Attorney Fee Recovery on a Contract Claim

In some cases, the possibility of recovering attorneys' fees on a successful contract claim can serve as an incentive to pursue a lawsuit, resulting in a substantial additional recovery for a successful plaintiff and expense for an unsuccessful defendant. Under current Texas case law, a successful plaintiff can recover attorneys' fees on a contract claim against a corporation or individual, but not on a contract claim against an LLC.[30] The Texas Legislature may fix this inconsistency in the legislative session, but it is currently Texas law and provides another benefit that a potential defendant LLC enjoys over a corporation.

Drawbacks to an LLC Taxed as an S-Corp

The primary drawbacks to an LLC taxed as an S-Corp arise from additional transaction costs, the care needed to draft the LLC's organizational documents and the required client education. Each of those elements is needed to meet and maintain an S-Corp's specific tax eligibility requirements. To the extent individuals are unfamiliar with the concept of an LLC taxed as an S-Corp, the traditional traps for the unwary that exist with S-Corps are heightened with an LLC taxed as an S-Corp.

One of the biggest potential risks in forming an LLC taxed as an S-Corp is mistakenly creating multiple classes of stock and invalidating the S-Corp election. An S-Corp must have only one class of stock with equal economic rights to distributions of profits and assets at liquidation.[31] Within the single class of stock, an S-Corp may have both voting and non-voting stock.[32] In contrast, for a typical LLC taxed as a partnership, preferred distributions and liquidation preferences often favor the economic interests of one member over another. This is not possible in an LLC taxed as an S-Corp. Owners of equity interests in an S-Corp must have equal economic rights in order to preserve the S-Corp election.

Another potential hazard arises if a member of an LLC taxed as an S-Corp transfers a membership interest in the LLC to an impermissible shareholder and inadvertently compromises the S-Corp tax election. An S-Corp can only have individuals who are U.S. persons and certain qualified trusts as its beneficial owners.[33] Partnerships, multimember LLCs and corporations cannot own S-Corps.[34] Because of a relative lack of familiarity with the LLC taxed as an S-Corp, an outside investor may see an LLC and think it is a partnership and not an S-Corp. Such an investment by a non-qualified entity would jeopardize the LLC's S-Corp election. Alternatively, if an owner of an LLC taxed as an S-Corp died and his/her estate plan transferred his/her interest to a foreign individual or a non-qualified trust, the LLC would terminate its S-Corp election.

The risks of creating two classes of stock and accidently allowing an impermissible shareholder to gain ownership arise from the S-Corp taxation requirements and are not unique to LLCs taxed as S-Corps. A corporation taxed as an S-Corp faces the same general risks. However, because attorneys, CPAs and business owners are familiar with the traditional corporation taxed as an S-Corp, these risks are somewhat mitigated because of standard drafting procedures and client education.

Company Agreement Considerations in an LLC Taxed as an S-Corp

A company agreement for an LLC taxed as an S-Corp must contain provisions that take into account the S-Corp status. As a starting

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point, a company agreement of an LLC taxed as an S-Corp must have specific provisions maintaining a single class of membership interests and allowing only persons who are eligible S-Corp owners to become members or assignees. The following discussion addresses a number of specific provisions that business owners may consider adding to the company agreement for an LLC taxed as an S-Corp to both preserve and take advantage of the S-Corp tax election.

Single Class of Membership Interests

As discussed previously, a requirement of S-Corp taxation is maintaining a single class of "stock" with equal economic rights. [35] The Internal Revenue Code focuses exclusively on economic rights; voting rights are not taken into account.[36] If the owners intend the LLC to have voting and non-voting ownership interests, it may be helpful to use the term "units" to represent the membership interests in the LLC. The number of units an individual owns divided by the total number of voting and non-voting units determines the percentage interest of the individual members. These percentage interests of the members then determine the members' rights to distribution and liquidation proceeds. [37]

The single class of "stock" requirement inherently requires equal allocations of income and distributions of income to the members in proportion to their respective membership interests in the LLC. This requirement eliminates the need for capital accounts. In addition, to maintain identical rights to liquidation proceeds, the liquidation provisions of the company agreement should provide that upon the payment of expenses and debts that the remaining assets of the LLC will be distributed to the members in accordance with their percentage interests in the LLC.

Ownership Restrictions

As discussed previously, an S-Corp has stringent ownership restrictions that limit eligible owners to individuals who are U.S. persons or qualified trusts.[38] Transfer restrictions that specifically limit transfers to only qualified S-Corp owners should be included in the company agreement. Company agreements often contain a requirement of approval of a majority or super-majority interest of the members to approve a transfer of membership interests and a subsequent vote of a majority or super-majority interest of the members to admit a transferee as a member.

An LLC can still maintain this standard two-tiered transfer approval process, but should take additional care to maintain the single class of stock by not inadvertently creating a non-economic member with voting rights, but no corresponding economic rights. An LLC can accomplish this by suspending the voting rights of a member who transfers economic rights without a corresponding admission of the transferee as a member. In addition, if the LLC is a closely held family business that allows for some degree of less restrictive intra-familial transfers while restricting transfers outside of the family, the definition of an eligible family transferee needs to track the eligibility requirements for qualified S-Corp owners.

Special Tax Elections

To maintain and take advantage of its S-Corp tax election, a company should consider including several tax-related provisions. First, the company agreement should provide that the LLC intends to be classified as an S-Corp for tax purposes and that its governing persons will take all reasonable actions to ensure the company maintains its S-Corp classification. In addition, the members should consider including a provision allowing the LLC to make an I.R.C. § 1377(a) election to close the taxable year on the sale of a member's entire interest in the LLC. This provision will allow the LLC to maintain two separate tax years in the year of disposition of a member's interest and to allocate the LLC's income to the appropriate owner. The members should also consider including a requirement to opt-in to an I.R.C. § 338(h)(10) election, which allows for a stock sale to be treated as an asset acquisition, without the unanimous vote of the shareholders, and adding a related drag-along provision for minority shareholders.[39]

Terminating Events and Buy-Sell Floor Price

The Treasury regulations addressing buy-sell agreements in S-Corps provide that an agreement to redeem or purchase stock at the time of death, divorce, disability or termination of employment will be disregarded in determining whether a corporation's shares of stock confer identical rights to distribution and liquidation proceeds.[40] Notably absent from this buy-sell safe harbor are bankruptcy and a failure to be a qualified owner of S-Corp stock – two events that many equity owners would want to be considered as terminating events triggering a buy-out provision.

Taking into consideration these nuances in the buy-sell provisions of the S-Corp regulations, a company agreement could provide that the buy-out price for a member's interest upon the occurrence of a terminating event is set at the floor of book value. By setting the floor for a forced purchase at book value, the LLC may take advantage of the safe harbor buy-out price provided in Treasury regulations § 1.1361-1(l)(iii)(A).

Conversion of an Existing S-Corp to an LLC Taxed as an S-Corp

Advanced planning is crucial for a corporation taxed as an S-Corp that is considering a conversion into an LLC or another entity form. The costs of a conversion include a review of existing contracts and loans for the possible consequences of a conversion, preparation of legal documents, including conversion documents and new governing documents for the entity, state filing fees, and providing notice of the name change and conversion to existing customers and vendors. No tax consequences will likely arise in a conversion from a corporation taxed as an S-Corp to an LLC taxed as an S-Corp if there are not any corresponding changes in ownership.

Company debt and contracts are two areas that require special attention before proceeding with an entity conversion. If a company has a loan or a revolving line of credit in place, a change in entity form without lender consent may breach a loan covenant and trigger an event of default under the loan documents. To avoid an inadvertent default, a company should examine its loan documents to determine whether a conversion would trigger a default, what consents its lender requires and then, if necessary, obtain those consents from the lender before proceeding with a conversion. In addition, although some contracts may not contain specific provisions that would be breached on a change in entity form, a company would be prudent to examine its material contracts to ascertain with certainty whether any provisions would be breached on a conversion.

An Alternative Worth Considering

Most small to mid-size businesses find being taxed as a partnership advantageous, but for those committed to the S-Corp, the LLC taxed as an S-Corp represents an alternative entity structure worth considering. The LLC entity form enjoys many structural advantages over the corporation.

An LLC taxed as an S-Corp presents unique challenges in management and structuring that are different from those of a corporation taxed as an S-Corp. Nevertheless, when properly structured and managed, the LLC taxed as an S-Corp can combine the tax benefits of an S-Corp with the legal and liability benefits of an LLC. ■

Footnotes

1. In 2012, the most recent year for which data is available, the IRS received 4,205,452 tax returns filed by S-Corps compared to 3,388,561 tax returns for all forms of partnerships and 1,617,739 for C-Corporations. SOI Tax Stats – Integrated Business Data, Table 1: Selected financial data on businesses, https://www.irs.gov/uac/soi-tax-stats-integrated-business-data (last visited Aug. 8, 2016).
2. No comparable provision to I.R.C. § 1361(b)(1) exists for partnerships.
3. Compare I.R.C. § 704(b) with §§ 1366(b)(1)(D), 1366(a)(1).
4. Compare I.R.C. §§ 722, 752 with § 1366(d)(1).
5. Compare I.R.C. § 731 with §§ 301, 311, 331, 336.
6. I.R.C. § 754 provides that in the case of certain distributions and certain dispositions, the partnership may file an election to step up the basis of the assets of the partnership. There is no comparable S-Corp provision.
7. The original version of the Texas Limited Liability Company Act was passed in 1991. Acts 1991, 72nd Leg., R.S., Ch. 901. In contrast, the Texas Business Corporation Act was passed in 1955 to replace older corporate statutes. Acts 1955, 54th Leg., R.S., Ch. 64.
8. House Comm. Business and Commerce, Bill Analysis, Tex. H.B. 278, 72nd Leg. R.S. (1991).
9. Tex. Bus. Org. Code § 101.052(a); *Seven Hills Commercial, LLC* v. Mirabal Custom Homes, Inc., 442 S.W.3d 706, 720 (Tex. App.-Dallas 2014, pet. denied).
10. See Tex. Bus. Org. Code §§ 101.052(c), 101.053.
11. Tex. Bus. Orgs. Code § 101.112(d), (f).
12. Id. § 101.112(c).
13. Id. § 101.112(b).
14. In re Prodigy Services, No. 14-14-00248-CV, 2014 WL 2936928, at *20 (Tex. App. Houston [14th] June 26, 2014, orig. proceeding) (mem. op.), affirmed on appeal, *Spates v. Office of the AG*, 485 S.W.3d 546, 556 (Tex. App.-Houston [14th] 2016, no pet.).
15. Tex. R. Civ. P. 649, 650.
16. Tex. Bus. Orgs. Code § 21.801; Tex. Bus. & Comm. Code § 8.112; Tex. R. Civ. P. 641 (levy), 669 (garnishment).
17. Tex. Bus. Orgs. Code §§ 21.401 (director powers), 21.417 (officers), 21.201 (shareholders). A Texas corporation is required to elect at a minimum a president and secretary as officers. Id. § 21.417. There is no requirement for having officers in a Texas LLC.
18. Tex. Bus. Orgs. Code § 101.251.
19. Id.
20. Id. §§ 101.106, 101.251.
21. Id. §§ 21.101(a)(2), 21.106.
22. Id. §§ 21.705, 21.713, 21.718, 21.725-.729.
23. Id. § 101.052(a); *Seven Hills Commercial, LLC*, 442 S.W.3d at 720.
24. Id. §§ 21.057 (bylaws), 21.101 (shareholders' agreement), 21.103 (stock certificate legend requirements).
25. Id. §§ 21.351 (annual meeting), 21.407 (director elections), 21.364(b) (fundamental action), 6.201 (shareholder unanimous written consent), 21.415(b) (director unanimous written consent), 21.367-.371 (proxy rules), 21.460 (dissent and appraisal).
26. Id. §§ 101.303 (manager's term), 101.356(b)-(c) (approval required for fundamental action), 101.358(b) (written consent requirement),101.351 (b)-(c) (no right to dissent and appraisal).
27. Tex. Bus. Orgs. Code § 2.209; Tex. Bus. & Comm. Code § 8.301-.302. Depending on an entity's ownership, management and capitalization structure, both LLC membership interests and shares in a corporation may be classified as a security and subject to state and federal securities laws that impose additional restrictions on transferability.
28. Tex. Bus. Orgs. Code § 101.108.
29. Id.
30. See *Fleming & Assocs., L.L.P. v. Barton*, 425 S.W.3d 560, 574-576 (Tex. App.-Houston [14th] 2014, pet. denied) (holding that attorneys' fee recovery in a contract case is limited to suits against individuals and corporations).
31. I.R.C. § 1361(b)(1)(D).
32. Treas. Reg. § 1.1361-1(1).
33. I.R.C. § 1361(b)(1)(B), (C).
34. Id.
35. Treas. Reg. § 1.1361-1(1).
36. Id.
37. It is also possible to arrive at the same conclusion by using percentage interests without the intervening use of the term units. However, because of the quasi-stock nomenclature attributable to units, the use of units to represent membership interests can provide an intuitive bridge between the corporate and LLC concepts. inherit in the LLC taxed as S-Corp structure.
38. I.R.C. § 1361(b)(1)(B), (C). U.S. persons include U.S. citizens and resident aliens. I.R.C. § 7701(a)(30); see also I.R.C. § 7701(b)(1)(A), (B) (defining resident and non-resident alien).
39. Treas. Reg. § 1.338(h)(10)-1(c)(3).
40. Treas. Reg. § 1.1361-1(l)(2)(iii)(B).

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By Joseph Struble, J.D., and Katherine E. David, J.D.

Considering the Alternative Entity Structure of an LLC Taxed as an S-Corp

1 Which of the following is not a tax advantage that an LLC taxed as a partnership has over an LLC taxed as an S-Corp?

A. An LLC taxed as a partnership has fewer restrictions on who can be an owner
B. An LLC taxed as a partnership may distribute appreciated property to its members without the members recognizing gain
C. The members of an LLC taxed as a partnership receive lower ordinary income tax rate treatment for profit distributions
D. A member of an LLC taxed as a partnership can receive special allocations and distributions of profits that do not match the member's underlying ownership percentage in the LLC

2 A judgment creditor of a member of an LLC taxed as an S-Corp who obtains a charging order against the LLC may:

A. Seize control of the voting and management rights of the LLC
B. Receive the distributions of profits from the LLC attributable to the debtor member
C. Seize the debtor member's membership interest and sell it at a public auction
D. Force the LLC to declare bankruptcy

3 True or false, a person who buys membership interests from a member of an LLC is automatically admitted as a member of the LLC?

A. True **B.** False

4 In order to achieve the same level of direct-owner management that a member-managed LLC taxed as an S-Corp enjoys, a Texas corporation taxed as an S-Corp would need to do the following:

A. Adopt a shareholders' agreement ceding management to the shareholders
B. Elect to be treated as a close corporation managed by the corporation's shareholders
C. Make a notation on the legend of the corporation's stock certificates that the corporation is managed by its shareholders
D. Either a or b

5 Which of the following is not an advantage of an LLC taxed as an S-Corp when compared to a corporation taxed as an S-Corp?

A. Increased liability protection from tort lawsuits for owners
B. Increased creditor protection
C. Fewer documents and formalities
D. Greater flexibility in organizational control

6 True or false, a successful plaintiff can recover attorney's fees on a contract claim against an LLC taxed as an S-Corp in Texas state courts.

A. True **B.** False

7 True or false, an LLC taxed as an S-Corp may have both voting and non-voting classes of membership interests.

A. True **B.** False

8 Which of the following may be an owner of an LLC taxed as an S-Corp?

A. A non-U.S. person living in Mexico
B. A multi-member LLC taxed as a partnership
C. A limited partnership taxed as a partnership
D. None of the above

9 To take advantage of the safe harbor provisions in the Treasury regulations, an LLC taxed as an S-Corp with buy-sell provisions that are triggered upon the occurrence of a member's bankruptcy or failure to be a qualified owner of S-Corp stock may want to set a buy-sell price floor at _________.

A. Book value
B. Fair market value
C. 70 percent of fair market value
D. A fixed dollar amount

10 Which of the following is not a cost of converting from a corporation taxed as an S-Corp to an LLC taxed as an S-Corp?

A. A review of existing contracts and loans for possible consequences of a conversion
B. Preparation of legal documents, including conversion documents and new governing documents
C. Providing notice of the conversion to existing customers and vendors
D. Federal tax liability for changing entity forms

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

$216,000 gross. Ft. Worth CPA firm. Nearly 90% derived from monthly accounting services, solid fee structure, location flexible in or around Ft. Worth area. TXN1426

$164,000 gross. NE Dallas CPA firm. Loyal client base, strong fee structure and cash flow around 60%, turn-key opportunity available after 4/15/17. TNX1427

$350,000 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 tax and accounting firm. 53% tax, 47% bookkeeping, good fees yield strong cash flow, turn-key practice. 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%), bkkpg (37%), payroll (11%), other (13%), flexible transition, available after 4/15/17. TXS1174

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

$360,000 gross. Champion Forest area CPA firm. 25% tax work, 75% accounting/bkkpg, knowledgeable staff in place, strong growth in recent years. TXS1191

$795,000 gross. Rural SE TX CPA firm. Tax (45%), accounting (24%), payroll (18%), misc. (13%), staff in place and owner available for extended transition. TXS1192

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