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MAY/JUNE 2018

Today's CPA

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

TSCPA's 2017-2018

Year in Review

Empowering Members to Lead and Succeed

Pass-Through Entities Not Left Out of Tax Reform

Are You Depleted? The Role of Ego Depletion in Accounting

A Primer on Mergers and Acquisitions Due Diligence for CPAs

Tax Court Jurisdiction is Not Automatic and Your Appeal Might Preclude It

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Ready to Ride?

By Jim Oliver, CPA, CGMA, 2017-2018 TSCPA Chairman

In August of my year as chairman-elect, I spotted a sign with this saying that may be familiar to you, but was new to me: "If you climb in the saddle, be ready for the ride." When I spoke at the chapter presidents-elect orientation a few weeks later, I borrowed that expression to apply to the importance of our being prepared to lead during our year.

At the time, I recalled summer vacation trail rides with my girls in which every horse seemingly had its own personality. Some stuck to the well-worn trail at an unchanging, plodding pace; another might bolt in its own direction; and the most stubborn would simply refuse to move. Occasionally, we might even get a horse that would go exactly where we wanted at the pace we desired. We never knew what to expect, so each ride was different, but thankfully, we always arrived safely back at the stables.

Looking back at this past year in the saddle, what a ride it has been … and, as with those trail rides, not exactly what I expected. As it should be, my early, tentative plans yielded not only to a new strategic plan, but also to events that I could not anticipate. Hurricane Harvey brought devastation to areas where 9,000 TSCPA members live. While what many had to endure was heartbreaking, the heartwarming response of Society and Houston Chapter staff and volunteers showed just how strong the CPA sense of community is.

This past year brought strategic changes to TSCPA as we adopted TSCPA 2020 as our new strategic plan with a vision to empower our members to lead and succeed. We addressed needed governance changes with a major Bylaws revision and an updated volunteer policies and procedures manual.

We saw, among others, the following new initiatives start in support of reaching the goals of TSCPA 2020:

- Technology assessment to identify where we must improve operationally to support and empower our members;
- Chapter audit to gain an overview of chapter operations to see how the Society may assist;
- Brand audit to determine how we can best communicate the value that we offer our current and future members;
- Dues investment/structure review to determine if our current approach best serves our members;
- TSCPA Exchange to provide an online platform for an active member community that shares knowledge and resources with one another.

In my chapter visits, I met vibrant, devoted leaders and saw young, energetic and diverse volunteers with big hopes for tomorrow. I reconnected with some "old" friends with whom I had served years ago still faithfully active in their chapters. Chapter volunteers are our boots on the ground to connect with the local university accounting professors and students, engage new and longstanding members, provide community service opportunities, advocate before their local legislators and do work that can only be done locally.

> "WITHOUT OUR VOLUNTEERS, WE WOULD NOT SUCCEED."

Our cover story in *Today's CPA* this month "TSCPA's 2017-2018 Year in Review" highlights some of this year's activity. However, Coach John Wooden once said, "Don't confuse activity with achievement." Those trail rides with my girls certainly qualified as activity, but what we achieved together in our common experience was community – being a family. From my view in the saddle this year, I saw that same sense of connection and community achieved through various TSCPA and chapter activities. Our committee and chapter volunteers work hard for all of us to meet our needs, often working under the radar. Without our volunteers, we would not succeed. We are stronger together as a result, just like a family.

I am grateful to you for the opportunity and privilege to be where I could witness the dedicated work of your TSCPA and chapter staff and our volunteer leaders at all levels. I appreciate my partners and other team members at CalvettiFerguson for supporting me and caring for clients when I was unavailable. To Tavia, my wife, best friend and the love of my life, I owe more than I can repay. Lastly, I recognize that only by God's grace and provision could I have served this year, especially in those times when I saw my own inadequacies and imperfections.

Unlike the old movie cowboys, I will not ride off into the sunset …but into an amazing sunrise. A bright future lies ahead for our profession, TSCPA and our chapters, in the capable hands of talented and committed staff, enthusiastic volunteers, an engaged executive board and upcoming chairmen whom I know and trust.

You can join and mold that future by volunteering for and connecting with the TSCPA community. You just never know where that trail might lead you. Are you ready for the ride?

Jim Oliver, CPA, CGMA is a partner with Houston-based CPA firm Calvetti Ferguson and resides in San Antonio. He can be contacted at joliver@calvettiferguson.com.

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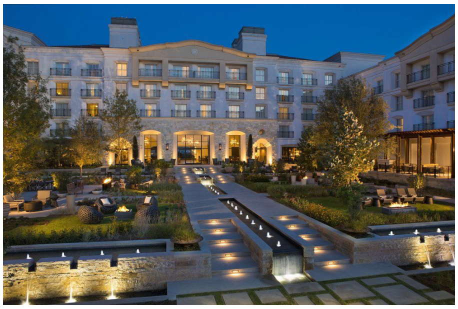

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Choice of Entity After Tax Reform

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

The choice of entity is a fundamental decision in structuring a trade or business. Tax considerations and state-law principles affecting owner liability, control and continuity play a role in the choice-of-entity analysis. A litany of other factors are important as well, including the capitalization structure and the necessity of accessing equity markets, debt requirements, employee compensation, the impact of foreign operations and exit strategies. The Tax Cuts and Jobs Act of 2017 (TCJA) introduced several new and important tax considerations.

While Congress and policymakers appear to have anticipated a flood of conversions to C corporations in light of the TCJA's new 21 percent flat corporate rate, the choice-of-entity decision is perhaps more contingent than ever on the particular facts and circumstances. And while it may buck conventional wisdom, for some taxpayers now may actually be the least expensive time in years to convert out of the C corporation form.

The Beginning. The most fundamental decision in the choice-of-entity context is whether to establish an entity or not – that is, whether the operation should be conducted as a sole proprietorship or through an entity. A sole proprietorship provides no personal liability protection to the owner. And from a tax perspective, the owner reports the tax activity directly on his/her personal tax return.

An entity, on the other hand, may provide owners with a degree of liability protection. The bread-and-butter state law entity structures include a limited liability company (LLC), partnership (general and limited) and corporation, although there are other more exotic structures. LLCs, limited partnerships and corporations provide owners with a degree of liability protection, but judicial doctrines – such as piercing the corporate veil and alter ego – can sometimes limit those protections where entity formalities are not properly followed.

The Federal Tax Classification Options. A single-member LLC can be taxed, for federal tax purposes, in one of two manners: as a disregarded entity or as a corporation (which, if qualified, may then be eligible to make a "S" corporation election). A multi-member LLC can be taxed as a partnership or corporation. A partnership may be taxed, again for federal tax purposes, as a partnership or a corporation, if it so elects. Finally, a corporation can generally be taxed as a "C" corporation or, if it so qualifies and elects, as a "S" corporation.

C Corporations. C corporation activities are taxed under a two-tier tax system. Corporate income is first subject to tax at the corporate level. Under the TCJA, the corporate tax rate was amended from a progressive rate structure with a top tax rate of 35 percent, to a flat 21 percent corporate rate. The new 21 percent rate also applies to personal service corporations. For some smaller corporations that were previously subject to a 15 percent rate, this new flat rate may actually result in an increased tax rate.

Income that is distributed to shareholders is then subject to a second level of tax as a dividend to the extent of corporate earnings and profits. A dividend is generally subject to a 15 or 20 percent qualified dividend rate plus (for some higher-earning taxpayers) a 3.8 percent net investment income tax. As a result of this two-tier tax system, the combined federal tax rate to get earnings out of corporate solution for a taxpayer subject to tax at the highest marginal tax rate equates to approximately 39.8 percent.

Passthroughs – Partnerships and S Corporations. Compared to the two-tier C corporation tax regime, partnerships and S corporations – even post tax reform – generally offer one level of taxation.

Partnerships. For federal tax purposes, the income and deductions from a partnership flow through to, and are reported on the returns of, its partners. Partners calculate tax based upon their applicable tax rates. Partnerships tend to offer the greatest level of flexibility in structuring partner compensation. That flexibility, however, can also create greater accounting complexities.

S Corporations. S corporations function somewhat similarly in that, with some exceptions, income and losses flow through to shareholders. S corporations, however, offer less flexibility due to restrictions that limit the number and type of shareholders, the one-class-of-stock rule, and a requirement that income and losses flow through in a pro rata manner. For some, however, this simplicity may be a virtue and may decrease accounting costs and other complexities.

The Section 199A Deduction for Qualified Business Income. The TCJA enacted new section 199A, which generally provides a deduction equal to 20 percent of "qualified business income" (QBI). QBI from flow-through entities – including sole proprietorships, partnerships or S corporations – is generally eligible for a 20 percent deduction. However, the deduction is not available to owners of entities in certain industries – so-called "specified service trades or businesses" – except to the extent that their owners have taxable income below certain thresholds.

Specified service trades or businesses include any trade or business engaged in the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset is the reputation or skill of one or more of its employees, or that involves the performance of services that consist of investing and investment management, trading or dealing in securities (as defined in section 475(c)(2)), partnership interests or commodities.

Where it applies, the 20 percent QBI deduction effectively provides for a top marginal tax rate of 29.6 percent on QBI. But as demonstrated above, the availability of the QBI deduction can vary depending on the passthrough's industry and the income levels of its owners – factors that add a layer of complexity into the mix.

Tax Rates. In comparing entity structures, advisors should consider the different tax rates that apply. However, advisors should also recognize that corporations may present opportunities to mitigate the two-tier tax system, such as through wage payments to shareholder/employees or through debt arrangements. Moreover, advisors should factor in the time value of money and the owner's exit strategy and time horizon. For example, where owners intend to reinvest earnings over a lengthy period of time, the lower 21 percent corporate tax rate may create a significant tax advantage depending on the time horizon.

The Bipartisan Budget Act. When considering the partnership form, advisors should also consider the implications of the Bipartisan Budget Act (BBA). The new partnership audit rules under the BBA repeal the TEFRA audit rules and dramatically change the regime that currently governs partnership tax audits, assessments and collection. The BBA imposes a new, centralized partnership audit regime that generally provides for the assessment and collection of tax at the partnership level. These new rules will have a dramatic impact on partner rights and the valuation of partnerships, creating a number of complexities for partnerships and impacting the choice-of-entity analysis.

Other Tax Considerations. Other tax factors should be considered, as well. For example, only corporations provide owners with the potential exclusion of gain on the sale of qualified small business stock under section 1202. C corporations, however, must also consider the accumulated earnings tax, which can impact corporations that retain funds beyond their reasonable needs. The ability to deduct losses is another factor that is relevant to the choice-of-entity analysis.

Foreign Operations. Foreign operations have always complicated the choice-of-entity analysis. This is particularly true after the TCJA. While a more in-depth analysis of the foreign factors is beyond the scope of this article, practitioners should be aware that the TCJA introduced a number of new considerations. Notably, the TCJA created a quasi-territorial system of taxation. Domestic C corporations now receive a 100 percent deduction with respect to the foreign-source portion of dividends received from certain foreign subsidiaries. This deduction is not available to passthrough entities. Other tax law changes, such as clarification on the impact of a foreign partner's sale of a partnership interest, may also be relevant.

Conversions

In light of these and other considerations, some entities may consider converting into another form. Below is a high-level summary of the general potential tax impact related to such conversions.

Partnership to Corporation. Partnership conversions into a corporation (C or S corporation) are generally tax free. Tax may be triggered, however, if partnership liabilities exceed the partnership's basis in its assets at the time of conversion.

S Corporation to C Corporation. An S corporation may convert into a C corporation on a tax-free basis. S corporations that convert to C corporation status are allowed to attribute distributions during the post-termination transition period to the accumulated adjustment account (AAA). For distributions occurring after that period, the distribution is treated as in part from the AAA and in part from prior C corporation earnings and profits.

C Corporation to Partnership. A conversion by a C corporation into a partnership is treated as a taxable liquidation, leading to a potential tax event at both the corporate and shareholder level. The cost of such a conversion, however, is historically relatively low in light of the reduction in corporate tax rates under the TCJA.

C Corporation to S Corporation. Finally, with certain limited exceptions, a C corporation's conversion to an S corporation generally does not result in immediate tax liability. However, such a conversion may lead to built-in-gain taxation to the extent the new S corporation disposes of assets during a five-year period following the conversion.

> **"NOTABLY, THE TCJA CREATED A QUASI-TERRITORIAL SYSTEM OF TAXATION"**

Concluding Remarks

As the factors above make clear, the choice-of-entity decision is not a one-size-fits-all analysis and is, perhaps more than ever, dependent upon the particular facts and circumstances. Taxpayers and advisors should consider the applicable effective tax rates in light of decreases in corporate tax rates and the enactment of Section 199A's deduction for qualified business income. They must, however, also consider other factors, such as the impact of the BBA, section 1202 and other unique factors, as well as the impact of foreign operations. ■

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Leading With Purpose

By Mano Mahadeva, CPA, MBA | Column Editor

The past 12 months have been an action-packed year in the world of corporate governance, with 2018 shaping up to be an equally demanding year for corporate boards. Mismanagement, disasters, corporate fraud, ethical scandals and workplace violence highlight a renewed focus for good governance, placing greater demands on independent directors.

Blood testing firm Theranos announced major layoffs after voiding nearly one million blood test results due to its proprietary machines producing unreliable test results. Equifax, which suffered a data breach impacting nearly 149 million consumers, failed to install security updates in a timely manner. Several prominent executives lost their jobs following alleged misdeeds of sexual misconduct that occurred in their past. General Electric announced intentions to restate earnings, disclosed a $6.2 billion after-tax charge to address problems with its insurance subsidy and is overhauling its board. Wells Fargo agreed to a $185 million settlement over opening as many as 3.5 million accounts with fictitious or unauthorized information.

With these and every additional company that unravels, the public becomes incrementally more cynical and trusts a little less.

Boards face more uncertainty today and at times, more danger than in the past. Companies are growing bigger and have complicated structures. Many forces – regulation, cybersecurity, geopolitical risk, business models, activists, national politics and customer preferences – have created disruptions across companies, creating challenges for directors in keeping up with their businesses and industries. Disruption is happening faster than ever, so companies need to develop a systematic approach to deal with change by accelerating discovery, scanning ruthlessly, confronting biases and preparing for surprises.

The superficial answer might be that we draw a group of independent directors from a deep well of acquired capabilities, knowledge, talents and teamwork. Those chosen feel free to contribute to all discussions with all their voices being heard. All members understand the rules of engagement and are comfortable with, and abide by, the expected norms of behavior and have productive contributions. But in reality, many boards are not equipped to take charge, as individual director levels of readiness, experience, talent and ability invariably vary. And roles and responsibilities of directors vary depending on their company circumstance and on its stage of development.

The board of directors' purpose is to act in the best interests of their companies and be unbiased in their dealing with shareholders. They get involved with investments, acquisitions, CEO selection and compensation, tender offers and company audits. They provide a set of checks and balances by offering safeguards and oversight over the activities of management. They establish policies and make significant strategic choices. Simply, they are responsible for the performance of their companies. However, it is clear from the sample of companies above, problems exist in many areas of oversight.

These areas can be organized under three broad groupings – a first grouping relating to management. The board depends on management for information as they work toward common goals. A demanding demeanor can create an unpleasant working relationship, possibly creating conflict avoidance. Directors could be close to management as they may share the same social circles and are more friends than business partners. This could lead to a "no questions asked, do not rock the boat" environment, leading to a rubber-stamped or check-the-list agenda.

A second problem area relates to the organization and structure of the board, which starts with the chair. If the chair and CEO are the same, conflicts abound. And if the chair does not have the knowledge, experience and/or leadership capabilities, the board is likely to lack a process and/or have a structural deficiency in governance. If the board is too small, it is likely that the board will do less than policy setting, as they may not have enough directors to place on committees. The lack of a nominating committee might lead to inexperienced directors joining a stale board.

A third problem area is that of time. If the chosen director is also the CEO or senior member of his/her company, he/she may not be able to spend the appropriate amount of time to fulfil his/her board responsibilities. If directors can offer only so much time, there is only so much the board can do, which might lead to more short-termism instead of a long-term view and a focus on tactics and dealing with daily "fire fights" instead of on strategy.

A diverse, committed group of independent directors is required for a board to be effective. We must determine the specific capabilities and expertise needed and recruit individuals who possess them. These individuals need to understand what their roles and responsibilities are in governing and leading, and how these differ from staff's duties. Those who have the courage to probe deeper, display good judgement, have high ethical standards and can spend the required time should be sought out.

It is also very important that these new directors receive appropriate onboarding to be effective in their roles. The present business environment provides an excellent opportunity for finance leaders to showcase their capabilities as able stewards of any willing organization.

Mano Mahadeva, CPA serves on the Editorial Board for TSCPA. He can be reached at manomahadeva@gmail.com.

Is There a Blockchain in Your Future?

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

Should you and I learn as much as we can about blockchain this year? The answer to that question is decidedly "yes." Implementation of blockchain technology is having a significant impact on accounting and auditing.

What is Blockchain and How Will it Impact Accounting?

Blockchain is a global digital ledger of transactions that is decentralized, transparent, continuously updated by countless users and considered by many as almost impossible to corrupt or hack. While invented to help transact bitcoin cryptocurrency, blockchain is more than bitcoin.

We may think of a blockchain as the rails that bitcoin and other cryptocurrencies ride on. A blockchain database consists of two types of records: transactions and blocks. Blocks hold batches of transactions. Each block is timestamped and linked to a previous block. Following are some other basic facts.

1. Blockchain is secure and immutable. All blockchain entries are distributed and cryptographically sealed. In theory, a blockchain cannot be hacked, because that would require overpowering all the computers that contribute to and update the ledger (i.e., the entire internet). Immutable implies permanent, unalterable, irreversible.

Once a blockchain is created, it is accompanied by a digital fingerprint (hash string). That fingerprint is immutably timestamped on the transaction, so it's impossible to access later without entering the identical hash string. Timestamping assures that the electronic document within the blockchain is archived for storage and may not be modified over the entire document lifecycle.

2. Blockchain might be considered the "internet of value." Whereas the internet as we know it focuses on the exchange and transmission of information, blockchain centers on transactions. Instead of keeping separate records based on transaction receipts, companies write their transactions directly into a joint distributed register, creating an interlocking system of enduring accounting records.

3. The most obvious applications of blockchain technology will be accounts payable and receivable transactions in the consumer products and manufacturing industries. The technology will verify dates, quantities and payment, and there will be no question that the customer sent the payment.

Buyers and sellers collaborate in executing the transactions, which are all settled in cryptocurrency, without the assistance of an intermediary like a bank. Although consumer products and manufacturing hold the most obvious applications, there is also significant blockchain activity in the health care, technology, media and telecommunications industries.

4. Blockchain technology allows for "smart contracts" or computer programs that automatically execute transactions under certain conditions. Picture a scanning device on a receiving dock. When delivered goods pass through the scanner, the system automatically matches the information with the purchase order and vendor's invoice and, if all information matches predetermined specifications, payment of the invoice is approved and sent electronically by cryptocurrency. Blockchain backbones can also provide a home for documents of all sorts, from contracts to property deeds to birth records.

How Will Blockchain Impact Auditing?

Blockchain has tremendous implications for auditing. Accessing a digitized timestamped transaction within a blockchain requires searching for it by providing the identical hash string, applying an appropriate audit procedure and returning the audited transaction to the ledger with a notation that it has been audited. The audited record has a different timestamp, so the entire audit trail of the information is retained.

Since blockchain transactions are digital, they are processed faster than traditional methods. Whereas the traditional audit can only be performed after the fact on historical data, often taking weeks or months, use of blockchain technology will allow for real-time continuous auditing, making the year-end audit process much more timely. Auditors will have to become more involved with the data on a real-time basis, using it with a forward rather than historic perspective.

Additionally, rather than being a top-down process, starting with an account balance and using sampled transactions as a basis for the evidence supporting the audit opinion, the auditor will be able to access an entire database of transactions, identifying those that are outside pre-specified parameters and focusing on them as potentially erroneous, thus making the audit more effective. As a result, the audit may be transformed into a higher-valued service than it presently holds.

Resources

In this column, we have just scratched the surface. If you want to stay in this game, you should learn more. Here are some excellent resources:

- Lou Carlozo, "Why Finance Executives Should Care About Blockchain," *CPA Insider*, AICPA, May 8, 2017.
- Lou Carlozo, "Why CPAs Need to Get a Grip on Blockchain," *Journal of Accountancy*, June 13, 2017.
- Don and Alex Tapscott, *Blockchain Revolution: How the Technology Behind Bitcoin is changing Money, Business and the World*. Go to https://www.ted.com/talks/don_tapscott_how_the_blockchain_is_changing_money_and_business.
- Deloitte's Blockchain Institute, available at www.deloitte.com/de/blockchain.

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Is Cyber Insurance Necessary?

By Randolph P. (Randy) Johnston

Cyber-attacks are becoming more frequent, more invasive and more lucrative to bad actors. It is not a matter of if your firm will have a breach of security, it is simply a matter of when this will occur. While experts try to argue the merits and risks of using cloud providers versus premise-based solutions from a security perspective, all types of technology are vulnerable, from your mobile phone to your hosted or SaaS service.

When an attack occurs, the costs of reporting required by compliance regulations, down time and loss of data will be among the losses. Since we can't be sure that all the efforts of your technology teams on cybersecurity will keep the bad actors out, one way to mitigate that risk is to shift the risk of cybercrime to cyber insurance carriers. There are almost 100 providers of these policies today.

Public practice firms, as well as industry businesses, have a variety of regulations that must be followed for computer systems and computer-based records. For example, breach reporting laws exist in 47 states. These laws have driven recommendations to encrypt all data whether in motion over the internet or at rest on a local drive, server or storage device. However, both Tennessee and Louisiana currently require reporting a breach even if the data is encrypted.

There are other regulations that control Personally Identifiable Information (PII), Personal Health Information (PHI) or Payment Card Industry (PCI) that frequently exist in our client records or on our mobile devices. One defense you can implement is multi-factor authentication (MFA). With the March 1, 2018, changes in PCI regulations requiring MFA, the fact that many banks and other financial institutions implement MFA for larger or business accounts, as well as the requirement early in 2017 by the Internal Revenue Service (IRS) to use MFA with tax software applications, it has become clear that the minimal best practice for security is adding MFA for most businesses. If you don't have MFA or encryption, your risks increase; just like in the 1990s when not having a firewall or anti-virus software increased your risks.

Consider having security training at least once per year, but perhaps as often as four times per year. Instruction for team members on what to do, or not, and how to recognize attacks will drive up awareness, and in turn, drive down your risk. This could include simple training like recognizing bad email, not clicking through links, making sure that anti-virus software is running properly, as well as how to report and respond to a suspected issue. You can use services that test your organization with social engineering and use tools that run network vulnerability scans or external penetration tests. Studies have shown that organizations that have security as a priority from the top levels of management have more security awareness throughout the organization and have fewer security errors made.

TSCPA offers a number of CPE programs on cyber risk and cybersecurity. Go to the CPE online catalog at tscpa.org and search on "cyber."

Bad actors, whether they are individual, organized crime or state actors, have discovered that obtaining PII data can be profitable when it allows them to access bank accounts, credit cards, retirement accounts, stock holdings and other monetary instruments. While the perception of many businesses is that the bad actors only target larger players, anyone who is connected to the internet is a potential target. This is made even easier with automated cracking tools that can be obtained for less than $100. Automated tools identify specific targets with vulnerabilities, desirable characteristics for monetary gain and easy targets for infection. Malware, that is malicious software such as ransomware, can be planted that demands payment, destroys live files and backups, or simply transfers valuable data from your business to the bad actor.

The most effective attacks are the ones that occur and you never detect. If a breach occurs on your data, and you have a reporting incident, industry standards suggest that $250-$500 per person is needed. Consider if you do work for a business and obtain individuals' records as part of that work. One project could result in hundreds or thousands of breach reports required.

Just because your provider claims to have appropriate backups, security and other protections in place, what have you done to confirm this? Have you tested your restore capabilities, business continuity/disaster recovery plan or reviewed your incident response plan (IRP) lately? What about your internal controls? Have you reviewed the strength of your various controls and procedures?

To counter this risk, insurance companies have begun to offer insurance to specifically protect against the threat of digital attacks. Most of you purchase casualty and liability insurance to protect the business from unforeseeable risk. Cyber insurers either offer separate policies or riders can be added to your existing policies to assist in reporting, forensics and litigation. The policies available and related premiums and coverage are still developing. As you review policies, listen to your underwriter, but consider the cost of:

- Downtime,
- Remediation,
- Forensics and litigation,
- Reputation damage,
- Loss of data.

It would be our hope that your business is never attacked or, worse yet, breached. However, with the simplicity of today's attack tools, the value of business data and vulnerabilities in our various hardware and software systems, even if everything is perfectly implemented, there are no guarantees that your protection mechanisms will keep the bad actors out. How can you shift the risk of cybercrime? Cyber insurance.

Randy Johnston is a shareholder in K2 Enterprises, LLC, a leading provider of CPE to state CPA societies. He also owns Network Management Group, Inc., a managed services provider that provides support 24x7 from Boston to Honolulu. Concepts for this article were extracted from the Technology Update session produced as part of the K2 Technology Conferences in 2017 and from his own experience working with technology at various firms in the United States.

Chapter Leaders Compare Notes

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

Chapter leaders gathered in January to encourage each other and to soak up information about their partnership with TSCPA. President-elect nominees met for the first time and forged bonds, while presidents-elect, presidents and executive directors strengthened their connections. A steering subcommittee of former chapter presidents guided some of the discussions and shared insights from their time at the helm.

The morning began with conversations among those from similar-sized chapters. They talked about members' needs unique to their area of the state and shared real-life solutions, which are sometimes driven by chapter resources. Programs are often shaped by economies of scale, such as the number of members in a chapter who need learning opportunities for specific topics or share a niche employment category.

There were also common threads that emerged. TSCPA and other CPA societies are in a time of change regarding the sources that members turn to for continuous learning. Chapters are adapting to an increased use of education delivered through technology. Their interest in partnering with the TSCPA CPE Foundation continues to grow, as success stories from early adopters encourage others to explore options. Involvement in educating students about the variety and rewards of careers in accounting is an investment in the future of the profession and the statewide Society; chapters are the natural connection with area schools, colleges and universities to reach future CPAs.

All participants came together in a general session to learn – and have an open dialog – about their exciting role in TSCPA's new strategic plan. Session highlights:

- There is an increased level of support to aid chapters in fulfilling the vision, which is to empower members to lead and succeed.
- Assistance is available to build a local action plan based on strategic plan pillars, guidelines and measurements.
- Chapters are an integral part of the Society's image and are included in the brand audit being conducted.
- A review of the state and chapter structure compared to other associations has yielded ideas for collaboration and increased efficiencies, such as shared technology.
- Chapters are crucial in spreading the word about the group billing program, which provides special benefits to participating employers and individual members.

The last segment of the morning brought together chapter leaders and top staff with their counterparts from the state level. Presidents had lunch with the TSCPA chairman, presidents-elect dined with the chairman-elect, president-elect nominees broke bread with the chairman-elect, and executive directors ate with the president and CEO. Ideas and excitement were shared in each group.

Enabling chapter leaders to lift the level of service to members at the local level is vital to TSCPA. Providing them with a place like this to meet and tap into the power of connectivity demonstrates the Society's commitment to their success.

Making Change

TSCPA Fall Conference Planned for Emerging Professionals

By Anne McDonald Davis

A self-described "Army brat" who lived all over growing up, **Stephanie Shaner**, CPA-Fort Worth, learned a long time ago to adapt to change, which she sees as essential for becoming the best CPA possible in the years ahead. While attending a recent statewide conference in Houston geared toward new technology, her Under 40 Professionals (UP) group began brainstorming how to convey this message at the Young CPAs and Emerging Professionals Conference in fall 2018.

"Keeping up can be daunting," Shaner nods. "There are constant tax updates, always new software coming out; a lot of information in today's world. But it's like my dad says, 'Whatever happens, happens. You'll figure it out.'"

The CPAs in Shaner's UP group also value having a forum to share issues specific to budding careers, including the development of soft skills. She asserts, "There are things you just can't learn in a classroom; making the transition from technician to manager, gaining leadership experience, deciding between public and industry."

A manager in Accounting Services with Auldridge Griffin, Shaner has found that public accounting suits her: "I enjoy having tons of different clients. I even get to work in industry in a way – it's just a different company every day. I see it as the best of both worlds."

She feels particularly fortunate to have the green light from her firm when it comes to TSCPA involvement, which is not always the case elsewhere where new staff CPAs are often under pressure to work long hours and focus solely on billables. "We have two past chapter presidents at my firm," she explains. "I went along to my first chapter event with some colleagues here. The firm is very supportive and encourages us to get involved. They even sponsor some of my community volunteer activities."

One volunteer effort near and dear to Shaner is Rivertree Academy, a private Christian school that provides community-funded education for under-resourced students in the Lake Como neighborhood. She periodically helps out with their accounting needs.

She recalls: "During a CPA service day when we were cleaning up the lot next door to the school, I overheard the head of the school talking about how they needed help with QuickBooks. I spoke up and said, 'I can do that!'"

Each year, the Fort Worth Chapter also organizes and sponsors a Christmas party for Rivertree that Shaner says is "a really big deal to the kids." The chapter's Santaccountants program provides Christmas presents for the students plus offers them an Amazon wish list with a variety of items so that they are also able to shop for the others in their lives.

She beams: "For most of the Rivertree children, this is a rare opportunity to be able to give Christmas presents to their families. We also have a craft table and my catering company client donates the snacks. It's lots of fun."

Stephanie Shaner, CPA-Fort Worth

Stephanie Shaner is a volunteer for the Fort Worth Chapter's Santaccountants program

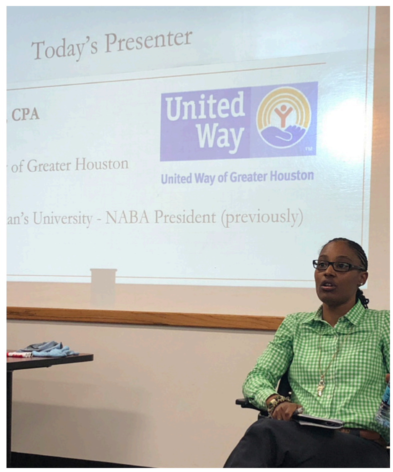
When having fun just for herself, Shaner chooses baseball. The last book she bought was on Cal Ripken. "I'm a huge fan," she enthuses. "I try to go to games as much as possible in the summer."

Only problem is … the games she attends these days take place at the Texas Rangers' home field in Arlington. Now Shaner's family is from Maryland. Many of her relatives still live there and she remains a loyal Baltimore Orioles fan. She even has the moxie to use her BO credit card to buy snacks at Rangers games.

She laughs: "The vendors give me a hard time – everyone in line gives me a hard time. The partners at the firm and most of the people in the office give me a hard time. And of course, if Baltimore is actually playing the Rangers, sorry, I'll be wearing my Orioles cap."

TSCPA Member Arielle Smith Shares Her Experiences with Future CPAs

On April 10, TSCPA member **Arielle Smith**, CPA-Houston, gave an insightful presentation to the NABA Chapter at Sam Houston State University. Smith currently serves as the senior manager of accounting at United Way of Greater Houston and was president of the NABA chapter at Texas Women's University during her undergrad education.



Her presentation included a discussion on her background, career, experience with the CPA Exam and the benefits of joining TSCPA. She was eager to share her experience with the next generation of CPAs.

Submit an Article to *Today's CPA* Magazine

The editors of *Today's CPA* are seeking article submissions for the magazine. *Today's CPA* is a peer-reviewed publication with an Editorial Board consisting of highly respected CPA practitioners.

The publication 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 technicaleditor@tscpa.net.

TSCPA Thanks 2017-2018 Student and Faculty Reps

As part of TSCPA's outreach to accounting students, the Society utilizes volunteer campus reps to maintain a presence at Texas colleges and universities. The campus rep program serves to promote TSCPA student membership, share information and gain valuable feedback from students. TSCPA would like to send a special thanks to those students and faculty members who represented this organization so well throughout the year.

Faculty Reps

Chuck Pier – Angelo State University
Larry G. Stephens – Austin Community College
Paula Miller – Collin College – Spring Creek Campus
Anthony B. Ross, Sr. – Concordia University Texas
Robert Nass-Worthington – Dallas Baptist University
Regina Brown – Eastfield College
Felicia Farrar – Houston Community College
Ricardo Colon – Lamar University
Jacqueline Pierson – Lone Star College – CyFair
Ray Besser – Lone Star College – Montgomery
Karen Russom – Lone Star College – Tomball
Sheryl Jimerson – Lone Star College – University Park
Bob Thomas – Midwestern State University
Stephanie Swaim – North Lake College
Michelle Avila – Our Lady of the Lake University
Ranita Nunn – St. Edwards University
Diane Glowacki – Tarrant County College – NE Campus
Tara Blasor – Texas A&M University
Rabih Zeidan – Texas A&M University – Corpus Christi
Anne-Marie Lelkes – Texas A&M University – Kingsville
Selena Jefferies – Texas A&M University - Texarkana
Dennis Elam - Texas A&M University – San Antonio
Janice Cobb – Texas Christian University
Richard Pitre – Texas Southern University
Kim Webb – Texas Wesleyan University
Lynn Irving – Texas Woman's University
Amy Foshee Holmes – Trinity University
Robert Walsh – University of Dallas
Michael R. Newman – University of Houston
Alicia Yancy – University of Houston – Downtown
Tiffany DeLuze – University of Mary Hardin-Baylor

Faculty Reps *continued*

Madhuri Bandla – University of North Texas
Patricia Wynn – University of North Texas at Dallas
Ramon Fernandez – University of St. Thomas
John Darcy – University of Texas – Rio Grande Valley
Stanley F. Seat – University of Texas at Arlington
Linda Valleo – University of Texas at San Antonio
Veronda F. Willis – University of Texas at Tyler
April Poe – University of the Incarnate Word

Student Reps

Mollie Walker – Austin Community College
Holly Nguyen – Austin Community College
Kristina Stasser – Hardin-Simmons University
Steven Heath – Houston Community College
Sharon Reed – Lamar University
Ali Enes Cek – Lone Star College
Caroline Daniels – Texas A&M University – Corpus Christi
Silvia Medrano – Texas A&M University – Kingsville
Cynthia Ruiz – Texas A&M University – San Antonio
Abagail Kluetz – Trinity University
Abetzi Reyes – University of Houston
Susan Caraway – University of Houston – Downtown
Nan Chen – University of North Texas
Julio Colon-Gonzalez – University of Texas at Arlington
Koffi Ashorgbor – University of Texas at Dallas
Kanishk Chaurasia – University of Texas at Dallas
Robert Pena – University of Texas at El Paso
Elizabeth Sepassi – University of Texas at San Antonio
Michael Pedraza – University of Texas at San Antonio
Tiffany Duffey – University of Texas at Tyler
Victoria Salazar – University of Texas of the Permian Basin

Renew Your TSCPA Membership

If you haven't already renewed your membership for the 2018-2019 year, now is the time! TSCPA dues renewal notices were sent to members in April. Renew your membership by June 1 to continue receiving all of your valuable TSCPA benefits and discounts. New this year, members can opt-in to our auto-renewal program for next year.

In addition, if you have more than one TSCPA member in your firm, company or organization, you are eligible for group billing benefits. TSCPA's Group Billing Program is tailored to meet your unique needs while ensuring that your membership dues investment returns the highest value available.

If you have a question regarding your dues, please contact Member Services at 800-428-0272, option 1. We look forward to continuing to serve you in 2018-19!

Today's CPA Magazine – CPE Quiz Available Online!

TSCPA is excited to offer the self-study exam in this *Today's CPA* magazine online! You can read the CPE article "Tax Court Jurisdiction is Not Automatic and Your Appeal Might Preclude It" on page 40 of this issue and take the quiz online.

Go to TSCPA's website at http://bit.ly/cpequiz and complete the quiz to earn one hour of continuing professional education credit. When your online registration is complete, a confirmation email will be sent and provide a hyperlink to access the quiz. TSCPA created the online access to assist you and give you a flexible way to meet your continuing professional education requirements.

CGMA® Designation for Management Accounting Professionals

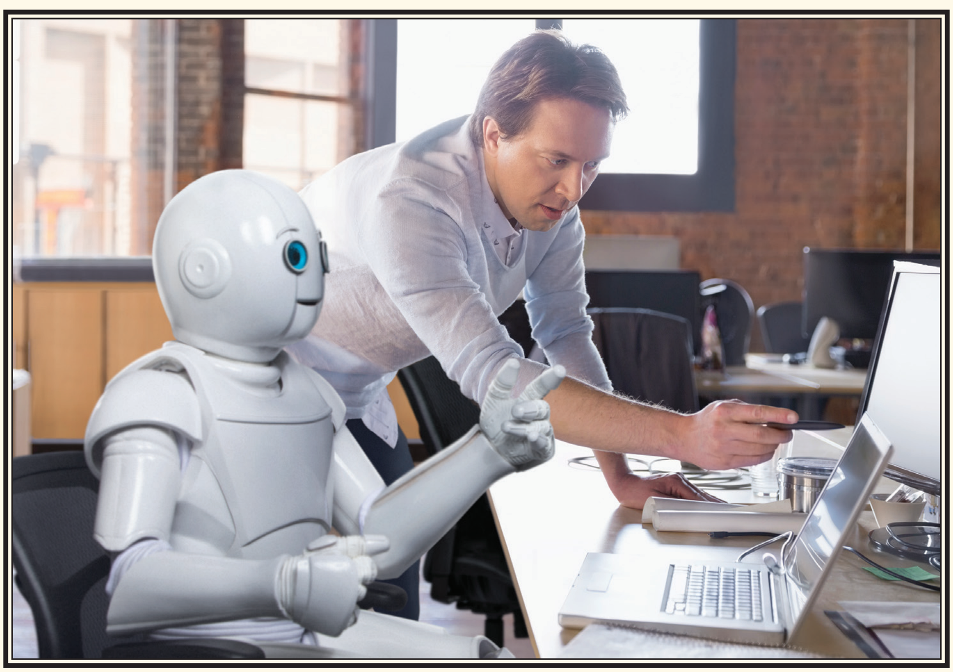
The Chartered Global Management Accountant (CGMA) designation from AICPA and the Chartered Institute of Management Accountants (CIMA) recognizes U.S. CPAs and CIMA members who work in management accounting roles. The CGMA is a respected complement to your CPA license.

The CGMA designation is backed by a number of benefits, including CGMA magazine and newsletter, tools and reports, videos, educational opportunities, a community/global network and more. For information about CGMA benefits, requirements and what the designation can do for your career, visit their website at cgma.org.

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 scroll down and select Practice Management Institute CE.



Sunset Approaches

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

The Sunset process for the Texas Public Accountancy Act (TPAA) and the Texas State Board of Public Accountancy (TSBPA) is underway. The members of the Texas Sunset Commission have been named and the Commission held its first meeting in March to adopt its timetable and meeting schedule for the remainder of the year.

What is Sunset?

For those unfamiliar with it, Sunset is the regular assessment of the continuing need for a state agency or program to exist. It was established by the Texas Legislature in 1977. Under Texas law, all agencies except universities, courts and agencies established by the Texas Constitution will be abolished on a specific date, generally 12 years after creation or renewal, unless the legislature passes specific legislation to continue its functions. According to the Council of State Governments, 35 states in addition to Texas have some kind of Sunset process.

While standard legislative oversight is concerned with agency compliance with legislative policies, Sunset starts with a more basic question: Do the agency's functions continue to be needed? The Sunset process works by setting an automatic termination (Sunset) date on which an agency will be abolished unless a bill is passed to continue it. Beyond this fundamental question, Sunset has always been about more than just limiting the size of government. The process creates a unique opportunity and powerful incentive for the legislature and stakeholders to look closely at each agency and make key improvements to how state government works.

In Texas, about 140 agencies are subject to the Texas Sunset Act. About 20 to 30 agencies go through the Sunset process each legislative session. This year, 32 agencies including TSBPA will be going through the Sunset process. Typically, an agency's enabling law specifies the date upon which the agency is abolished, unless continued by legislation. The TPAA in Sec. 901.006 specifies that, "The Texas State Board of Public Accountancy is subject to Chapter 325, Government Code (Texas Sunset Act). Unless continued in existence as provided by that chapter, the board is abolished and this chapter expires Sept. 1, 2019." So, unless the legislature approves the continuation of the TPAA and TSBPA, they will expire next year.

Texas Sunset Commission Members

Senate Members
Brian Birdwell (Granbury) – Chair
Dawn Buckingham, MD (Lakeway)
Bob Hall (Canton)
Robert Nichols (Jacksonville)
Kirk Watson (Austin)
Emily Pataki (Cedar Park) – Public Member

House Members
Chris Paddie (Marshall) – Vice Chair
Dan Flynn (Van)
Stan Lambert (Abilene)
Pancho Nevarez (Eagle Pass)
Senfronia Thompson (Houston)
Ronald Steinhart (Dallas) – Public Member – Retired CPA

The Texas Sunset Commission

The 12-member Sunset Commission has five members of the Senate and one public member appointed by the lieutenant governor, and five members of the House and one public member appointed by the speaker of the House of Representatives. Senate and House members serve four-year terms and public members serve two-year terms.

The chairmanship rotates between the Senate and the House every two years and this year, Senator Brian Birdwell (R-Granbury) will chair the commission for the 2018-2019 review cycle. The Sunset Commission also appoints a director who employs staff to carry out the commission's responsibilities. (See a listing of Sunset Commission members in the accompanying chart.)

How the Process Works

The first step in the Sunset process is a self-evaluation report prepared by the agency under review. TSBPA completed its self-evaluation report and submitted it to the Sunset Commission last fall. You can see a copy of TSBPA's self-evaluation report by going to the Sunset Commission website at: www.sunset.texas.gov/reviews-and-reports/agencies/texas-state-board-public-accountancy.

The next step in the process is a review of TSBPA performed by the Sunset Commission staff. As part of its review, the Sunset staff looks at the agency's self-evaluation report, evaluates the agency and identifies any possible problems, and develops recommendations for the Commission's consideration. During this process, the Sunset staff also receives input from interested parties. When completed, this staff report will be shared with TSBPA, which can respond and provide input or rebuttal to things in the report. The Sunset Commission Staff Report and any response from TSBPA are then shared with the members of the Sunset Commission.

According to the calendar adopted by the Sunset Commission, the staff report will go to the Sunset Commission sometime in late July/early August. The Commission is scheduled to meet on Aug. 28 and 29 to receive the report and recommendations and deliberate TSBPA's continuation. TSBPA will have an opportunity to testify at the Commission hearing and the Commission can also hear testimony from the public and other interested parties like TSCPA.

Finally, the Commission will meet again in mid-November to finalize its report and recommendations. If the decision is to continue TSBPA, then appropriate legislation will be developed by

“TSCPA WILL WORK TO ASSURE THAT THE LICENSED CPA PROFESSION IS CONTINUED IN TEXAS AND THAT TSBPA AND THE TPAA WILL BE RENEWED FOR THE FUTURE.”

the Commission for submission to the legislature for the legislative session in 2019. The Sunset bill must go through the legislative process like any other proposed legislation and must be passed by the legislature to be effective.

TSCPA Involvement in the Process

TSCPA will be closely monitoring the Sunset process as it plays out over the remainder of the year. We will work to assure that the licensed CPA profession is continued and that TSBPA and the TPAA will be renewed for the future. Our involvement will consist of monitoring the work of the Sunset Commission and providing our input where appropriate through public testimony and communications with legislators. And once a bill is introduced in the 2019 legislature, we will lobby to seek its passage.

Fortunately, the Sunset process only happens, on average, every 12 years. But when it does, it’s a very important matter that warrants the full attention of TSCPA and all licensed CPAs. We plan to be prepared to participate in the process and to help assure the continued existence of the licensed profession and the agency that oversees it in Texas. Stay tuned for future progress reports as this process plays out over the upcoming months.

In the meantime, if you have not already done so, please contribute to the CPA-PAC. It’s the vehicle for TSCPA to support good, business friendly candidates for the legislature and is a vital component of our governmental affairs program. Thanks for your consideration and support.

You can read the entire plan that Abbott is proposing by going to: https://www.gregabbott.com/propertytaxes/. ■

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

An Update on *Today's CPA*

By *Today's CPA* Technical Editor Brinn Serbanic and *Today's CPA* Managing Editor DeLynn Deakins

Thus far in 2018, the content of *Today's CPA* has focused on looking ahead. In doing so, we hope to turn the attention of our readers towards the considerable challenges and opportunities that our profession faces in the near future.

From the most significant tax reform in 30 years to virtual currencies to blockchain, the list of potential change in the world of accounting is staggering. The current landscape of our economy and business is characterized by rapid innovation, and our profession is not unaffected. Overnight startups such as Uber and AirBnB have created the "sharing economy" and left large, traditional companies in their wake. Amazon Prime can have seemingly anything in the world delivered to our doorsteps in two days. How will traditional retail and department stores fare? How close are mainstream self-driving cars and delivery drones?

> **"THE CPE QUIZ IN *TODAY'S CPA* MAGAZINE IS NOW AVAILABLE TO TAKE ONLINE. GO TO THE *TODAY'S CPA* SECTION OF THE WEBSITE AT TSCPA.ORG."**

Bill Gates said: "We always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next 10. Don't let yourself be lulled into inaction." The Editorial Board of *Today's CPA* looks forward to the challenge of keeping our readers abreast of the latest technology and developments in accounting and finance.

Overview

Today's CPA is a bi-monthly, peer-reviewed magazine supplied for the benefit of the 28,000 members of TSCPA. Articles submitted for consideration in *Today's CPA* are reviewed and selected by members of the TSCPA's Editorial Board. The Editorial Board is also charged with brainstorming potential topics to be covered in the magazine and soliciting submissions from a diverse author pool. The names of the members are listed in the magazine's masthead each issue. The Editorial Board represents a cross-section of the overall membership of TSCPA, including representatives from industry, public practice and academia.

Certain issues of the magazine during the year are devoted to a specific interest area of TSCPA's membership, such as industry, tax or students and young professionals. Each issue includes feature columns, as well as an article that offers continuing professional education (CPE) credit. The CPE article is peer-reviewed and the quiz is pre-tested by reviewers prior to publication. Articles in the publication may include case studies, technical analysis, and informed commentary on the topic.

The CPE quiz in *Today's CPA* magazine is now available to take online. Go to the *Today's CPA* section of the website at tscpa.org.

Figure 1 is a comparative summary of our activities for the past three calendar years. Submissions fell slightly in the last quarter of 2017, most likely a result of potential authors waiting to explore the rich supply of topics provided by new tax legislation. The key to maintaining high-quality material in our journal is increasing the number of submissions.

Figure 1. Summary of 2015 - 2017 Activity

Articles	2017	2016	2015
Received	36	45	36
Accepted	25 (69%)	29 (64%)	21 (58%)
Rejected	10 (28%)	15 (33%)	11 (31%)
In Review	1	1	4
Invited Short Articles	2 accepted	2 accepted	2 accepted

Acknowledgements

We would like to thank the members of the **Editorial Board** for their time and effort in volunteering to review articles for publication, pre-test CPE quizzes, and participate in meetings and on conference calls. We also recognize and thank our copy editor and contributing writer, **Anne Davis**, and the column editors and contributors: TSCPA Chairman **Jim Oliver**, CPA-San Antonio; **Jason Freeman**, CPA-Dallas; **Mano Mahadeva**, CPA-Dallas; **C. William (Bill) Thomas**,

CPA-Central Texas; TSCPA Chapter Relations Representative **Rhonda Ledbetter**; and TSCPA Managing Director of Governmental Affairs **John Sharbaugh**, CAE.

We also thank the accounting and financial professionals who author articles for *Today's CPA*. If you or someone in your organization would like to write an article for *Today's CPA* or have an idea you feel can be developed into an article, we encourage you to contact us. The Editorial Board maintains a list of topics desired for publication, and we would be willing to work with you to find a match to your particular area of expertise. If you would like to receive our editorial guidelines, please contact DeLynn Deakins at ddeakins@tscpa.net or visit the TSCPA website.

Pass-Through Entities Not Left Out of Tax Reform

By Tim Thomasson and Don Carpenter

This article is the second in a series of articles examining the major changes to the tax code resulting from the new tax reform bill. In this article, we will address the Qualified Business Income (QBI) deduction available for business conducted in pass-through entities, including any limitations. We will discuss some of the many questions raised by this new tax law which hopefully the Treasury Department addresses in future legislation.

Much discussion of the new tax law has centered around the highly publicized reduction in individual and corporate income tax rates. However, a recent Tax Foundation publication indicated over 90 percent of businesses in the United States operate through pass-through entities. With a reduction in the corporate income tax rate, absent action from Congress, business conducted in pass-through entities would have been at a comparative disadvantage. In fact, after considering the repeal of the 9 percent Domestic Production Activities Deduction (DPAD), owners of pass-through entities may have seen their tax liability actually increase. Congress addressed this issue by temporarily providing non-corporate taxpayers a deduction for 20 percent of qualified business income (the QBI deduction) from a pass-through entity. Absent further action from Congress, the QBI deduction expires for taxable years beginning after Dec. 31, 2025.

To be clear, Limited Liability Companies (LLCs) are a common form of pass-through entity. LLCs are treated for tax purposes as either sole proprietorships, partnerships or S corporations for income tax purposes, depending on the number of owners and any entity classification elections made. Therefore, we have omitted the LLC terminology from this article. The QBI deduction also includes qualified REIT dividends and certain income from publicly traded partnerships. The focus of this article is on traditional pass-through entities.

The QBI Deduction – Reducing the Effective Tax Rate on Pass-Through Earnings

At first glance, the calculation of the QBI deduction appears straightforward. We will use Robert and Mary Smith, a married couple who file a joint return, as an example. In 2018, Robert has $100,000 of taxable wages from his employer. Mary received a salary of $20,000 from Small Corporation, an S corporation in which Mary owns 20 percent. Small Corporation manufactures widgets in the United States. Mary's Schedule K-1 from Small Corporation reflected $90,000 of ordinary business income and $5,000 of taxable interest income. Assume the couple will claim the standard deduction for 2018. In Figure 1, we calculate their taxable income, including the QBI deduction.

We will walk through the calculation of the QBI deduction using the illustration in Figure 1.

Not All Income Qualifies

We calculate the Smiths' QBI deduction as 20 percent of Mary's $90,000 share of ordinary business income from Small Corporation. Note the QBI deduction only applies to Small Corporation's business income, not to her share of interest income from the company or to the salary she received. The new tax law specifically excludes from the definition of QBI most types of investment income, such as interest or dividends, allocated from a pass-through entity.

In addition, QBI does not include reasonable compensation paid by an S corporation to a shareholder. A similar rule applies to guaranteed payments made by a partnership to a partner. Note there is no mention, in the committee reports or in the Act itself, of reasonable compensation in the case of a sole proprietorship and its owner. We will discuss this point in more detail later.

A New Deduction "From AGI"

The Smith's QBI deduction is "from adjusted gross income (AGI)," and is available even though they are claiming the standard deduction. This new deduction from AGI is a rare exception in a tax act that eliminated longstanding above-the-line deductions, such as moving expenses and alimony. Accordingly, the Smiths claim the QBI deduction even though they do not itemize. But because it is a deduction from AGI rather than a deduction to compute AGI, it will not affect the limitation on any deductions determined by AGI, such as charitable contributions.

Not Everyone Benefits

As with many tax benefits, Congress giveth and Congress taketh away. The QBI deduction is no exception. Once a taxpayer's taxable income (exclusive of this deduction) reaches a certain threshold, the benefit from the QBI deduction may be reduced. The threshold for married taxpayers filing a joint return begins at $315,000 and is phased-in over the next $100,000. The threshold for other filers begins at $157,500 and is phased-in over the next $50,000. Unlike many phase-out ranges based on income, taxpayers affected by these thresholds can still fully benefit from the QBI deduction if they do not run afoul of two limitations.

Figure 1.

Robert's salary	$100,000
Mary's income from Small Corporation	
Salary	20,000
Ordinary business income	90,000
Interest income	5,000
Adjusted Gross Income (AGI)	$215,000
QBI deduction	(18,000)
Standard deduction	(24,000)
Taxable income	$173,000

Qualified Business Limitation

As we discussed in calculating the QBI deduction for the Smiths, the QBI deduction is not available for wages received for providing services to an entity nor is it available for most types of investment income. If a taxpayer's income is above the limitation threshold discussed above, the QBI deduction is also not available for income from a "specified service business." In defining a specified service business, Congress looked to the definition used for two other purposes: the IRC Section 1202 partial exclusion on sale of small business stock and the IRC Section 475 mark-to-market rules for dealers in securities. Accordingly, a specified service business is any business involving the performance of services in the fields of:

- health,
- law,
- accounting,
- actuarial science,
- performing arts,
- consulting,
- athletics,
- financial services,
- brokerage services,
- investing,
- investment management,
- trading or dealing in securities,
- partnership interests or commodities, or
- any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees.

It is noteworthy, however, that Congress specifically excluded "engineering" and "architecture," both of which are included in the IRC Section 1202 definition, from the prohibited list of services.

In the original example for the Smiths above, we noted that Mary's salary and investment income from Small Corporation did not qualify for the QBI deduction. A determination of whether Small Corporation was engaged in a specified service business was not relevant since the Smiths' taxable income, before the QBI deduction, was not above $315,000.

Assume instead that Robert's salary was $299,000, increasing the couple's taxable income, before the QBI deduction, to $390,000. Since Small Corporation is engaged in the manufacturing and selling of widgets, there is no reduction in the QBI deduction under this limitation, because the business income is not from a specified service business.

But what if Small Corporation provided actuarial services instead? Now, the Smiths QBI deduction is limited since Small Corporation is engaged in a specified service business. The couple's income exceeds the threshold amount by $75,000. Therefore, the QBI deduction is reduced by 75 percent, calculated as $75,000/$100,000. This limitation reduces the Smiths' QBI deduction from $18,000 to $4,500. Had the Smiths' taxable income exceeded $415,000, there would be no QBI deduction.

W-2 Wages and Qualified Property Limitation

The second limitation, which also only applies if income is above the limitation threshold, ties the QBI deduction to the wages and depreciable personal property attributable to the business. Specifically, this limitation caps the QBI deduction at the greater of (1) 50 percent of W-2 wages or (2) the sum of 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis, immediately after acquisition, of qualified property.

W-2 Wages. The W-2 wages include not only the amounts currently taxable to an employee in Box 1 of the Form W-2, but also elective deferrals reportable in Box 12 that an employee makes to 401(k) or similar plans.

continued on next page

Figure 2. Examples

Let's revisit the Smiths. Remember the Smiths' QBI deduction in our original example is $18,000. If Robert's salary was $324,000, increasing the Smith's taxable income (prior to the QBI deduction) to $415,000, the W-2 wages/qualified property limitation applies.	
Assume the following information from Small Corporation with regards to its wages:	
Total employee wages (including Mary's)	$200,000
Less: employee deferrals to a 401(k) plan reported in Box 12 of W-2	(30,000)
Taxable wages reported in Box 1 of W-2	$170,000
W-2 wages for purposes of the QBI deduction would be $200,000, taxable wages prior to any deferrals elected by the employee. Mary has a 20 percent interest in Small Corporation's income. Her share of W-2 wages would be $40,000.	
Assume further the following unadjusted basis of Small Corporation's property, plant and equipment at the end of the tax year:	
Building (39-year recovery period, placed in service in 2004)	$1,900,000
Land	200,000
Furniture (7-year recovery period, placed in service in 2007)	100,000
Equipment (7-year recovery period placed in service in 2010)	2,500,000
Qualified property would not include the land, which is not depreciable, or the furniture since its depreciable period has now expired. As real property, the building is not included in the definition of qualified property. That leaves only the equipment. Although the recovery period for the equipment has ended, the depreciable period is the longer of the recovery period or 10 years. The depreciable period does not end until 2020. Therefore, the equipment is considered qualified property. It should also be noted that the unadjusted basis does not change over the 10-year period, as it is not reduced by depreciation.	
As a result, the unadjusted basis of qualified property is $2,500,000. Mary's share would be $500,000, or $2,500,000 X 20%.	
The Smiths' QBI deduction cannot exceed the greater of: (1) $20,000 ($40,000 times 50%) or (2) $22,500 (sum of (1) $40,000 times 25% and $500,000 times 2.5%)	
In this case, the limitation does not reduce the QBI deduction and the Smiths can deduct $18,000. However, if Mary's share of W-2 wages were only $10,000, the deduction would be limited to $15,000, calculated as the greater of: (1) $5,000 ($10,000 times 50%) or (2) $15,000 (sum of $10,000 times 25% and $500,000 times 2.5%) There is no carryover of any QBI deduction disallowed by either limitation.	

Figure 3. Examples

What if a Taxpayer Has More Than One Qualified Business? What if Mary Smith also owns a 20 percent interest in Tiny Corporation, an S corporation engaged in a qualified business? For 2018, assume that Small and Tiny Corporations report the following to Mary:		
	Small Corporation	**Tiny Corporation**
Qualified business income	$90,000	$100,000
W-2 wages	10,000	70,000
Qualified property	500,000	600,000
If the couple's income is above the limitation threshold, their QBI deduction is calculated as follows:		
20% of business income	$18,000	$20,000
50% of W-2 wages	5,000	35,000
25% of W-2 wages plus 2.5% of qualified property	15,000	32,500
QBI deduction	$15,000	$20,000
Separate Calculation for Each Qualified Business The Smiths' QBI deduction would be $35,000. The W-2 wages/qualified property limitation is first calculated for each qualified business. This limitation reduces the deduction for Small Corporation from $18,000 to $15,000, but does not reduce the deduction for Tiny Corporation. Note the W-2 wages and qualified property of Tiny Corporation do not impact the calculation for Small Corporation. There would have been no limitation had the Smiths been permitted to consider W-2 wages and qualified property on an aggregate basis.		
Losses Further Complicate the Calculation What if Mary's allocable share from Tiny Corporation was a ($50,000) loss instead of $100,000 income? The QBI deduction attributable to Tiny would be ($10,000), calculated as ($50,000) times 20%. The Smiths' overall pass through deduction would be $5,000, representing $15,000 from Small Corporation less $10,000 from Tiny Corporation. If Mary's allocable share from Tiny Corporation was a ($100,000) loss, the sum of her QBI from all activities would be ($5,000) comprised of ($20,000) from Tiny Corporation and $15,000 from Small Corporation. In this instance, the Smith's combined QBI deduction would be zero. They are required to carry $5,000 forward indefinitely, reducing QBI in future years. The QBI deduction also cannot exceed 20 percent of overall taxable income, before this deduction and certain other adjustments. If the Smiths' only income was Mary's share of business income from Small Corporation, the couple's QBI deduction would be limited by the standard deduction, which reduces taxable income.		

Qualified Property. Qualified property represents depreciable personal property (1) held by the taxpayer at the end of the taxable year and available for use in the business, (2) used at some point in the year in generating qualified business income and (3) still within its depreciable period by the end of the tax year. The depreciable period begins on the date the asset is placed in service and ends on the date that is the later of (1) 10 years or (2) the end of the recovery period allowed for MACRS purposes.

Note that property must be personal and must be placed in service. Accordingly, neither real estate nor property that has yet to be placed in service will benefit a taxpayer when calculating this limitation.

Please see Figures 2 and 3 for examples.

The QBI Deduction Raises Many Questions

As with most complex tax reform, the legislation itself raises additional questions. The Treasury Department is already writing regulations to assist taxpayers with application and compliance issues specifically related to the QBI deduction. However, these regulations may take time and still leave significant issues unresolved.

Exactly What is a Business?

While the Internal Revenue Code uses the term "trade or business" numerous times, it never specifically defines what a business is. The hobby loss rules provide guidance as to what a trade or business is not. The rules for the QBI deduction specifically list certain types of

investment activity that do not qualify as "income" for purposes of the deduction. But what about the ownership of rental real estate? The law itself is not clear. Rental income is not specifically listed as a type of investment income for which the QBI deduction is prohibited. In addition, taxpayers can offset rental expense against rental income in determining AGI, even if the result is a loss (subject to the passive activity rules). This result is analogous to other activities that meet the definition of a business.

Therefore, it appears that rental income should qualify for the QBI deduction. Hopefully, future regulations will provide more clarity. Given that rental activity typically does not include significant, or any, W-2 wages and rental real estate is not qualified property, taxpayers with income above the limitation threshold would likely not be able to claim the QBI deduction.

How Will the Treasury Department Interpret "Principal Asset of the Trade or Business?"

When a taxpayer's income has reached the limitation threshold, the qualified business limitation reduces or eliminates the QBI deduction if the pass-through entity is engaged in a specified service business. While the law refers to several specific examples of a service business, it concludes with a catch-all phrase that includes "any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees." Absent significant guidance from the Treasury Department, and possibly even with such guidance, this vague definition is likely to lead to controversy between a taxpayer and the IRS long after the QBI deduction sunsets. Controversy may also occur when services are a significant component, but not the only component, of a business.

How Do Taxpayers Determine W-2 Wages?

For taxpayers with higher income, the determination of W-2 wages allocable to a qualified business is critical in calculating the amount of the QBI deduction. We discussed W-2 wages in an earlier example. But what if an employer outsources the employer-employee relationship to a third party, such as an employee leasing company? The now-defunct domestic production activities deduction (DPAD), which also contained a limitation tied to W-2 wages, provided some ability to include wages of a third party if state common law treated the employees as those of the taxpayer and not the third party. There are similarities between the DPAD and QBI deduction. Whether a similar process is allowable under the QBI deduction is not clear.

W-2 wages paid to an employee-shareholder of an S corporation are included in the calculation of the W-2 wages limitation. But there is no mechanism to impute a compensation element for a sole proprietor and guaranteed payments made by a partnership to a partner are not considered W-2 wages. Whether this distinction for S corporation wages to an employee-owner was intentional, or something that will be addressed in future guidance from the Treasury Department, remains to be seen.

What is Meant By the "Immediately After Acquisition?"

In calculating the W-2 wages/qualified property limitation, the new tax law references the cost of qualified property "immediately after acquisition." Should taxpayers interpret this terminology to mean future additions, such as a new engine in a truck, would not count as qualified property? A more logical conclusion would be to interpret "immediately after acquisition" for each addition to the asset, as well. Hopefully, future guidance will address this uncertainty.

Should a Pass-Through Claim Bonus Depreciation?

Although pass-through entities do not pay tax, they do make most of the elections that impact the amount of income, gain, loss or deduction allocable to the owners. The new tax bill expanded and extended the deduction for 100 percent bonus depreciation. A taxpayer must elect out of bonus depreciation to opt out of this deduction. Bonus depreciation would lower QBI and the QBI deduction.

At first, this appears to be a timing issue, as income in subsequent years would be higher. However, the QBI deduction sunsets after Dec. 31, 2025. As that date gets closer, pass-through entities may consider electing out of bonus depreciation to preserve as much of the QBI deduction as possible and utilize depreciation against income after the sunset.

Is the Benefit Only Temporary to the Taxpayer?

In addition to a possible sunsetting of the deduction, there is the potential that claiming the deduction may result in less of a deduction or additional income elsewhere in the calculation of current or future year's taxable income. For example, assume that Mary was required to reduce her tax basis in Small Corporation by the QBI deduction. That benefit would be temporary as she would have less basis to absorb future distributions or a larger gain on the future disposition of the entity. While the new law itself is silent, regulations for the DPAD stated that the deduction would not impact the tax basis of a pass-through entity. Absent any further guidance, taxpayers could reasonably expect a similar result with the QBI deduction.

Another area where the QBI deduction could have an adverse offsetting tax implication is passive losses. If the law required a taxpayer to reduce passive income by the deduction, the benefit of the QBI deduction could be offset, at least partially, by a reduction in allowable passive losses. Taxpayers calculated the DPAD after

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> **THE CHOICE OF BUSINESS ENTITY IS ONE OF THE MOST CRITICAL DECISIONS IN TAX PLANNING.**

applying the passive activity rules. Accordingly, the deduction itself did not cause additional limitation of passive losses. Again, absent any further guidance, taxpayers could reasonably expect a similar result with the QBI deduction.

What is the Optimal Entity Choice Given This New Deduction?

The choice of business entity is one of the most critical decisions in tax planning. The QBI deduction complicates the decision for a variety of reasons.

The QBI Deduction Sunsets after 2025. First, the deduction itself sunsets after Dec. 31, 2025. As a comparison, the reduction in the corporate tax rate to 21 percent is permanent. Of course, Congress could always permanently extend the QBI deduction or could increase the corporate income tax rate. This might encourage owners of pass-through entities to structure their operations with a view to possibly elect C corporation status when and if the deduction sunsets.

S Corporation versus Sole Proprietorship. Absent further guidance, or technical corrections to the law itself, the choice of pass-through entity matters. Consider the discussion above regarding W-2 wages. As noted, there is no equivalent to W-2 wages for compensation to a sole proprietor or partner. Compensation paid from an S corporation to an owner-employee is considered W-2 wages for the purpose of applying this limitation. This discrepancy is a distinct disadvantage for pass-throughs operating as proprietorships or partnerships.

Assume Ted Jones, single, operates a business through a pass-through entity. This business generates $100,000 of income and represents Ted's only source of income. The business has no employees except Ted and no qualified property. In Scenario One, Ted operates the business through a sole proprietorship. In Scenario Two, Ted operates the business through an S corporation, paying himself a salary of $40,000 and leaving $60,000 of business income. Ted's income is well below the limitation threshold. As a result, the absence of W-2 wages for the sole proprietorship does not impact his QBI deduction.

In Scenario One, he is entitled to a QBI deduction of $20,000. However, in Scenario Two, his business income is only $60,000, as W-2 wages from a pass-through entity are not eligible for the QBI deduction. Accordingly, his deduction would only be $12,000. Under these circumstances, Ted receives a larger deduction by conducting his business through a sole proprietorship than an S corporation. However, it is likely his self-employment tax in Scenario One would offset any benefit from a higher QBI deduction.

Now assume Ted has taxable income of $225,000 from other sources. His income is above the limitation threshold and his QBI deduction is subject to the W-2 wages/qualified property limitation. Under Scenario One, Ted's QBI deduction would be zero since the sole proprietorship has no W-2 wages or qualified property. Under Scenario Two, Ted's QBI deduction would be $12,000, which is below the W-2 wages limit. Although his compensation from the pass-through entity is not considered QBI, it does count in calculating W-2 wages of the entity. In this instance, Ted receives a larger deduction by conducting his business through an S corporation rather than a sole proprietorship.

Partnerships versus Other Pass-Through Entities. Initially, it appears that a partnership would be less desirable than a sole proprietorship or an S corporation. Guaranteed payments to partners for services provided are not considered W-2 wages for purposes of the W-2 wages/qualified property limitation. However, these payments are also not considered QBI. Therefore, guaranteed payments reduce QBI while not increasing the wage limitation.

However, partnerships may make special allocations. If certain partners of the partnership can benefit from the QBI deduction and others cannot, proper planning could result in an increase of amounts allocable to eligible partners. Congress apparently was concerned about this issue and has specifically authorized the Treasury Department to issue regulations preventing abusive special allocations.

Material Provisions of the QBI Deduction

Although not exhaustive, this article has focused on the most material provisions of the QBI deduction contained in the new tax bill and the impact on owners of sole proprietorships, partnerships or S corporations. The tax reform law article in the next issue of *Today's CPA* will consider the major changes affecting C corporations. ■

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Tax Cuts and Jobs Act Learning Opportunities

The Tax Cuts and Jobs Act (TCJA) brought the most significant tax law changes in 30 years. You can count on TSCPA for the education resources you need to help you best serve your clients and employers. We have a full schedule of programs available for you.

Tax Reform: Understanding the Tax Cuts and Jobs Act (4 hours)

Austin, July 13

Houston, July 16

Dallas, July 18

San Antonio, Aug. 10

The Tax Cuts and Jobs Act: A Guide to the Most Sweeping Tax Reform in Over 30 Years (4 hours)

South Padre Island, June 20 – Part of the South Padre Cluster

Grapevine, June 26 – Part of the Cowboy Cluster

San Antonio, July 11 – Part of the Hill Country Cluster

Galveston, Aug 1 – Part of the Galveston Cluster

Tax Reform: Tax Planning for Pass Through Entities

Houston, Jan 14, 2019

San Antonio, Jan. 18, 2019

Austin, Jan. 22, 2019

Dallas, Jan. 28, 2019

Webcast and on-demand learning opportunities covering the tax law changes are also available to meet the demands of your busy schedule.

To learn more and register, go to the CPE section of our website at tscpa.org or call 800-428-0272, option 1, for personal assistance.

Are You Depleted? The Role of Ego Depletion in Accounting

By Kelsey R. Brasel, Ph.D., CPA, Sharon Huang, Ph.D., and Erin B. Nickell, Ph.D., CPA

Like most professionals, auditors perform actions that generally involve overriding one's natural responses. For example, auditors often struggle to maintain focus on difficult tasks. Recent research has shown that resisting the urge to quit a challenging task in favor of something less strenuous can result in a depletion of mental resources needed to make sound professional judgments.

The phenomenon has been found to negatively affect an auditor's task performance and decision quality, and reduce audit effectiveness. Practicing CPAs should be aware of the risks of ego depletion, particularly in extremely complex audit environments, and should be educated about potential strategies for effectively combatting this risk.

Overriding one's natural responses can be extremely difficult – so difficult, in fact, that successful resistance can drain an individual's capacity for self-control. Over time, limited self-control resources become depleted; this negatively impacts future task performance. This experience may be familiar to anyone who has attempted to reduce their caffeine intake or eat more salads yet ended up giving in to the very temptation they set out to avoid.

Known as ego depletion, research has shown that this phenomenon can be as harmful to our professional lives as it is to our personal lives, particularly when it comes to maintaining focus on difficult tasks. Consequently, it poses a serious threat to audit effectiveness, as auditors often make important professional judgments after depleting activities, such as exerting significant mental effort on complex audit tasks. This article discusses the psychological concept of ego depletion, explores the causes and dangers of ego depletion and suggests specific strategies for auditors to combat the effects of ego depletion.

What is Ego Depletion?

As individuals exercise self-control, they are depleting limited cognitive resources. In a professional setting, self-control frequently involves resisting the urge to quit a difficult task or maintaining diligence while working toward a goal. Consumption of these self-regulating resources has a negative impact on subsequent decision-making.

Although psychologists have studied ego depletion for many years, it was not until recently that academics began studying the effects of ego depletion in an audit setting. In general, research has found that performing complex audit tasks, an activity that requires quite a bit of self-control, causes ego depletion in auditors and harms their performance on subsequent tasks (Hurley 2015). Professors Lori Bhaskar, Tracie Majors and Adam Vitalis identify ego depletion as "a pervasive threat to auditor effectiveness" and "one potential root cause to help explain audit deficiencies" (2015). They show that depletion impairs auditor effectiveness, especially for "good" auditors who work comparatively harder than their peers. Fortunately, accounting research is examining depletion to understand its causes, identify strategies to combat consequent risks and ultimately improve audit effectiveness. Accounting research is examining ego depletion to understand its causes, identify strategies to combat consequent risks and ultimately improve audit effectiveness.

Causes of Ego Depletion

The causes can be attributed to both external and internal factors that are prevalent in an audit setting. External factors include task characteristics, such as complexity and uncertainty. For example, as more companies move toward fair value as a means of measuring assets and liabilities, auditors are faced with an increased amount of measurement uncertainty. It is, therefore, becoming increasingly important that auditors broaden their skillset with regard to valuation methodologies and develop an ability to evaluate complex models with ambiguous assumptions. For these reasons, it is expected that the severity of ego depletion is dependent on the task being performed, where more difficult and complex tasks are associated with a greater risk of depletion.

Depletion is also caused by internal factors, such as an individual's desire to maintain focus. For example, resisting the temptation to switch tasks to work on something less difficult and cognitively demanding depletes an individual's self-control resources. We are also more susceptible when performing tasks that require large amounts of working memory (i.e., requiring an increased cognitive load) or when we are interrupted in the middle of a task. This is especially true when the task is near completion and distracting information must be ignored. Additionally, the extent to which we must comply with requests from supervisors or more senior audit team members increases the likelihood of ego depletion.

"ACCOUNTING RESEARCH IS EXAMINING EGO DEPLETION TO UNDERSTAND ITS CAUSES, IDENTIFY STRATEGIES TO COMBAT CONSEQUENT RISKS AND ULTIMATELY IMPROVE AUDIT EFFECTIVENESS"

Efforts to control our emotions, and therefore overriding natural responses, can also lead to ego depletion. For example, auditors often deal with substantial amounts of stress related to time pressure and accountability. How they respond to these stressors can have implications for the likelihood of depletion.

Managing interpersonal interactions can also lead to emotional strain. Auditors must interact with superiors and subordinates on their engagement team, as well as a variety of employees within a client's organization that requires monitoring for relational cues in interactions. These interactions often require auditors to suppress thoughts and opinions as a means of managing the relationship.

Compounding this effect, depletion is more likely to occur when individuals lack adequate sleep or when blood glucose levels have decreased. Finally, younger, less experienced staff or auditors who are indecisive are especially susceptible to depletion.

The Dangers

The consequences in an auditing environment can be significant. As discussed above, auditors can be depleted by factors including task complexity, uncertainty, time pressure and interpersonal relationships. Unfortunately, ego depletion can harm performance and impair decision quality.

Research has found that a depleted auditor is more likely to reduce effort on a task (Bhaskar et al. 2015) and may experience an impaired ability to identify misstated accounts (Kremin 2015). One study demonstrated that it could also hinder an auditor's ability to detect when a client is withholding information or being dishonest. For example, depleted auditors were found to be significantly more susceptible to a CFO's attempts to explain away unusual financial trends indicative of fraud (Hurley 2015b). This is particularly concerning

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considering that a lack of professional skepticism and overreliance on management explanations are among the leading causes of audit failures related to fraudulent financial reporting.

Other studies have shown that depleted auditors make significantly less accurate risk assessments (Bhaskar et al. 2015). Considering the impact on the nature and extent of audit procedures, these assessments can have serious implications for the overall quality of the audit.

Additional concerns involve the rate at which an individual can become depleted, as well as the extent. Effects have been shown to occur after only 10 or 15 minutes of exerting self-control (e.g., resisting temptations or working on a complex task). The extent of depletion depends on the amount of self-control involved in a task rather than its duration. For example, an auditor may be more depleted while completing a risk assessment task than if the auditor was reviewing a subordinate's work, regardless of which task takes more time, simply because the risk assessment work was more cognitively challenging. Finally, ego depletion is especially risky because those who are affected are usually unaware that they are not performing at maximum capacity.

Combatting Ego Depletion

The negative effects are plentiful; therefore, it is important for auditors to understand how to combat this harmful phenomenon. As previously noted, it is particularly common for younger, less experienced auditors, because they are less likely to be familiar with the audit task and more likely to perceive it as complex or challenging. In this case, managers can prevent depletion by ensuring that experienced staff members are assigned more complex tasks and less experienced auditors are given ample opportunity to shadow and observe others before being assigned new tasks.

For all levels of auditors, maintaining high levels of motivation through self-affirmation can reduce depletion. Self-affirmation can be as simple as telling yourself you are not depleted. Research has also found that auditors who are exposed to the concept of persistence, examples of non-depleted individuals and the general concept of money experience fewer negative consequences.

Additionally, auditors can take steps to reduce the transfer of ego depletion between days. During work hours, auditors will find it beneficial to take short breaks to induce relaxation during difficult tasks. Outside of work, obtaining adequate rest, engaging in meditation, and participating in enjoyable events and hobbies can help to decrease depletion carryover. Limiting the carryover is particularly important during busy season, as auditors have been found to experience an accumulation of ego depletion and reduced performance during this time of year (Hurley 2015c).

Long-term practice of self-control (to increase self-control endurance) and distracting oneself from temptations by increasing cognitive load are additional strategies. Finally, becoming aware using self-reflection of one's self-control performance can also help to reduce depletion.

Maintaining Focus and Vigilance

The Public Company Accounting Oversight Board cites a lack of auditor effectiveness as a major component of audit failures. Ego depletion may help to explain auditors' poor decision-making quality in audit failure cases.

Depletion negatively affects auditors by impairing their judgments and decision-making quality, and it is particularly prevalent during complex audit tasks where the auditor must maintain focus and vigilance. It is important for auditors to be aware of ego depletion and implement strategies for counteracting the negative effects.

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TSCPA's 2017-2018 Year in Review

Empowering Members to Lead and Succeed

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

Tax reform, Hurricane Harvey recovery, high-profile data breaches, focus on audit quality, the new lease accounting standard, the new revenue recognition model and health care changes and trends.

These and other significant issues are impacting TSCPA members and the accounting profession. In responding to this environment of constant change, our new dynamic three-year strategic plan – TSCPA 2020 – was created to take our organization into the future. TSCPA 2020 is the product of research and conversations with members from across the state, and it formalized our vision to empower members to lead and succeed.

Three pillars of success – Community and Connection, Advocacy and Professional Excellence – are the foundation of TSCPA 2020. As we close out the 2017-2018 year, we take a look at key TSCPA initiatives, programs, services and educational opportunities that we've implemented to support our new vision.

Community and Connection

TSCPA is all about you, our members, and helping you with success and growth is at the heart of all we do. We're here to assist in growing your professional community with the introduction of the next generation of CPAs, as well as providing you with opportunities and resources to connect, serve and lead.

A few highlights of the year in the membership area include:

- The TSCPA student and candidate population increased by 4.7 percent between April 2017 and April 2018;
- TSCPA had 209 firms participate in the group billing program in 2017-2018 and as of the end of April, we have billed 288 firms for the 2018-2019 renewal cycle, exceeding our goal of 250; those firms equate to 4,730 individual memberships, including 150 new members.

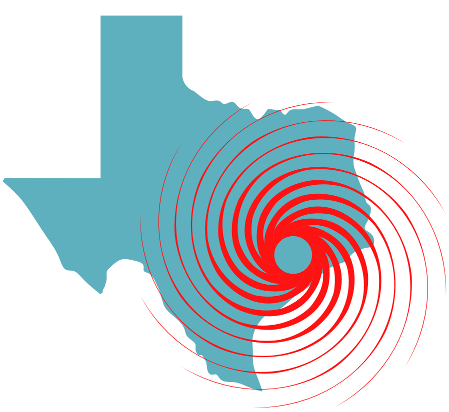
If you haven't already renewed your membership for the 2018-2019 year, be sure to renew by June 1 to avoid losing access to your valuable discounts and benefits. Dues renewal notices were sent in

late-April. New this year, members can opt-in to our auto-renewal program for next year. If you have a question regarding your dues, please contact Member Services at 800-428-0272, option 1.

Keeping the Pipeline Strong

Welcoming the next generation of CPAs to the profession and to our association is vital to a vibrant future for TSCPA. We're working to keep the pipeline of new CPAs strong:

- The career awareness program offers career resources and guest speakers for various grade levels, from elementary to college;
- The campus and faculty ambassadors program helps TSCPA have a presence on Texas campuses and recruit more students to the profession and to membership;
- Student and candidate memberships give a membership option to college students and recent grads who are preparing to sit for the CPA Exam;
- Scholarships from AICPA, TSCPA and our chapters help support deserving accounting students in Texas;
- The Accounting Program for Building the Profession, offered from AICPA and the state societies, equips high school teachers with a high-level curriculum;
- Free boot camps for students provide networking opportunities and keynote presentations on business etiquette, dressing for success and applying to sit for the CPA Exam.



Hurricane Harvey Response

Hurricane Harvey devastated the Gulf Coast. TSCPA had 9,000 members in the affected areas. In response to this disaster, the Society created a Hurricane Harvey Assistance page on the website at tscpa.org. This page included resources, FAQs, IRS announcements and other disaster-related information for members, their clients and their companies.

TSCPA advocated for immediate tax relief legislation for federal tax deadlines and related forms, as well as reporting deadlines that were not automatically extended. We also requested that Congress enact legislation that would provide automatic and consistent relief for all federal disaster areas, and additional legislation to aid victims

“ TSCPA'S VISION SUMS UP OUR MOST IMPORTANT CHARGE: EMPOWERING MEMBERS TO LEAD AND SUCCEED

of both Hurricane Harvey and Hurricane Irma.

In other efforts, TSCPA sent a needs assessment email to members to see how we could help those in the affected areas. Feedback was used to match members in need with members who were positioned to help.

Last November, representatives from the AICPA Benevolent Fund came to Houston to meet with individuals needing assistance. As of press time, more than $500,000 in assistance had been distributed to Texas members.

Office space assistance was provided for those in need of office space to be put in contact with those who have office space to offer.

A technical question Q&A was set up with **Jerry Schreiber**, CPA, partner with Schreiber & Schreiber, CPAs in Metairie, LA. He answered questions on an ongoing basis for those affected by Hurricane Harvey. TSCPA also hosted a free two-hour CPE program on Hurricane Harvey tax deadlines and 1,000 members participated either online or in person.

Communications and Connecting on TSCPA Exchange

TSCPA EXCHANGE
Where members connect and collaborate

Late last fall, we launched TSCPA Exchange as a way to strengthen our community connections. TSCPA Exchange is a members-only forum to discuss ideas, share questions and leverage the knowledge of TSCPA's 28,000 members. It also includes a robust searchable member directory.

With more than 600 discussion posts to date, topics have ranged from advice for starting a practice, to how to help staff sit for and pass the CPA Exam, to navigating tax reform. We encourage you to update your bio, add a photo and participate in the conversation.

TSCPA also continues to reach out to members through our other communications tools, including social media channels, e-newsletters, the website at tscpa.org, *Today's CPA* magazine and more.

State and Chapter Collaboration

This past fall, a review was completed of TSCPA's state and chapter structure compared to other associations. This review provided feedback, best practices, recommendations, and ideas for areas of collaboration and increased efficiencies. TSCPA and the chapters continue to explore opportunities to enhance the member experience.

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Advocacy

TSCPA protects and promotes your Texas CPA certificate. We vigilantly keep watch on the professional and business environment so that we can effectively be the voice of our members before policy makers and the public.

The Texas State Board of Public Accountancy (TSBPA) will undergo Sunset Review next year. The Sunset process was implemented by the Texas Legislature to assess the need of a state agency to exist. Legislation will need to be passed to reauthorize TSBPA and the Texas Public Accountancy Act.

TSCPA's Legislative Advisory Committee has reviewed and approved proposed changes to the TPAA. The majority of the proposed changes are being sought by TSBPA and one change is being requested by the Accountants' Coalition (TAC). Please see the Capitol Interest article in this *Today's CPA* magazine for more details on the Sunset process.

Federal Tax Policy Committee

TSCPA's Federal Tax Policy Committee continued its work this year advocating on behalf of members to the IRS, U.S. Congress and Department of the Treasury on U.S. tax matters. Last August, the committee issued a letter to IRS Commissioner **John Koskinen** raising concerns about recent changes to the Internal Revenue Manual. The committee encouraged the IRS to clarify and limit the degree of other IRS divisions' involvement in appeals conferences to preserve fair and impartial proceedings.

Last September, **David Colmenero**, JD, CPA-Dallas, and **David Donnelly**, CPA-Houston, traveled to Washington, D.C., to represent the FTP at an IRS public hearing on the centralized partnership audit proposed rules.

In February, the FTP urged Congress to support the IRS budget at a level to properly fund taxpayer services and to implement recent significant tax law changes. The committee believes a newly appointed commissioner (awaiting confirmation as of press time), along with a well-funded budget, could bring change and restore congressional and public confidence in our tax system.

In March, the committee issued comments to the IRS on proposed partnership audit push-out election regulations for tiered partnerships under Sections 6226 and 6227 (REG-120232-17; REG-120233-17).

National Taxpayer Advocate **Nina Olson's** *2017 Report to Congress* recognized the quality work of the FTP by referencing a January 2017 letter to the IRS regarding in-person appeals conference concerns.

Strengthening TSCPA's Brand

A brand audit will be completed this year. Society leadership and staff provided their input, then focus groups and a member survey were used to uncover key findings of the TSCPA brand. A preliminary report was presented to the Executive Board at their meeting in April. Recommendations will be used to help us promote TSCPA and the CPA brand in a consistent and effective way.

2017 Texas Legislative Session

In the 2017 legislative session:

- 7,002 total bills were filed – 2,420 in the Senate and 4,582 in the House;
- Of those, 18.5 percent or 1,295 were passed by the legislature;
- 1,091 bills were signed by the governor;
- 154 became law without his signature;
- 50 bills were vetoed by the governor.

TSCPA successes:

- HB 1930 requires state and local governments to adhere to generally accepted accounting principles (GAAP) in issuing their financial reports;
- SB 1083 created a de Minimis exemption for a CPA firm whose work for a client may unintentionally stray into the state's broad definition of "insurance services."

Professional Excellence

TSCPA provides resources to assist you in the achievement of professional and personal success. We give you the tools and education you need to stay on top of new laws and changing regulations, as well as maintain and exhibit a high level of ethical standards. In the CPE area, a new strategic plan will be geared specifically toward CPE.

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Thank you for your membership and commitment to the success of your professional organization. We look forward to continuing to work for you and with you in the new year. ■

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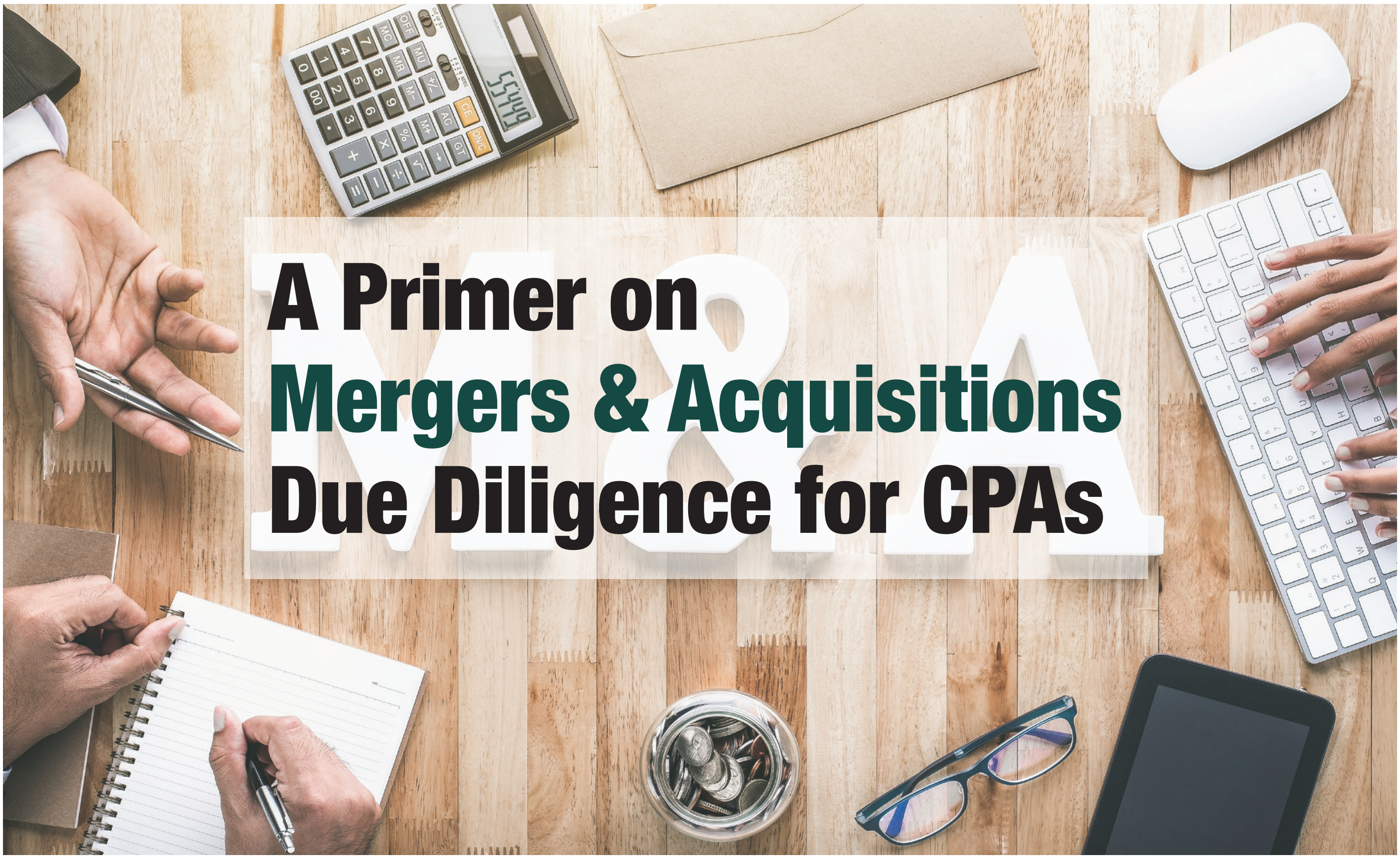

A Primer on Mergers & Acquisitions Due Diligence for CPAs

By David R. Johanson, J.D., Michael W. Thicksten, J.D., and Teresa Y. Huang, J.D.

The U.S. stock market experienced phenomenal growth in 2017, with overall gains for the Dow Jones Industrial Average of approximately 25 percent and for the S&P 500 of approximately 19 percent.[i] Despite losses in the Dow Jones earlier this year due to concerns of a potential global trade war prompted by tariffs on China[ii], institutions such as Goldman Sachs and Wells Fargo project mergers and acquisitions activity to rise in 2018.[iii] The combination of economic growth throughout the world, U.S. corporate tax cuts and repatriation of offshore profits attributable to the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97), and renewed interest in growth stocks may result in a remarkable year for mergers and acquisitions.[iv]

With the growing number of potential deals, CPAs may best serve their clients and themselves if they are well prepared for the anticipated increase in the volume of mergers and acquisitions and more involvement in the overall transaction process. Our country has anticipated a major boom in mergers and acquisitions activity since the Great Recession dating back to 2008. It appears that the time for a significant uptick in sales of businesses is finally on the horizon.

Companies continuously attempt to increase earnings by more efficiently controlling overhead and developing top-line growth with effective marketing and sales. Global market pressures increasingly require boards of directors, officers and executive management to consider mergers and acquisitions as a means for growth in revenues and market share, a reasonable return on shareholders' investments, and/or an exit strategy for a struggling business or a more mature profitable business with no viable management successors.

Conducting such transactions is normally a complex endeavor that requires advance consideration of the short-term and long-term business objectives, a thorough due diligence process and a well-crafted integration plan (for surviving corporate entities). When executed successfully, mergers and acquisitions facilitate:

- Growing market share by establishing new distribution channels,
- Increasing the potential to cross-sell goods or services to new markets, improving access to technology,
- Adding talent,
- Increasing efficiency and profits by realizing greater economy of scale,
- Better positioning in the value chain for the acquirers and
- Creating an orderly disposition of business assets and liabilities for an acceptable price for sellers.

Importance of the Due Diligence Process

Proactive due diligence efforts remain vital to any company anticipating a sale, irrespective of whether the company is an acquirer or target company. Every stage of a merger or acquisition transaction involves the diversion of corporate resources (human and otherwise) away from revenue generating and expense controlling matters. Companies that are doing well may receive frequent expressions of interest; however, very few offers may be worth pursuing.

Proactive due diligence efforts remain vital to any company anticipating a sale, irrespective of whether the company is an acquirer or target company.

Conducting a due diligence review in advance may help sellers evaluate whether any unsolicited offers are bona fide offers and thus help sellers avoid wasting resources on non-viable offers. Selling companies that make the investment in due diligence prior to engaging in substantive negotiations with potential buyers may also realize greater purchase prices and improved odds of closing a transaction. Early investment in due diligence affords the selling company the opportunity to assess underlying risks and take corrective action before a buyer uses them as bargaining chips to reduce the purchase price or other consideration to be paid at closing.

If a company is in the preliminary stages of a transaction, initial due diligence may facilitate the process of marketing the firm (directly, through investment bankers on a blind or fully disclosed business, or through other business contacts). Providing a professionally assembled presentation, "deal book," or packet of financial information with respect to a selling company to strategic and financial buyers may help justify a premium purchase price and allay concerns about operations.

An acquiring company determines a target company's proper value through an objective and meticulous due diligence process. Thorough typically includes legal, financial and operational analyses of the target company, in large part to validate the buyer's assumptions and/or preliminary impressions of the target company against factual data. A prudent process should cover more than an evaluation of the target company's balance sheet and profit and loss statements. It should also evaluate information about every aspect of the selling company and its business operations, including without limitation, the following:

- Business strategy,
- Operations,
- Working capital requirements,
- Taxes,
- Competitors,
- Consolidation in the industry (if any),
- Labor disputes,
- Litigation (ongoing, pending, threatened or potential lawsuits, and other contingent liabilities) and
- Other factors that may impact the valuation of the selling company.

From the buyer's perspective, a detailed due diligence review will reveal any hidden issues, such as pending litigation or a previously undisclosed downturn in the selling company's financial performance. Unexpected discoveries can serve as compelling reasons for buyers to modify the deal terms or, in extreme cases, findings of sufficient risk may warrant walking away from the deal entirely. Buyers should also determine whether the target company has made prior efforts to sell. Multiple unsuccessful divestment attempts could signal substantial valuation, operational or risk concerns.

Throughout the assessment, the acquiring company's representative(s) should advise the acquirer of the advantages and disadvantages of the proposed structure of the transaction and the feasibility of the target company as a going concern, and assist the buyer with an assessment of the cash flow and financing alternatives required to acquire the target company. The aim should be to provide sufficient information to the buyer so that it may determine whether the acquisition will satisfy all of the buyer's business objectives without presenting a level of financial, business and legal risk that the buyer finds unacceptable. An assessment of the acquiring company's goals should include an analysis of growth strategies balanced with the buyer's overall corporate strategy. Understanding the business objectives of the acquisition helps the buyer's advisors prioritize the due diligence efforts and decide what data is relevant.

Start of the Process

While the buyer and seller should initiate the due diligence process as soon as practicable to allow for sufficient time to analyze data, in an ideal situation, both parties will have entered into a letter of intent (LOI) or offering memorandum (offer memo) before undertaking an exhaustive due diligence and document review. Agreement in an LOI or offer memo should review the structure of the transaction and other important matters, including without limitation, confidentiality, whether an exclusivity period applies, which party will bear the costs of the transaction, a mutually acceptable period for conducting the due diligence review and negotiations for the definitive sale and purchase agreement, the consequences to either or both parties if the transaction fails to close successfully, and indemnification baskets and caps. This narrows the objectives of the transaction, and avoids confusion and premature disclosure of sensitive information.

Furthermore, the identification of the transaction structure (whether an asset purchase or stock purchase) and the applicable representations and warranties of the parties will serve as a guideline for the particular due diligence documents that the selling company should provide, and the buyer should obtain and review.

Types of Due Diligence Documents

A robust due diligence process should cover the following, without limitation:

- Evaluation of the target company's owners and employees,
- Assets,
- Clients and customers (both in terms of revenue, as well as concentration risks),
- Employee benefits,
- Company policies and procedures,
- Potential and pending litigation,
- Regulatory reviews and investigations,
- Tax considerations,
- Other sources of potential liabilities (i.e., labor and employment, environmental hazards, real property concerns, etc.),
- Information technology structure and
- Intellectual property rights.

Adequate due diligence also includes a thorough analysis of competitors and competitive markets in the same industry. CPAs may guess correctly that the target company's financial statements, whether prepared internally, reviewed, audited or compiled, constitute one

continued on next page

> **"PROACTIVE DUE DILIGENCE EFFORTS REMAIN VITAL TO ANY COMPANY ANTICIPATING A SALE, IRRESPECTIVE OF WHETHER THE COMPANY IS AN ACQUIRER OR TARGET COMPANY."**

of the primary types of due diligence documents that a buyer should review prior to closing a transaction. In preparing compiled, reviewed or audited financial statements, CPAs are limited to determining if the target's historical financial statements are an accurate representation of the company's operations. In the context of a pending transaction, however, the due diligence process may also require a financial forecast from the target company as part of the purchase price negotiations and the buyer's review of such financial projections for reasonableness.

In certain transactions, particularly those involving companies whose stocks or securities are not traded on an established securities market such as NASDAQ or the NYSE, which is true with all closely held companies, the buyer may need to commission an independent business or stock valuation from an independent appraiser and financial advisor. Financial forecasts and the reasonableness of such projects are particularly important in such valuations. Even in transactions that do not require a separate valuation, buyers may rely upon CPAs for assistance in evaluating the target company's cash flow, earnings, growth potential, reasonableness of debt to equity ratio, appropriateness of accounts receivables and accounts payables, and other financial metrics.

Along with the financial statements and related assessments, buyers and/or sellers may request their respective accountants to assist with the evaluation of the potential tax implications of completing the transaction. If the transaction involves a corporate reorganization, accountants may need to evaluate whether such transaction structure complies with the requirements for tax-deferred treatment under Section 351, et seq. of the Internal Revenue Code of 1986, as amended (the Code). Under Section 338 of the Code, certain stock purchases are treated as asset acquisitions and an election under Section 338(h)(10) of the Code permits an acquirer to purchase a target's stock and, for tax purposes, acquire the target's assets, resulting in a stepped-up basis in the assets. Both the buyer and the seller must make the election under Section 338(h)(10) of the Code.

It may also be helpful to consider other tax-deferral opportunities – such as a qualifying sale of employer securities to an employee stock ownership plan and trust (as defined in Section 4975(e)(7) of the Code) along with the selling shareholder's election to defer recognition of capital gains taxes under Section 1042 of the Code. Also, potential tax liabilities, such as transfer taxes, may impact the decision to structure the transaction as a stock or asset purchase. Employee Stock Ownership/Option Plan (ESOP) transactions can also be funded with pre-tax contributions under certain circumstances and potentially involve a great means of sharing equity on a broad basis with employees. CPAs who conduct an appropriate review will position themselves to help their clients determine how best to structure the transaction from a tax savings perspective.

Additional due diligence consideration should include a thorough review of whether the target company has timely filed all of its income and sales tax (and other reporting and information) returns. This is of particular concern in stock acquisition transactions, where the buyer essentially assumes all of the liabilities of the target company.

If the target company has failed to file their sales and income tax returns in a timely manner and make corresponding tax payments (income, employment or other taxes) on a timely basis to federal and state agencies, the buyer may be faced with the burden of addressing such tax deficiencies following the close of the transaction. Any such tax deficiencies identified during the due diligence period will have a negative effect on the consideration that the buyer is willing to offer for the acquisition, so the seller has a vested interest in proactively addressing any such tax deficiencies.

While it may seem obvious, making a careful review of prior tax returns and making sure that they have been timely filed pays off in dividends to limit exposure to risk down the line. Typical document requests will include the target company's tax returns for the taxable years open to assessment under the Code, documents relating to any governmental tax audits and correspondence with taxing authorities pertaining to potential tax issues. Generally under Section 6501 of the Code, the statute of limitations for the Internal Revenue Service (IRS) to assess taxes is within three years following the filing of a tax return, unless extended with the taxpayer's voluntary agreement or if the taxpayer has failed to file a tax return at all or committed fraud.

Beyond the familiar areas of corporate financial statements and tax returns, CPAs should be aware of other potential areas that may require further scrutiny. Review of a thorough organization structure chart identifies subsidiaries, ownership, parent company relationship and the state(s) of incorporation. The organization chart reveals often overlooked minority shareholders and the complexity of the target company. Companies with a complex corporate structure or new or multiple product lines or types of services offered to customers tend to be more challenging to incorporate into existing business lines and/or further develop. If buyers intend to diversify their business, they will need to familiarize themselves with standards and regulations applicable to the new industry or line of business, which may require advice from experienced legal counsel.

Standard representations and warranties also address whether the parties have the authority to enter into the transaction, if the seller has legal title to the assets or the shares free and clear, if there are any outstanding liens that need to be addressed and whether the target company has operated in the ordinary course of business during the negotiations period. Buyers and sellers should also ensure that there are no change of control provisions in prior contractual agreements that trigger upon the sale; e.g., do landlords, lenders and other contracting parties have claims against the seller and/or buyer downstream? An

Post-Closing

Even if the business parties have established document retention policies, the parties to the transaction (or their advisors) may find it procedurally prudent to circulate a complete record of the due diligence document requests and responses (the due diligence records) contemporaneously with the formal closing binder (which contains the executed transaction documents and any related ancillary documents) on a post-closing basis.

Circulating the due diligence records in such manner avoids any future claim of any ambiguity with respect to which documents have been furnished to the requesting party in advance of closing and preserves written evidence (which is more reliable than personal recall) in case of any future judicial, administrative or regulatory proceeding.

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Want to learn more about what to consider with a merger or acquisition? TSCPA offers CPE programs online. Go to the CPE catalog on the website at tscpa.org.

effective due diligence will mitigate the risk of the parties identifying last-minute surprises that may terminate the deal.

Other areas of concern include, without limitation, workers' compensation claims, and other labor and employment claims, such as ERISA (Employee Retirement Income Security Act of 1974) claims for unfunded pension liabilities that can potentially apply to individuals who own the selling company and may subject the buyer to substantial financial obligations to collectively bargained retirement plans.

Another area of concern is whether the target company owns or leases real property. If the former, then has the target company complied with its obligations as a real property owner? If the latter, does the target company have proper lease or sublease agreements in place? Furthermore, the buyer will need to determine whether the target company or any employee benefit plan that the target company maintains is the subject of any lawsuits, investigation or regulatory proceeding, and whether the target company has sufficient ERISA fiduciary insurance coverage, especially in a stock acquisition with the target company surviving as a subsidiary of the buyer.

In summary, one of the primary purposes of a due diligence review is to ensure that there are no or limited anomalies that the seller needs to disclose in the definitive agreement or mitigate on a pre-closing basis, or that the buyer considers significant in finalizing the consideration that the buyer will pay in the transaction or that the buyer will use as a bargaining tool in crafting some other remedy to minimize the buyer's acquisition risks (such as modifications to a post-closing purchase price adjustment formula, increase in indemnification or other form of holdback amount held in escrow, extension of the escrow period or indemnification period, etc.). It is strongly advisable for the buyer and seller to arrange for their advisors to prepare a formal due diligence report that documents all of these material and significant issues discussed in this article.

Final Remarks

With markets becoming increasingly competitive, companies must find ways to sustain business operations and promote growth. Mergers and acquisitions have many complex facets that involve the intersection of a variety of experienced professionals, including, but not limited to, attorneys, accountants, environmental specialists, information technology experts, marketing teams, human resources, projection management, auditors and consultants.

A professional and thorough due diligence process in which all parties and their respective legal, accounting and tax advisors participate and collaborate minimizes the likelihood of unexpected and unpleasant surprises, and increases the likelihood of reaching a successful closing.

Footnotes

i. Mohamed A. El-Erian, "Markets Benefit from What Didn't Happen in 2017," *Bloomberg*, Jan. 1, 2018, at https://www.bloomberg.com/view/articles/2018-01-02/markets-benefited-from-what-didn-t-happen-in-2017.

ii. Matt Egan, "Dow Plunges 724 Points as Trade War Fears Rock Wall Street," *CNN Money,* March 22, 2018, at http://money.cnn.com/2018/03/22/investing/dow-jones-trade-war-china/index.html.

iii. Joe Ciolli, "Wall Street: more blockbuster mergers are coming," *Business Insider*, Dec. 6, 2017, at http://www.businessinsider.com/wall-street-says-expect-more-mega-mergers-in-2018-2017-12.

iv. Alex Morrell, "2018 has all the makings of a monster year for dealmakers," *Business Insider*, Jan. 11, 2018, at http://www.businessinsider.com/2018-mergers-and-acquisitions-outlook-citi-2018-1.

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Tax Court Jurisdiction is Not Automatic and Your Appeal Might Preclude It

By Marcus J. Brooks

Curriculum: Tax

Level: Intermediate

Designed For: Tax practitioners, CPAs in public practice

Objectives: Learn more about Tax Court jurisdiction, related court cases, judicial review and considerations for Appeals Office determinations

Key Topics: Notice of deficiency and potential for Tax Court review, collection due process hearings, deficiency cases vs. non-deficiency cases, appeals conferences and collection due process hearings

Prerequisites: None

Advanced Preparation: None

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http://bit.ly/cpequiz

One of the many things separating the IRS from most potential creditors is that the IRS has the ability to assess taxes and collect taxes without having to sue the taxpayer, reduce the liability to an enforceable judgment and then proceed with collection activities. Subject to affirmative procedural options on behalf of the taxpayer, discussed further below, the IRS can make an assessment of taxes and simply begin collecting, including utilizing its substantial powers of lien and levy. In other words, if the taxpayer just sits there, the IRS can eventually show up and collect without ever having to file or set foot in front of a judge.

The opportunity for a taxpayer to seek pre-payment judicial review in front of the Tax Court covers most potential tax liabilities. Many taxpayers assume that the opportunity for Tax Court jurisdiction and the procedural protections that generally come with it (e.g., a post-petition appeals conference if the matter has not had consideration by appeals, attention from IRS counsel individually assigned to the case and finally a trial in front of a Tax Court judge) are axiomatic. There are, however, circumstances in which Tax Court review is not available and there are even some situations in which the taxpayer may cut off the opportunity for Tax Court review by seeking an appeals conference prior to a collection due process (CDP) hearing.

A recent case out of the Seventh Circuit, *Our Country Home Enterprises, Inc. v Comm'r*, 855 F.3d 773 (7th Cir. 2017), highlights these issues as it takes a methodical walk through what the court refers to as "the abstruse world of federal-tax procedure." The opinion starts with a big picture, macro take of tax procedure. It then winnows down to the question at issue in that case, namely whether a taxpayer was precluded from challenging liability for a penalty (§6707A failure to include reportable transaction information with return) in a CDP hearing, because the taxpayer previously challenged its liability in an appeals hearing that did not offer the potential for judicial review. The court answers the question in the affirmative, ostensibly leaving the taxpayer to walk the longer and more expensive road of paying the penalty and eventually filing a refund suit if the taxpayer chooses to challenge the IRS' position.

In so doing, the opinion outlines the difference between (i) taxes and related penalties that are subject to deficiency procedures and consequently an opportunity for Tax Court review prior to assessment and collection and (ii) taxes or penalties that are not subject to the deficiency procedures, i.e., "non-deficiency taxes," which do not provide the taxpayer with an opportunity for Tax Court review prior to assessment and collection. It also underscores some situations in which taxpayers might not want to request an appeal, as doing so may cut off an opportunity for Tax Court review.

Deficiency Procedures – i.e., Notice of Deficiency and Potential for Tax Court Review

The court observes that Congress enacted sections 6212 and 6213 to prohibit the IRS from assessing a deficiency in income, estate, gift and certain excise taxes until the IRS issues a notice of deficiency, giving the taxpayer access to Tax Court. A taxpayer then has 90 days (or 150 days if he/she lives outside the United States) to petition the Tax Court for review.

If the taxpayer does not timely file a petition in Tax Court after having received a notice of deficiency, the IRS can assess (or formally record) the deficiency under section 6203. The assessment "is given the force of a judgment," authorizing the IRS to collect the tax. *Bull v. United States*, 295 U.S. 247, 260, 55 S. Ct. 695, 79 L. Ed. 1421, 81 Ct. Cl. 974, 1935-1 C.B. 310 (1935); *Matter of Carlson*, 580 F.2d 1365, 1368 (10th Cir. 1978).

Within 60 days of an assessment, the IRS must notify the taxpayer of the amount due and demand payment. IRC §6303(a). Failure by the IRS to follow the appropriate procedures regarding notice could result in invalidation of a lien or levy. If the taxpayer fails to pay what is due, the IRS can file a notice of federal tax lien, which places a lien on all of the taxpayer's property. IRC §6321. The IRS can also levy on a taxpayer's property, after giving the taxpayer 30 days prior notice. IRC §6331. Finally, the IRS may commence a civil case for collection purposes. *Anuforo v. Comm'r*, 614 F.3d 799, 805 (8th Cir. 2010).

Certain Taxes Not Subject to Deficiency Procedures

Some taxes are not considered deficiencies under the Internal Revenue Code. Certain penalties are, by statute, explicitly exempted from deficiency procedures. *Smith v. Comm'r*, 133 T.C. 424, 428 (2009).[i] Other penalties, such as reporting penalties imposed for failing to report participation in various tax-shelter transactions, have been found to be exempt from deficiency procedures based on the fact that the Tax Court is a court of limited, statutory jurisdiction and an analysis of the penalty at issue. *Smith*, 133 T.C. at 429 (finding section 6707A taxes to be exempt from deficiency procedures).[ii] *Our Country Home* notes that, for these non-deficiency taxes, which are not subject to deficiency procedures like prepayment judicial review in Tax Court,[iii] the IRS can make an immediate assessment.

Collection Due Process Hearings – Procedure and Scope

Prior to 1998, the IRS could reach a delinquent taxpayer's assets by lien or levy providing any sort of pre-attachment process or judicial oversight. In response to concerns about this expansive collection power without judicial oversight, Congress enacted sections 6320 and 6330, granting a taxpayer the right to a CDP hearing within the IRS Office of Appeals after the IRS issues a notice of federal tax lien (§6320) or before the IRS levies on the taxpayer's property (§6330).

Importantly, pursuant to section 6330(d)(1), a taxpayer who disagrees with the Appeals Office's decision in a CDP hearing can appeal that decision to Tax Court. When the issue involves liability for the penalty, the Tax Court reviews the Appeals Office's determination *de novo*. *Goza v. Comm'r*, 114 T.C. 176, 181–82 (2000). However, that Tax Court review is only available for items that were at issue in the CDP hearing. Taxpayers or their representatives can be forgiven for often being confused about what may or may not be raised in a CDP hearing, as it is situation specific and even depends on the type of tax at issue. To wit:

- A taxpayer may raise "any relevant issue relating to the unpaid tax or the proposed levy," including collection alternatives and challenges to the proposed collection action unless "the issue was raised and considered at a ... previous administrative or judicial proceeding" and the taxpayer 'participated meaningfully' in that proceeding." IRC § 6330(c)(2)(A) & (c)(4)(A). [iv]
- A taxpayer may also challenge liability for the tax, but only if the taxpayer "did not receive any statutory notice of

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deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." IRC § 6330(c)(2)(B).

- "An opportunity to dispute the underlying liability includes a prior opportunity for a conference with Appeals that was offered either before or after the assessment of the liability." Treas. Reg. § 301.6330-1(e)(3) Q&A-E2.
- However, "[a]n opportunity for a conference with [the] Appeals [Office] prior to the assessment of a tax subject to deficiency procedures is not a prior opportunity for this purpose." *Id.*

In *Our Country Home*, the court affirmed the Tax Court's refusal to entertain liability arguments by the taxpayer, because the taxpayer had previously participated in an appeals conference. Even though no judicial review had been available from the appeals conference, the court, upholding the pertinent regulations under a *Chevron* deference analysis, held that this presented two separate prohibitions for the taxpayer, even though there had been no opportunity for judicial review of that appeals conference: (i) a prior opportunity to argue liability and (ii) a prior conference in which the taxpayer meaningfully participated. This reading, upheld by the Seventh Circuit here, has also been recently upheld by the Tax Court and the Fourth Circuit. [v]

Section 6330 and the IRS interpretation of the regulations, supported by the court in *Our Country Home*, raise some risks and considerations for taxpayers who would prefer the opportunity for Tax Court review (i.e., for any judicial review prior to collection). They also present some different and significant procedural considerations for taxpayers in a deficiency context versus taxpayers presented with a non-deficiency case.

Considerations Relating to Non-Deficiency Taxes

With respect to non-deficiency taxes, the regulations provide that any opportunity to go to appeals precludes consideration of liability at a CDP hearing. This means that, for non-deficiency taxes, taxpayers should be aware if they are provided an opportunity for an appeals conference prior to collections and a CDP hearing, they may not have an opportunity for judicial review unless they pay the amount and sue for a refund. [vi]

Pre-collection appeals opportunities are not provided in every non-deficiency case. This raises the somewhat perverse incentive for a taxpayer to hope against a pre-collection appeals conference and certainly not to raise the issue lest they be offered such a hearing in a pre-CDP context that provides no opportunity for Tax Court review. If the taxpayer's first opportunity for an appeals hearing is in the CDP context, then Tax Court review of liability should be available. Pursuant to the IRS' reading of the regulations, upheld in dicta by the Seventh Circuit in *Our Country Home*, for non-deficiency cases this would be the taxpayer's only opportunity for pre-collection judicial review.

Considerations Relating to Deficiency Cases

With respect to taxes subject to the deficiency procedures, however, the opportunity for a pre-assessment appeals conference does not constitute a prior opportunity under the regulations. Nevertheless, it is still the case that CDP consideration of liability is unavailable under section 6330(c)(4)(A) if "the issue was raised and considered at a ... previous administrative or judicial proceeding" and the taxpayer "participated meaningfully" in that proceeding. Therefore, where a taxpayer in a deficiency case is presented with an opportunity for appeals, but for some reason did not receive a statutory notice of deficiency or did not receive one in time to file a Tax Court petition,[vii] that taxpayer may still have the opportunity for judicial review through a CDP hearing.

If, however, the taxpayer had "meaningfully participated" in a prior appeals hearing, then the taxpayer has run into a separate prohibition. If the taxpayer had instead foregone participating in an appeals conference at that time, an appeals conference would likely be provided later, after the taxpayer had filed a Tax Court petition, without threatening the potential for Tax Court review on a CDP hearing. While this is probably an insufficient reason, standing alone, to forego pre-Tax Court petition appeals, it is at least one consideration when determining whether to request appeals pre-Tax Court petition or whether to forego appeals until after the Tax Court petition has been filed.

Tax Court Review

Taxpayers should be aware that Tax Court review is not axiomatic. When it is unavailable, or has been foregone, it leaves the taxpayer in the position of having to pay the tax and seek a refund in order to seek judicial review of the IRS' determinations.

In deficiency cases, Tax Court review should be made available either pre-assessment or in a CDP hearing. However, if for some reason a notice of deficiency is not received in time for the taxpayer to seek Tax Court review, the taxpayer's participation in a pre-assessment appeals conference might ultimately preclude pre-collection review by the Tax Court.

In non-deficiency cases, Tax Court review may only be available if the taxpayer pursues a CDP hearing and has not previously had the opportunity for an appeals hearing. An early awareness of these rules, and the identity of your case as a deficiency or non-deficiency case, is necessary in order to (i) set appropriate client expectations, (ii) make the appropriate strategic calls early in a case to save time/resources and (iii) not accidentally forfeit the opportunity for Tax Court review.

Footnotes

i. Internal citation to sections 6677(e), failure to file information with respect to foreign trust, 6679(b) failure to file returns, etc., with respect to foreign corporations or foreign partnerships, 6682(c) false information with respect to withholding, 6693(d) failure to provide reports on certain tax-favored accounts or annuities, 6696(b) rules applicable with respect to secs. 6694, 6695 and

6695A, 6697(c) assessable penalties with respect to liability for tax of regulated investment companies, 6706(c) original issue discount information requirements, 6713(c) disclosure or use of information by preparers of returns, 6716(e) failure to file information with respect to certain transfers at death and gifts.

ii. Internal citations to *Shaw v. United States*, 331 F.2d 493 (9th Cir. 1964) distinguishing section 6672 penalties not subject to deficiency proceedings from section 6651 additions subject to deficiency proceedings; *Medeiros v. Comm'r*, 77 T.C. 1255 (1981) this court lacks jurisdiction to review previously assessed section 6672 penalties, affd. 742 F.2d 1446 (2d Cir. 1983); *Judd v. Comm'r*, 74 T.C. 651 (1981) this court lacks jurisdiction to review assessment of section 6652 additions to tax.

iii. See Internal Revenue Manual §8.17.7.1.1 "When the Tax Court Lacks Jurisdiction" and internal cites therein for information regarding which penalties the IRS views as being outside Tax Court jurisdiction.

iv. It is worth noting that the IRS formerly interpreted section 6330(c)(4)(A) not to apply to liability issues in light of Section 6330(c)(2)(B)'s explicit discussion on that point. See Office of Chief Counsel, Internal Revenue Serv., Notice CC-2003-016, at 20 (2003). But the IRS' current interpretation, affirmed in *Our Country Home* and other cases cited *infra*, simply restates the statutory language. See Office of Chief Counsel, Internal Revenue Serv., Notice CC-2006-019, at 33 (2006).

v. *E.g., Durda v. Comm'r*), T.C. Memo 2017-89 where taxpayer disputed the tax liabilities in a prior appeals hearing, §6330(c)(2)(B) barred him from contesting those liabilities during the CDP process; *Iames v. Comm'r*, 850 F.3d 160, 165 (4th Cir. 2017) finding the regulation to be a "straightforward interpretation of [s]ection 6330(c)(2)(B)."

vi. In *Our Country Home*, the Seventh Circuit stated: "Section 6330(c)(2)(B) speaks to opportunities to dispute liability, not opportunities that a taxpayer actually exercised. … Thus, a taxpayer need not pursue that opportunity to be barred from raising a liability challenge in a CDP hearing." 855 F.3d at 788. The Tax Court itself has not yet had to squarely answer the question of whether just the offer of an Appeals conference is enough to preclude review in a subsequent CDP proceeding if the taxpayer declined the offer. See *Bitter v. Comm'r*, T.C. Memo. 2017-46, at footnote 6 (declining to address the question and citing to *Lewis v. Comm'r*, 128 T.C. 48, 61 n.9 (2007); but also citing *Thompson v. Comm'r*, T.C. Memo. 2012-87 for the proposition that "[a] taxpayer has the opportunity to dispute his liability for a trust fund recovery penalty when he receives a Letter 1153" offering an appeals conference). This at least leaves open an opportunity to decline the appeals conference and argue that a CDP hearing and Tax Court review should still be available. However, the Seventh Circuit's opinion and Tax Court dicta raise questions about the strength of this argument.

vii. Treas. Reg. § 301.6330-1(e)(4) Example 2.

Marcus J. Brooks is a shareholder with Winstead, PC, and a member of Winstead's Taxation, Employee Benefits & Private Business Practice Group. His practice focuses on tax controversies and litigation and tax planning at both the federal and state levels. Brooks also serves as an adjunct professor at Baylor Law School.

By Marcus J. Brooks

Tax Court Jurisdiction is Not Automatic and Your Appeal Might Preclude It

1 Does the IRS have to sue a taxpayer to collect a tax deficiency owed by that taxpayer?

A. Yes
B. No
C. It depends on the kind of federal tax at issue
D. Only if the taxpayer sues in Tax Court first

2 Do taxpayers have to pay a tax in order to obtain judicial review re: whether the tax was owed?

A. Yes
B. No
C. It depends
D. Only for excise taxes

3 What does CDP stand for?

A. Community Deposit Procedures
B. Communes Don't Pay
C. Civil Disobedience Process
D. Collection Due Process

4 A section 6707A penalty is:

A. Subject to deficiency procedures
B. Not subject to deficiency procedures
C. It depends
D. Unreviewable

5 Non-deficiency taxes are:

A. Not subject to deficiency procedures
B. Taxes that you don't owe
C. Taxes that are paid timely
D. Taxes that are paid voluntarily

6 Which of the following is true for deficiency taxes?

A. The IRS can never assess the tax prior to a Tax Court hearing
B. The IRS cannot assess prior to providing the taxpayer with a notice of deficiency
C. The IRS must file a petition in Tax Court prior to assessment
D. All of the above are true

7 Which of the following is true for non-deficiency taxes?

A. The IRS can never assess the tax prior to a Tax Court hearing
B. The IRS cannot assess prior to providing the taxpayer with a notice of deficiency
C. The IRS must file a petition in Tax Court prior to assessment
D. None of the above are true

8 Liability must be considered at a CDP hearing, if requested by the taxpayer.

A. True
B. False
C. It depends on the type of tax
D. It depends on the amount at issue

9 Non-deficiency taxes may be challenged in Tax Court

A. Never
B. Any time before assessment
C. Only after a CDP hearing
D. Only after assessment

10 All appeals conferences offer an opportunity for judicial review.

A. True
B. False

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June 12	New! Cybersecurity Advisory Engagement Essentials	Houston
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June 25-27	Cowboy Summer Cluster at The Gaylord Texan Resort	Grapevine
June 27	2018 Audits of Employee Benefit Plans Conference	Addison
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July 10	Personal & Professional Ethics for Texas CPAs	Fort Worth
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July 13	New! Cybersecurity Advisory Engagement Essentials	Fort Worth
July 16	Revenue Recognition: Mastering the New FASB Requirements	Fort Worth
July 16	Tax Reform: Understanding the Tax Cuts and Job Act	Houston
July 17	Personal & Professional Ethics for Texas CPAs	Dallas
July 17	Annual Update for Accountants and Auditors	Fort Worth
July 17	Texas Franchise Tax	Austin
July 18	Tax Reform: Understanding the Tax Cuts and Job Act	Dallas
July 18	Advanced Business Law for CPAs	Houston
July 19	Revenue Recognition: Mastering the New FASB Requirements	Houston
July 20	Annual Update for Accountants and Auditors	Houston
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