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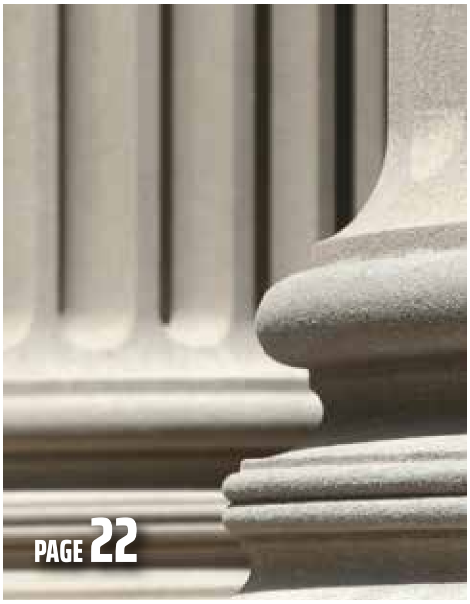

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EVOLVING PRIORITIES

By TXCPA Chairman Lei D. Testa, CPA-Fort Worth, CGMA

Share Your Thoughts
I'd love to hear your feedback and answer your questions. Drop me a note at chairman@tscpa.net.

Happy New Year! That's right. At TXCPA, we celebrate a new year each June. As we move through our first quarter, we're delivering even more value to members and continuing forward on the commitments set in our strategic plan. I'm excited about what lies ahead this year and I know you will be too, as you watch the value of your membership continue to grow!

Our strategic plan outlines three pillars of success under which we deliver benefits to members – community and connection, professional excellence and advocacy. Within these pillars are various programs and services that are evaluated and enhanced each year.

In 2019-2020, your leadership is specifically working on five priorities to build on our successes and fulfill our promises to members. Our priorities this year are to:

- Engage the next generation of CPAs;
- Enhance state and chapter collaboration;
- Extend the brand to promote the profession;
- Expand digital learning opportunities;
- Educate stakeholders on the significance of professional licensing.

I hope you'll join me in working in these five areas. Whether it's through local service in your chapter, speaking to a group of students at your alma mater or participating in one of our many new learning opportunities, the contributions of each member add up to measurable impact on the future of our profession.

Thank you for your membership and involvement in TXCPA! I look forward to the great things we will do together!

SEC PROPOSES EXPANSION OF EXEMPTION FROM INTERNAL CONTROL ATTESTATION

By Don Carpenter, MSAcc/CPA

More than 15 years ago, Sarbanes-Oxley (SOX) moved internal controls into the spotlight for SEC filers. With its enactment, SOX required:

- The CEO and CFO to provide certifications regarding the effectiveness of an organization's internal controls (SOX 302);
- Organizations to establish and assess the effectiveness of internal controls over financial reporting (SOX 404a);
- The filer's independent audit firm to assess and attest to the effectiveness of the client's internal controls (SOX 404b);
- Organizations to have an audit committee of independent board members, including a designated financial expert with oversight responsibility for internal controls (SOX 407).

At the same time, SOX also introduced three categories of filers: large accelerated filers, accelerated filers and non-accelerated filers. The primary focus of the stratification is the due dates for an entity's Forms 10-K and 10-Q.

Overlaying this three-tier filing stratification, however, is a distinct category of filers identified as smaller reporting companies (SRC). SRC status eases some of the disclosure burden for smaller companies, which arguably have a more limited investor base. Each of these categories is delineated by the magnitude of a company's public float. In the case of SRCs, this is coupled with an annual revenue limit. Table 1 gives the stratification.

Under certain circumstances, an SRC can be either an accelerated filer or a non-accelerated filer and benefit from the reduced disclosure requirements of the SRC reporting regime.

However, it is non-accelerated filers, rather than SRCs, that are exempted from the requirement to include the independent auditor's attestation to the effectiveness of the filer's internal controls over financial reporting (SOX 404b). And herein lies the impetus for the SEC's proposal to simplify and expand the category of companies that qualify for this exemption. The proposal justifies the expansion as an effort to reduce audit fees for smaller public companies, thereby freeing up cash for investment in the business.

The SEC's proposal would conform the non-accelerated filer thresholds to the SRC thresholds. Under the new thresholds, an entity would be a non-accelerated filer and an SRC if its public float is less than $75 million

TABLE 1. STRATIFICATION OF ENTITIES

CATEGORY OF FILER	DEFINITION	FILING DEADLINE 10-K	FILING DEADLINE 10-Q
Large Accelerated Filer	Public float of at least $700 million	60 days	40 days
Accelerated Filer	Public float of at least $75 million, but less than $700 million	75 days	40 days
Non-accelerated Filer	Public float of less than $75 million	90 days	45 days
Smaller Reporting Companies (SRC)	Public float of less than $250 million OR Annual revenues of less than $100 million and public float of less than $700 million	Not applicable – either accelerated or non-accelerated filing status	

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or its public float is less than $700 million and annual revenues are less than $100 million.

In reviewing historical data, the SEC estimates that the proposal could result in 539 additional issuers qualifying for non-accelerated filer status. Of these, 181 already qualify under the "emerging growth company" exemption from the internal control attestation, resulting in an additional 358 additional issuers qualifying for the exemption.

Inherent in this proposal is the assumption that the expanded exemption is justified under a cost (increased risk to investors) / benefit (reduced audit fees) analysis. On the risk side of the equation, 27.5% of non-accelerated filers had ineffective internal controls for two consecutive years in 2016-2017, based on management reporting. This compares to single digit ineffectiveness by accelerated filers. On the cost side, average audit fees for non-accelerated filers averaged just over $170,000 for the past four reporting cycles compared to about $435,000 for accelerated filers with less than $100 million of revenue. Based on surveys and trend analysis, the SEC estimates that roughly 30% of audit fees are related to the internal controls attestation during the years reviewed. With the new risk assessment auditing standards, the SEC rounded down the annual savings to $100,000. The estimate attempts to adjust for the reality that costs on the substantive audit will increase as the independent auditor puts less reliance on internal controls.

In making this proposal, the SEC is relying on the fact that the company must continue to self-report on the effectiveness of its internal controls over financial reporting and the CEO and CFO must continue providing the required certifications. What is not evident from the SEC's proposal is the extent to which the independent auditor's involvement in the assessment of internal controls has assisted non-accelerated filers in identifying the internal control ineffectiveness cited above. One must also question whether smaller companies will become less diligent if the oversight of the independent auditor is absent. Only time will tell.

If the proposal is adopted, some companies should consider retaining the independent auditor attestation if they anticipate an additional float or growth in revenues that will result in no longer qualifying for the exemption. Reestablishing the attestation could prove costly and time consuming.

It may be somewhat surprising that the SEC is diluting requirements surrounding internal controls. As comments are received, it will be interesting to see how investors react to this proposal.

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WAYFAIR AND THE MINEFIELD OF SALES TAX ECONOMIC NEXUS

By David Brennan

For better or worse, sales tax is changing. If your clients meet a certain sales or transaction threshold, they now have the obligation to collect sales tax in potentially multiple jurisdictions … not just within Texas! You need to have an immediate discussion with your clients about economic nexus and its risks before a state has that talk with your client for you.

Economic Nexus Replaces Physical Presence

In the golden years of sales tax, the United States Supreme Court stated physical presence was required to compel a company to collect sales tax in the landmark case *Quill Corp. v. North Dakota.* If physical presence was not the baseline requirement, then every taxing jurisdiction in the nation could require sales tax to be collected. Companies could easily determine where they had to collect sales tax. Companies could also decide where they did not want to collect sales tax. Compliance was simple.

States noticed online sellers were not collecting sales tax, since the online seller was not physically present in the state and purchasers would not remit the required use tax. As a result, tax revenues were decreasing. In response, states came up with various ways to attempt to get sellers outside of the state to collect sales tax. One method was called economic nexus.

Economic nexus means an out-of-state company must collect sales tax if the business makes a certain dollar amount of sales or number of transactions into a state. One of the states instituting economic nexus was South Dakota. South Dakota stated if a company made more than $100,000 of sales or at least 200 sales transactions into South Dakota, the company had to collect sales tax for the state.

This South Dakota law was immediately taken to court. The case became known as *South Dakota v. Wayfair* and eventually found its way to the United States

Supreme Court. The United States Supreme Court threw out the physical presence requirement. In other words, the Supreme Court said South Dakota's law was constitutional. Many of the ramifications of this decision remain unclear, including how low a state can go on its economic nexus thresholds and remain constitutional.

Economic Nexus Trending Nationwide

After the *Wayfair* decision, states began implementing thresholds similar to South Dakota with an effective date anywhere from a couple of weeks after the decision to several months later. Some states even chose to implement higher thresholds. It is highly likely this trend of economic nexus implementation will continue until almost all states have such a standard. As state legislatures have been having session since *Wayfair* was decided, these states have been adopting the "Wayfair" standard. However, the biggest implication of the decision is now every taxing jurisdiction nationwide can implement economic nexus – states, counties, municipalities or any other jurisdiction imposing a sales tax. For Texas CPAs, the burden of knowing a lot about everything has been taken to new heights with economic nexus.

The potential ramifications are astounding. Not only might a client have to become registered with a state for sales and use tax purposes, but also with a county and municipality. While some states do provide a consolidated application and administration, not all states do so, which effectively triples the number of taxing jurisdictions for clients (or you on behalf of your clients) to register in and file returns. Such a problem only becomes more frustrating for clients as they try to grapple with the new requirements thrust upon them.

Businesses now have the enjoyable exercise of determining the taxability of their sales in each taxing jurisdiction for which the business is required to collect sales tax. In addition to the taxability determination, research must be done for each jurisdiction as to what exemptions might apply and how to fully document the exemption.

We are particularly concerned about taxpayers being contacted directly by taxing jurisdictions. These jurisdictions are not waiting around on the chance to grab revenues from any source possible … including your client. States are actively pursuing companies they believe meet the thresholds. A failure of the company to timely respond to the inquiry or the wrong answer to the inquiry can lead to potentially devastating results. In the eyes of the states, your client is guilty until proven innocent.

THERE ARE A FEW STEPS YOU CAN TAKE TO GET YOUR CLIENT THE IMMEDIATE HELP THEY NEED.

The Minefield of Economic Nexus

Economic nexus has created numerous pitfalls for the unwary. The slightest misstep could significantly exacerbate the issues your client faces, as clients can no longer be concerned solely with Texas. There are a few steps you can take to get your client the immediate help they need. The key is you should take the proactive step to act now before the issue worsens.

1. As an initial matter, you need to have a complete understanding of your client's business even if the business is only physically present in Texas. Know it inside and out. Besides what the client sells, you need to know how and where sales are made. Document your understanding.

Additionally, you must find out whether any services are provided after the sale and where inventory is kept. For instance, does your client use Amazon's FBA Services? If so, your client's inventory could be spread across the country, leading to nexus long before the change in the law. Worse, clients oftentimes have no idea their inventory has been moved or where the inventory is currently located. This Amazon FBA inventory problem is something we have already seen states aggressively pursuing.

2. Next, obtain from your client the sales and number of transactions broken out by state by year. An Excel spreadsheet of this information is best. The information may even need to be broken out by county/municipality. Sales might be made from the client's location in Texas, but most states will take the position the sale counts toward the threshold based on where the goods are delivered (destination based). Cross-reference this information from your client against the jurisdictions imposing economic nexus. You need to take this step to determine your client's exposure nationwide.

3. Now, the decisions are up to the client on what to do next and when. Based on the jurisdictions with economic nexus, the client can make an informed decision on which jurisdictions outside of Texas to register in to mitigate overall exposure. Some clients may want to register everywhere and some clients may decide to register nowhere. Still other clients may conclude to register on a rolling basis for business

reasons (e.g., to allow time to integrate tax software with websites, point-of-sales systems, etc.). The longer it takes for the client to reach a decision, the greater the client's liability becomes, as sales tax is not being collected from its customers. And again, you may want to document your discussion with the client and their decision.

Registration Pitfalls

For the jurisdictions your client wishes to register in, you must be careful when completing the registration applications. We have seen application questions that lead businesses to a particular response that permit the state to audit the business from the beginning of the business start date. While a question appears to be benign, it is not.

You must have a formulated position on when your client had nexus with the state, as placing any date could lead to the state instituting an audit for the prior period, and an assessment of tax, penalties and interest. Answering these registration questions in a careful, but accurate manner is precisely how we have advised clients and has been our objective.

In our experience, we generally suggest having a client with exposure in a state register through the voluntary disclosure program. The voluntary disclosure program allows your client to minimize penalties, reduce the state's look-back period and apply for forgiveness for taxes not collected from customers. However, if your client has already been contacted by the state, voluntary disclosure may be off the table.

Another pitfall hidden in the application is potentially admitting to a requirement for registering for other tax types, which is discussed in more detail below. With these other tax types, your client then has to build the additional cost of doing business in a given state into higher sales prices instead of simply passing the tax on to the customer as one would with a sales tax. Imagine the anxiety a client would have after receiving an audit assessment that could put them out of business. The sad part is the devastating assessment could have been avoided if certain actions had been taken earlier.

Finally, simply registering in all taxing jurisdictions is not always the right answer. There are two significant issues with blindly registering everywhere. First, by registering for sales tax everywhere, the possibility exists of the need to also register for other tax types. While states have similar tax types, there are certain states with unique taxes that will trap the unwary. Therefore, your client should be certain of registering in specific jurisdictions, due to other unknown tax types lurking in the shadows.

Wayfair Legislation in Texas

During the 2019 legislative session, HB 2153 was passed to allow the Texas comptroller to identify a single tax rate to apply to remote sellers with the intent to simplify online vendors' sales tax calculations. A related bill, HB 1525, also passed and requires "marketplaces" such as Etsy, Ebay and Amazon to collect sales tax on third-party, out-of-state sellers.

It is expected to yield more than half a billion dollars for the state. Both HB 2153 and HB 1525 became law and are effective effective on October 1. TXCPA will keep members informed about new Texas Comptroller regulations that conform to the new laws as they become available.

Every time a registration is made for a specific tax type, your client will most likely have an audit on the tax sometime in the future. While the number of audits for the tax may vary, imagine having a full company audit every two months. Even for the more sophisticated Texas businesses, such a frequency is unsustainable!

Being Proactive

In conclusion, you and your clients need a clear path to tackle the new burdens associated with economic nexus. Understanding the traps for the unwary can help ensure a smoother process.

It is important for taxpayers to take action swiftly to avoid the expense of battling with a state. In fact, the states are already sending out inquiry letters. Why wait until a letter is received to do something? Be proactive and help clients mitigate their exposure right away.

About the Author:

David Brennan is a Florida attorney at Moffa, Sutton, and Donnini, P.A., which has a primary focus on multistate sales and use tax controversy. Brennan was a senior attorney at the Florida Department of Revenue from 2014 to 2016. He focuses his practice primarily on sales and use tax issues. He can be contacted by email at DavidBrennan@FloridaSalesTax.com or via telephone at 850-250-3830. He would like to thank James Sutton for his contribution to this article.

IT'S OVER!

WHAT A DIFFERENCE TWO YEARS CAN MAKE

By John Sharbaugh, CAE

The Texas Legislature ended its 140-day session on May 27, 2019. Right on schedule. What a difference two years can make. In 2017, the legislature was still in the midst of a special session at this point, extending their work past its normal end.

And two years ago, the legislative session was also one defined by controversy and infighting over a variety of social and political issues that played out on a near-daily basis. Heck, last time, a couple of legislators almost came to physical blows on the floor of the House. Not so this session. Rather, this legislative session produced few fireworks and was boringly efficient in addressing some of the major issues facing the state.

John Sharbaugh, CAE, TXCPA Managing Director, Governmental Affairs

What caused the change? Well, last year's election probably had an effect. The Democrats picked up seats in the House and Senate and the margin of victory for many Republicans fell well short of historical standards. That sent a message to the state's top leaders (all Republicans) that they needed to keep the focus on getting some practical things accomplished for voters, rather than waging battles on controversial issues.

Another factor was that one of those top leaders – the speaker of the House – was a new player. With the retirement of former Speaker Joe Straus, Rep. Dennis Bonnen was elected to fill that leadership post. He worked hard to change the atmosphere in that chamber and he also had a better working relationship with Lt. Governor Dan Patrick and Governor Greg Abbott. All these factors combined to produce less fighting and more cooperation to get things done.

An Active Session

Since legislators weren't fighting as much this session, they had more time to focus on getting things done and the statistics bear that out. There were 7,324 bills introduced, and 1,429 were passed and sent to the governor. That's a pass rate of 19.5% and is in line with recent historic norms.

Many bills are introduced, but only a portion are actually passed. It was the largest number of bills introduced in the last 10 years and there were nearly 700 more bills introduced than in the last legislative session.

Sunset Success

The number one priority for TXCPA and the CPA profession heading into the legislative session was to ensure the renewal and continuation of the Texas State Board of Public Accountancy (TSBPA) and the Texas Public Accountancy Act (TPAA) as they went through the sunset review process. I'm happy to report that we were successful on that front, and legislation (HB 1520) reauthorizing TSBPA and the TPAA was passed and signed by the governor. So, the licensed CPA profession in Texas will continue on for another 12 years until 2031, our turn for sunset review again.

In addition to continuing TSBPA for another 12 years, the legislation passed includes several changes to the TPAA that TXCPA lobbied for as the process played out. The TPAA now conforms with the AICPA/NASBA Uniform Accountancy Act and most other states on the issues of CPA firm mobility and resident manager requirements for CPA firms.

TXCPA was also successful in having the newly enacted fingerprint-based background check requirement for licensed CPAs modified to exempt retired and disabled CPAs. And we were able to convince the Sunset Commission to defer on reducing the number of CPAs serving on TSBPA and going to a majority public member board.

SUCCESSFUL PASSAGE OF THE SUNSET BILL CONCLUDES NEARLY A YEAR OF WORK ON THIS TOP ADVOCACY PRIORITY FOR TXCPA. PASSAGE OF THIS VITAL LEGISLATION ENSURES THAT TSBPA – AND THE CPA PROFESSION IN TEXAS – WILL CONTINUE FOR AT LEAST ANOTHER 12 YEARS.

In the end, the Sunset Commission recommended, and the legislature adopted, another way to deal with the possible loss of the state exemption under the federal anti-trust laws. SB 1995, which was passed this session, will create a new division within the governor's office that will provide the "active state supervision" to help address this issue for licensing boards that may have a majority of licensees serving on them.

Other Issues Affecting CPAs

In addition to sunset review, TXCPA focused on several other issues on behalf of our members this session. These included:

- Vendor Monitoring Software: TXCPA opposed HB 1352, which would have required vendors who provide professional services or technical information technology services to governmental entities in Texas to install software on their computers that would track their key strokes and require that screen shots be captured once every three minutes and be maintained for seven years. TXCPA and several other groups testified against the proposed legislation and the bill did not make it out of committee, so our opposition was successful. But the issue could always come back in the future.

- Nonprofit Disclosure Requirements: TXCPA supported passage of SB 1463, a bill that would modify record-sharing requirements for nonprofits in Texas to provide clarity as to exactly what kinds of information they must share with the public on request, hopefully reducing the number of harassing and abusive requests under the current law. SB 1463 was passed in the Senate, but it was never scheduled for a vote in the House before the deadline for passing Senate bills. This issue will have to be re-introduced in the next legislative session.

- *Wayfair* Legislation: There were a couple of bills designed to implement last year's U.S. Supreme Court decision related to the ability of states to make out-of-state sellers collect sales tax on sales to in-state buyers. HB 2153 was passed to allow the Texas comptroller to identify a single tax rate to apply to remote sellers with the intent to simplify online vendors' sales tax calculations. A related bill, HB 1525, also passed and requires marketplaces such as Etsy, Ebay and Amazon to collect sales tax on third-party, out-of-state sellers. It is expected to yield more than half a billion dollars for the state. HB 2153 and HB 1525 were both signed by the governor and are both effective on October 1. For more information on the *Wayfair* decision, please see the Tax Topics article in this *Today's CPA* issue.

THE OVERARCHING ISSUES THE LEGISLATURE FOCUSED ON THIS SESSION WERE TO ENHANCE AND IMPROVE THE WAY PUBLIC SCHOOLS ARE FINANCED AND TO REDUCE OR SLOW THE GROWTH RATE OF PROPERTY TAXES FOR HOMEOWNERS.

School Finance and Property Tax Reform – The Big Issues

The overarching issues the legislature focused on this session were to enhance and improve the way public schools are financed and to reduce, or at least slow the growth rate of, property taxes for Texas homeowners. The governor had identified both of these issues as priorities at the outset of the legislative session. After months of debate, the House and Senate finally agreed on solutions to both.

On the school finance front, the legislature passed HB 3 that will, among other things, provide an additional $6.5 billion in funding for public education and increase the state's share of school funding to 45% from the current 38%. It provides money to raise teacher pay and funds full-day pre-K for eligible four-year-olds and increases revenue to educate low-income students. HB 3 also provides $5.1 billion in property tax relief and limits the future growth of school district property tax increases to 2.5%.

The main property tax relief bill (SB 2) will slow the growth of future property taxes by setting a new ceiling of 3.5% for cities, counties and other taxing units before they would be mandated to let voters approve any larger proposed increase. The effect of these various measures is estimated to provide a property tax decrease of a few hundred dollars on a home valued at $250,000. While the immediate effect on property taxes may be limited, future increases will likely be smaller, due to the necessity to get voter approval.

Budget

The only thing the legislature is mandated to do each legislative session is pass a budget and they complied with their constitutional duty again this year. The legislature approved spending $250.7 billion over the next two years. That's an increase of 16% over the 2018/19 budget.

They also adopted a supplemental budget to cover the shortfall of the current budget to the tune of $9.9 billion, including using $6.1 billion from the state's Rainy Day Fund. Much of that supplemental budget will be used to cover the shortfall in the state's Medicaid costs, as well as for Hurricane Harvey relief and some large infrastructure projects.

What's in Store for 2021?

While the legislature had plenty of money to use this go around (the comptroller authorized $9 billion more than two years ago), that may not be the case in 2021 when the legislature convenes again. If the economy slows and/or oil prices drop, the 2021 legislative session may prove challenging for legislators to maintain some of the initiatives they adopted this year. Since the legislature is required to adopt a "balanced budget" if revenues drop, they will be faced with cutting costs or seeking new sources of income, meaning taxes of some sort.

The 2021 legislative session may be more contentious, since the legislature will re-draw the state's political maps based on the results of the 2020 census. The 2020 election will probably also have an effect on how the next session plays out. Democrats are determined to try and pick up additional seats in the legislature, playing off their success from last year. And Republicans will work to defend their seats and maintain their majorities in both chambers. While this session was relatively mild in terms of political fights, that may not be the case in two years. Only time will tell.

Thanks to Our Advocacy Team

As noted above, passing legislation is not easy and only around 20% of bills introduced end up getting passed. There is no guarantee that a bill will make it through the legislative process. To have a chance, you need to be organized and have a good legislative team to support you.

A big thank you to all of the Advocacy volunteers on our team who were involved in our efforts this session. Many thanks to all of our TXCPA Key Persons and to all who contributed to the TXCPA CPA-PAC. Your involvement made a big difference and our success is directly related to your involvement.

Over the next two years, TXCPA will be planning and strategizing on its agenda for 2021 and studying the issues that may come into play that could affect CPAs and the broader business community. Our various advocacy-related committees will be mapping out our proposed course of action. If you're interested in getting involved in the TXCPA Advocacy program, please volunteer for one of our committees by going to the TXCPA website at tscpa.org. We welcome your interest and your support.

KATE DEVEY, CPA-PERMIAN BASIN

Kate Devey is a tax manager at Johnson, Miller & Co., CPAs in Midland. She is an active member of TXCPA Permian Basin, currently serving as chapter vice president, and was named a TXCPA 2019 Rising Star. We recently caught up with her to learn more about her background and community involvement.

Kate Devey

Where were you born and where did you grow up?
I was born and raised in Midland, Texas.

Tell us about your family.
My husband and I have seven fur-babies: five dogs and two cats. We love border collies and any other rescue dog. I also love to hang out with and spoil my nephew.

Why was it so important to you to get your CPA license?
I believe in finishing goals when you start them. Earning my CPA license was never optional and was not only the most important goal I've had in my life, but also the most rewarding. The value my CPA license added to my career opportunities and professional fulfillment are immeasurable.

Tell us about a project or accomplishment that you consider to be very significant in your career.
One of my greatest accomplishments has been through mentoring and training staff members at our firm. Helping new accountants as they make huge strides both professionally and personally in their first few years is rewarding. Personal experience has allowed me to help steer new staff members clear of potential pitfalls and towards their long-term goals, whatever those may be. Watching them have lightbulb moments is one of the best parts of what I do.

I was also lucky enough to participate in the Generations Program put on by the Nonprofit Management Center in Midland. Generations is a select training program for future board members that helps provide a pipeline of volunteers for the local nonprofit sector. This program gave me the building blocks to effectively serve Mission Center Adult Day Service as a director and officer. My board service has not only given me personal fulfillment, but it has helped me continue my professional growth.

Who has been the biggest influence on your life and/or career and why?
My hero will always be my mom's dad. He was my best buddy growing up. His stories were larger than life; they painted vivid pictures of Texas before and during the Depression, the University of Texas campus, World War II and the American glory days that followed. He was always full of life; he never met a stranger and would always go out of his way to help someone in need. He showed his love for his family and his wife every day. He never let anything go to waste. His life was an example that I will always try to live up to.

You're active with your TXCPA chapter and in your community, serving on several boards in the area. Why is involvement in your chapter and local community so important to you?
As CPAs, we are blessed with many advantages. It is our responsibility to give back to our communities in any way that our passions guide us or that our skill set can do the greatest good. We also have a duty to our profession to further the mission of TXCPA so that our profession can continue to prosper in perpetuity. Being actively involved with TXCPA and my community is a duty that will last long after my professional career.

What is your favorite vacation destination? Any upcoming travel plans?
I like to spend time in the mountains or any place that is cooler than Texas during the summer months. I plan on spending quality time with my family and catching a couple of concerts this summer.

Renew Your Membership

Make sure you promptly renew your membership. By renewing today, you'll avoid an interruption in your benefits, including complimentary ethics CPE, deep discounts on the new TXCPA Passport CPE and full access to TXCPA Exchange.

For questions regarding member dues or the renewal process, please contact Member Services at 800-428-0272, option 1.

Next *Today's CPA* Magazine is Digital Only

The September/October issue of *Today's CPA* will be digital only. You'll be able to enjoy the convenience of this valuable member resource delivered on your device or home or office computer. Be sure to watch your inbox for a link to the digital version of *Today's CPA* coming in September.

CGMA® Designation – Distinguish Yourself as a Strategic Leader

The Chartered Global Management Accountant (CGMA®) designation recognizes U.S. CPAs and CIMA members who work in management accounting roles. It is powered by AICPA and CIMA, two of the world's leading accounting organizations.

The CGMA designation:

- Showcases your global value by demonstrating your leadership, people, digital and financial skills;
- Was developed for finance professionals, based on input from hundreds of companies around the globe;
- Helps finance professionals become strategic business partners and advisers to other departments in the business;
- Teaches both hard and soft skills, leading to well-rounded employees.

Jumpstart your career today! For more information about the program and its benefits, visit their website at cgma.org.

TXCPA Passport Offers Special CPE Savings for Members

If you're looking for outstanding savings and a convenient way to earn your CPE credit, be sure to subscribe to our new TXCPA Passport! For only $199, you'll receive one year of unlimited access to a catalog of more than 160 hours of on-demand CPE courses available to watch at any time.

The Passport gives you an immediate connection to a library of online programming covering a variety of topics. More than 50 programs are available and your subscription includes access to new course additions to the catalog as they become available.

Upgrade your CPE experience today! Go to the Education section of our website at tscpa.org, click on Online Learning and then TXCPA Passport to start receiving your special savings designated exclusively for TXCPA members.

Accountants Confidential Assistance Network Resources

Eight Tips for Leading a More Balanced Life

Through administration of the Accountants Confidential Assistance Network (ACAN), the TXCPA Peer Assistance Foundation makes a positive impact on the CPA profession in Texas. This year, we're celebrating 25 years of ACAN and the work they do to help CPAs, exam candidates and accounting students learn how to merge healthier living with a demanding accounting career.

Achieving a work-life balance for CPAs can seem like an impossible task, but these eight tips can help you achieve a healthier balance between your personal and professional life:

- **Unplug Your Phone at Night** – After you get home and settled in, take a break from your phone, email and social media accounts until morning;
- **Get a Hobby** – Having a hobby will allow you to spend time doing something that's not only enjoyable, but also more fulfilling than watching TV;
- **Plan a Trip** – A change of scenery along with spending time not thinking about work can do wonders for your mood and even boost your productivity once you get back to the office;
- **Automate and Outsource What You Can** – Work smarter, not harder by leveraging automation tools and project management software, and outsourcing tasks when possible;
- **Practice Self-Care** – Making diet, physical activity and other healthy adjustments can increase efficiency and happiness levels;
- **Maximize Your Downtime** – Look for ways to maximize your time out of the office just like you attempt to maximize your time when you're working;
- **Lead By Example** – Having a leader who strives for work-life balance and embodies that culture can lead to a more productive and efficient team;
- **Define Balance for Yourself** – Think about what work-life balance means to you, define it, document it and make it happen.

Think critically about how you spend your time and energy. Although work-life balance can mean something different to every individual, these tips can help you find the balance that's right for you.

Source: Forbes.com

TXCPA Recognizes 2019 Rising Stars

TXCPA congratulates the 2019 Rising Stars honorees. A task force selected these 20 up-and-comers based on their contributions to the accounting profession and their communities.

The 2019 Rising Stars will be featured in an upcoming issue of *Today's CPA* magazine. They include:

- **Jessica Lopez** - Austin Chapter
- **Omolara Akinboye** - Austin Chapter
- **Caitlin Chupe** - Corpus Christi Chapter
- **Brett Morrison** - Corpus Christi Chapter
- **Lucy Turek** - Dallas Chapter
- **Heather Sanders** - East Texas Chapter
- **Adrian Brito** - El Paso Chapter
- **Megan Terrell** - Fort Worth Chapter
- **Rachel Glasser** - Fort Worth Chapter
- **Phillip Hernandez** - Fort Worth Chapter
- **Stephanie Buduhan** - Fort Worth Chapter
- **Marianne Barry** - Fort Worth Chapter
- **Stephanie Shaner** - Fort Worth Chapter
- **Ruben Yeriazarian** - Houston Chapter
- **Robert Allen** - Houston Chapter
- **Nina Perez** - Houston Chapter
- **Laura Mardis** - Houston Chapter
- **Kathryn Devey** - Permian Basin Chapter
- **Chad Valentine** - Permian Basin Chapter
- **Lauren Seaux** - Southeast Texas Chapter

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.

2019 SUMMER AND FALL
TXCPA CONFERENCES

Mark your calendar for TXCPA's popular, live learning opportunities being held this summer and fall. Come for the sessions, benefit from the networking and leave with knowledge to advance your career.

Texas State Taxation Conference
Houston, August 5

Forensic, Litigation and Valuation Services Conference
San Antonio, August 8-9

Advanced Estate Planning Conference Plus Pre-Conference Workshop
San Antonio, August 14-16

CPE Value Conference
Dallas/Addison, August 26

Financial Institutions Conference
Dallas, September 16-17

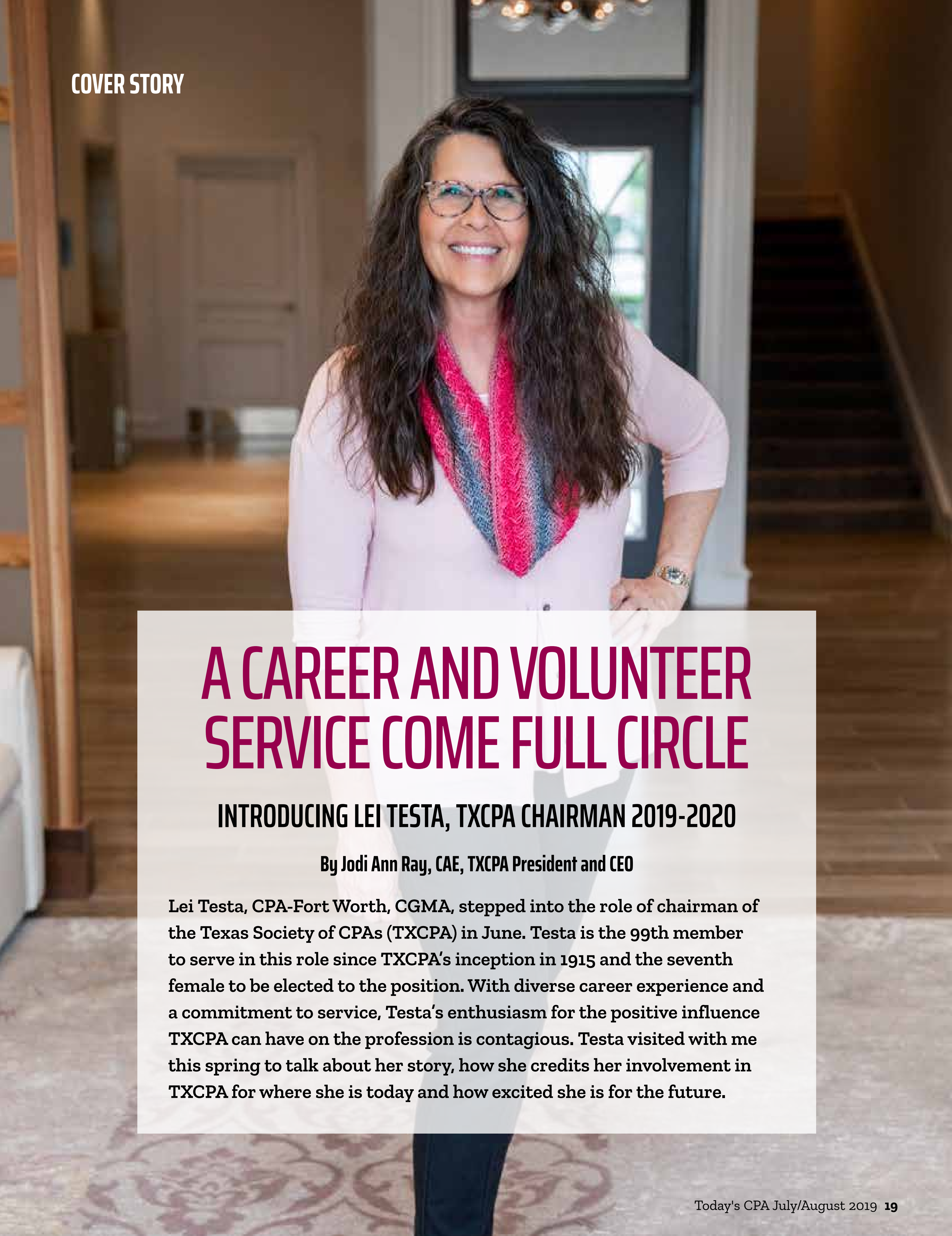
Governmental Accounting & Single Audits Conference Plus Optional Bonus Session
Austin, September 29-October 1

Accounting Education Conference
Austin, October 4-5

Texas CPA Tax Institute
Dallas, November 14-15

Texas CPA Tax Institute
San Antonio, November 14-15, 2019

To learn more and register, go to **tscpa.org**.



A CAREER AND VOLUNTEER SERVICE COME FULL CIRCLE

INTRODUCING LEI TESTA, TXCPA CHAIRMAN 2019-2020

By Jodi Ann Ray, CAE, TXCPA President and CEO

Lei Testa, CPA-Fort Worth, CGMA, stepped into the role of chairman of the Texas Society of CPAs (TXCPA) in June. Testa is the 99th member to serve in this role since TXCPA's inception in 1915 and the seventh female to be elected to the position. With diverse career experience and a commitment to service, Testa's enthusiasm for the positive influence TXCPA can have on the profession is contagious. Testa visited with me this spring to talk about her story, how she credits her involvement in TXCPA for where she is today and how excited she is for the future.

First Stop: The Big 6

Testa took a traditional path to accounting. Graduating from the University of Texas at Arlington with a degree in accounting, Testa was the first in her family to go to college. After graduating, she spent four years with Deloitte in Dallas, which at the time was one of the Big 6 accounting firms. While at Deloitte, she was exposed to working with many different industries, including oil and gas, health care, manufacturing and distribution, as well as retail. Testa gained tremendous experience completing inventories on everything from the catalog warehouse at Neiman Marcus, where the security was tight, to completing a 100% count in a recycling yard where the thermometer read 137 degrees!

A mentor told her that if she did inventories whenever she was asked, the scheduler would remember that. She was appreciative of never having to work on New Year's Eve, because the scheduler did remember.

Her Passion for Health Care

Although she thoroughly enjoyed her time and experience at Deloitte, Testa quickly found that her passion was in the health care field. She left Deloitte and went to work in the general ledger department for Cook Children's Health Care System. The department was responsible for closing the books for six entities and Testa distinctly remembers that at one time, the whole department decided to leave Cook Children's on the same day, with the exception of two of them. Those two had to close the books for the six entities for several more months until the department could be re-staffed. They had no choice but to quickly learn how to be more efficient with their processes.

Next, Testa went to Cook Children's Physicians Network, where she assisted with the accounting functions of numerous physician practices, including billing, collections, payroll and budgeting. Her focus on budgeting and financial performance helped her create a role for herself as the director of budgeting, and she helped the physician practices stay accountable to their budgets. She credits this role with helping her build diplomacy skills and the ability to talk to intelligent people about financial statements, their concepts and impact on business.

It was while she was employed at Cook Children's that she met her husband Frank, who was also on staff there. When they decided to get married, one of them had to leave their role with the company to comply with company policy. Lei decided to leave for more progressively responsible roles with US Oncology, a physician practice management company, and Texas Oncology. She served as the finance director for US Oncology with oversight for 11 practices in seven different states.

Moving from Finance to Operations

Testa was offered the opportunity to serve Texas Oncology as their executive director in 2011. She enjoyed moving to operations and administration, but quickly learned she had to "let go of the finance side of the house and let the controller do her thing." Testa's finance background allowed her to pay attention to things that were impactful to the business. She and her staff were able to identify close to $1 million in savings with their careful review of the financials and increased focus on efficiency and quality by executing a green belt project to get certified in Lean Six Sigma.

Testa was only in the executive director role for two years before she was tapped to serve as a regional senior vice president for McKesson, where she had executive directors from other practices reporting to her for three years from 2013-2016. She focused on financial planning, budgeting, dashboards for metrics, and supporting the renegotiation of physician and managed care contracts. Since she was on the road in this role almost 100% of the time, she decided to move in a different direction to stay closer to home and served as a financial advisor with Averitt Financial for a year and a half.

Lei Testa, CPA, CGMA

- Licensed as a Texas CPA in 1997
- Resides in Fort Worth, Texas
- Current Professional Role: Principal, Outsourcing, CliftonLarsonAllen, Fort Worth
- Husband: Frank Testa, married in 2006
- Personal Interests:

  Love of travel,

  The water,

  Fishing,

  Boating on Eagle Mountain Lake

  Prolific knitter

  Driving Corvettes

Going Back to Public Accounting

Testa has now been a partner with CliftonLarsonAllen (CLA) in Fort Worth since May of 2018. She is the office leader of outsourcing business operations in Fort Worth, where she oversees their team's work with clients from basic bookkeeping to outsourced CFO services.

Going back to public accounting after many years in the private sector has been an interesting transition for Testa. Luckily, her previous roles required her to be a self-starter and that has helped her with the transition. She had to start from scratch building a book of business, because her clients were wealth advisory clients. She has been working to get up to speed on bringing clients to the firm and working to grow the health care business at CLA.

Commitment to Her Community

In preparation for her role as TXCPA chairman, Testa stepped down from several boards and commissions.

Honored with the opportunity to give back and serve the Society and the profession that has given her so much, Testa is excited to begin her term.

Community service has always been part of her professional and personal life. Most recently, she served on the board of the Foundation for Tarrant County College and served three years as chairman of UTA's Accounting Department Advisory Board.

Engagement With the Society

Testa was a student auxiliary member in the Fort Worth Chapter while in school and then rejoined the Society when she went to work for Cook Children's. She shared her story of how some things come full circle. At that time, Bretta Milner, CPA-Fort Worth, was the chapter president and Rick Baumeister, CPA-Fort Worth, served as president-elect. Testa completed the Fort Worth Chapter's Leadership Program and got more involved by serving on the chapter board and as chapter president. She became a member of TXCPA's Board of Directors and was asked to serve on the Executive Board when Jeff Gregg, CPA-Wichita Falls, was chairman and Rick Baumeister was treasurer.

Fast forward many years and Baumeister, who serves as the managing director for CLA in Fort Worth, was looking for someone with health care experience. He reached out to Testa because of his connections with her from working at TXCPA and the Fort Worth Chapter in volunteer and leadership roles.

Testa says: "There have always been smart people looking out for us in our profession. They have been forward thinking and that has had an impact on me. I would not be where I am today if it were not for TXCPA."

Serving as Chairman

Testa says she was "humbled and blown away" that someone would think that she could do something as lofty as serving as TXCPA chairman. Honored with the opportunity to give back and serve the Society and the profession that has given her so much, Testa is excited to begin her term.

She is eager to see our work continue this year with faculty and student initiatives. "For us to make headway in this area would be one of the most foundational things we could do," Testa comments. She adds, "This will also be a critical time for us to continue the expansion of the brand, so people know who we are and understand what we are about."

Testa concludes: "I have seen a positive experience occur with the changes taking place at the Society. That focus and excitement will help us serve future CPAs, and I want to help lead some of that positive forward movement."

About the Author:

Jodi Ann Ray, CAE, is TXCPA's president and CEO. Contact her at jray@tscpa.net.

Professional photographs provided by Jessica Cernat Photography, Frisco, Texas

CECL IS JUST FOR FINANCIAL INSTITUTIONS, RIGHT?

By John Griffin

Effective for public companies in 2020 and others in subsequent years is a new accounting standard that has become a widely discussed subject for the banking industry. The buzz surrounding the new accounting standard – commonly referred to as the current expected credit loss (CECL) standard – primarily stems from how it changes the accounting for the allowance from loan and lease losses from an incurred loss model to a life of loan loss concept.

Accounting Standards Codification (ASC) 326, *Financial Instruments – Credit Losses,* added by Accounting Standards Update 2016-13 (Topic 326), has been a hot topic in the financial services industry since its issuance in June 2016. However, this standard isn't just for financial institutions. It's broad in scope and affects entities holding loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and any other financial assets carried at amortized cost[1], not excluded from the scope that have the contractual right to receive cash.

This article examines trade receivables and investments, as many entities outside of financial institutions hold these types of financial assets.

Trade Receivables

Trade receivables or traditional accounts receivable related to the sale of goods are considered within the scope of Topic 326. So how does transitioning to a lifetime loss estimate affect trade receivables? As a starting point, the standard setters provided an example – Example 5 – of how Topic 326 could be implemented for entities holding trade receivables.

Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule (as illustrated in ASC 326)

Facts: Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers are typically provided with payment terms of 90 days with a 2% discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

1 As defined in ASC 326, the amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion or amortization of premium, discount, and net deferred fees or costs, collection of cash, write offs, foreign exchange and fair value hedge accounting adjustments.

Past-Due Status	Historical Loss %
Current	0.3%
1-30 days past due	8%
31-60 days past due	26%
61-90 days past due	58%
More than 90 days past due	82%

Entity E believes this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date, because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit loss percentages. (That is, the similar risk characteristics of its customers and its lending practices haven't changed significantly over time.)

However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date and Entity E expects there will be an additional decrease in unemployment over the next year.

To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10% in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

At the reporting date, Entity E develops the aging schedule shown in Table 1 to estimate expected credit losses.

Based on this example provided in the guidance, the methodology isn't unlike how many calculate the reserve for uncollectible accounts, except that consideration must now be given for future periods and how economic conditions affect that outlook. The guidance is clear that an entity shall not rely solely on past events to estimate expected credit losses. The entity should adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated.

A key consideration with respect to trade receivables is the type of business and customer owing the outstanding debt. For many companies, the short-term nature of a majority of receivables will likely result in very few differences to today; however, the longer the life of the trade receivable, the more consideration should be given to what could happen after the end of a period.

The customer's ability to repay should be tied to some economic variable that can better estimate expected losses. An entity should consider all relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s).

TABLE 1. AGING SCHEDULE

Past Due Status	Amortized Cost Basis	Historical Loss Rate	Adjustment	Credit Loss Rate	Expected Credit Loss Estimate
Current	$5,984,698	0.3%	(0.03%)	0.27%	$16,159
1-30 days past due	8,272	8%	(0.8%)	7.2%	596
31-60 days past due	2,882	26%	(2.6%)	23.4%	674
61-90 days past due	842	58%	(5.8%)	52.2%	440
More than 90 days past due	1,100	82%	(8.2%)	73.8%	812
	$5,997,794				$18,681

Investments

Many entities hold investments in debt securities, and Topic 326 changes how an entity measures and when it recognizes credit losses for these holdings. The potential effect for each entity depends on if the investments are classified as held-to-maturity (HTM) or available-for-sale (AFS).

The most significant change to investments under Topic 326 is the inclusion of HTM debt securities under the CECL model of the standard. An entity must consider its estimate of expected lifetime credit losses on pools of similar risk or individual HTM debt securities. This is a substantial shift from current generally accepted accounting principles (GAAP), which only require analysis of potential credit loss if the security's fair value is less than the amortized cost basis.

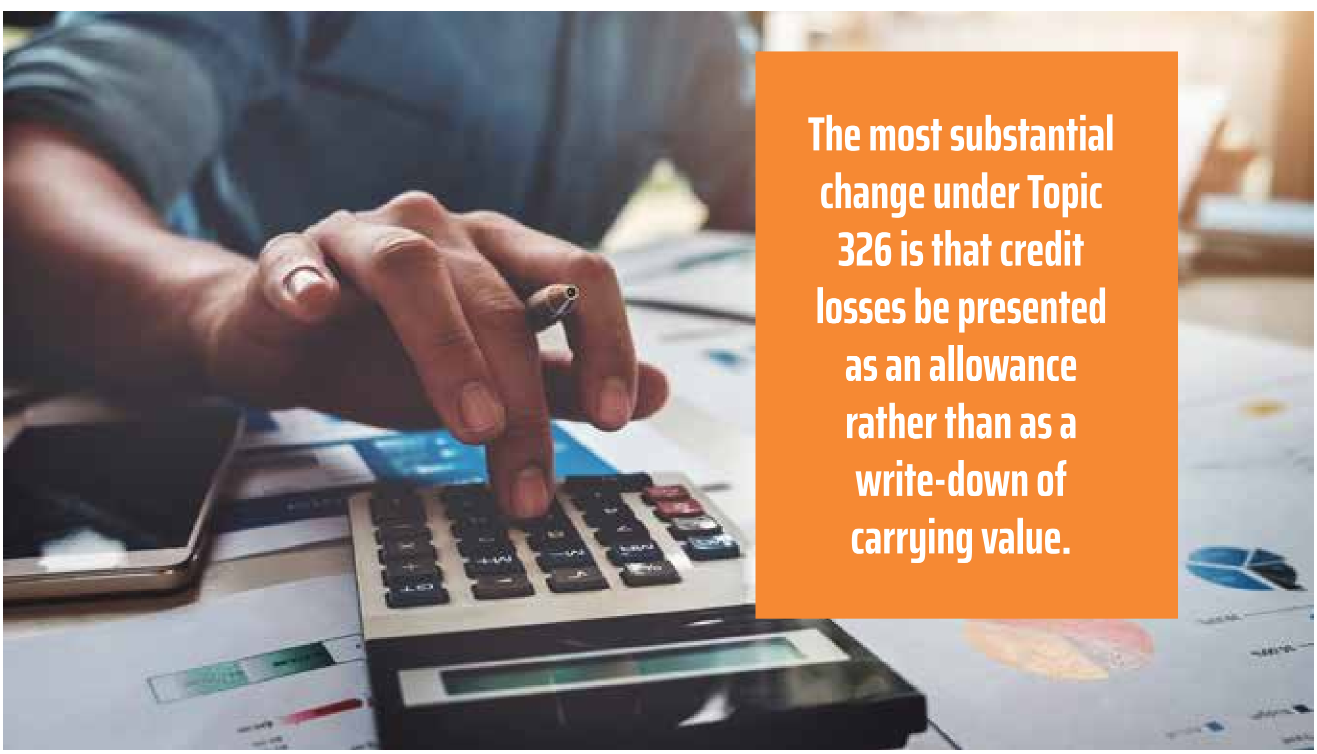
In addition, an entity must determine expected credit loss even if risk of credit loss is remote. It's not the most likely outcome that matters under CECL, but the potential for loss. The standard doesn't prescribe specific debt securities that would have zero expectation of loss; however, there are circumstances, such as U.S. Department of the Treasury (Treasury) and government agency securities, where the potential for default could be greater than zero, but expected nonpayment is zero. In this case, the long history with no credit losses for Treasury securities indicates an expectation that nonpayment of the amortized cost basis is zero, even if the U.S. government were to technically default.

This is considered appropriate, as these securities are explicitly fully guaranteed by a sovereign entity that can print its own currency and that entity's currency is:

- Routinely held by central banks and other major financial institutions;
- Used in international commerce;
- Commonly viewed as a reserve currency, all of which qualitatively indicate that historical credit loss information should be minimally affected by current conditions and reasonable and supportable forecasts.

Credit losses on AFS debt securities should be measured in a manner similar to current GAAP. Although the length of time that an investment's fair value is less than the amortized cost is no longer a factor, a company should consider certain factors in determining whether a decline in fair value below the amortized cost basis has resulted from credit loss or some other reason. The factors include:

- The extent to which the fair value is less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry or geographic area; for example, changes in the financial condition of the issuer of the security or, in the case of an asset-backed debt security, changes in the financial condition of the underlying loan obligors; examples of those changes include any of the following:
  - Changes in technology;
  - The discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security;
  - Changes in the quality of the credit enhancement;
- The payment structure of the debt



The most substantial change under Topic 326 is that credit losses be presented as an allowance rather than as a write-down of carrying value.

security and the likelihood of the issuer being able to make payments that increase in the future;
- Failure of the issuer of the security to make scheduled interest or principal payments;
- Any changes to the rating of the security by a rating agency.

As stated in the ASC 326-30-35-6, "In assessing whether a credit loss exists, an entity shall compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. If the present value of cash flows expected to be collected is less than the amortized cost basis of the security, a credit loss exists and an allowance for credit losses shall be recorded for the credit loss, limited by the amount that the fair value is less than amortized cost basis. Credit losses on an impaired security shall continue to be measured using the present value of expected future cash flows."

As such, the most substantial change under Topic 326 is that credit losses be presented as an allowance rather than as a write-down of carrying value. This is an improvement in current GAAP, as it allows for immediate recovery of previously recorded losses when credit loss expectations improve.

In addition, as Topic 326 removes the ability to consider the length of time a security is in an unrealized loss position when determining whether a credit loss exists, this could increase the likelihood of recording an allowance under the new standard when you otherwise wouldn't have recorded an other-than-temporary impairment under current GAAP, as duration is a main consideration in assessing impairment.

Assessment Needed

This standard affects all entities, not just financial institutions. If an entity holds loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and any other financial assets not excluded from the scope that have the contractual right to receive cash, then this standard will apply. Although the standard isn't applicable for a few years, entities should assess their holdings and determine if this standard will be applicable.

The complexity of implementing the standard depends on the type of holdings. Data and disclosure requirements may need to be adjusted.

About the Author:

John Griffin is a partner at BKD CPAs & Advisors in Dallas. Contact him at jhgriffin@bkd.com.

FEATURE

IF YOU'RE HACKED, WHAT'S YOUR CYBERSECURITY LIABILITY?

By Cathy Whitley

Cybersecurity attacks are inevitable. That's the unfortunate reality. In fact, in a special report, Cybersecurity Ventures projects cybercrime's global cost will exceed $1 trillion between 2017 and 2021[1].

Safeguarding clients' nonpublic information from cyber-criminals is a top priority for CPA firms. The latest data breach statistics from the 2018 Identity Theft Resource Center Data Breach Report[2] show an alarming number of exposed consumer records in the U.S., including:

- 1,244 reported breaches, exposing 446 million records;
- 46% of all breaches involved businesses;
- 39% of all breaches resulted from hacking by outside sources;
- 49% of all breaches exposed Social Security numbers.

Now more than ever, organizations and accounting firms of all sizes need to be vigilant about protecting data and responding to threats.

1 2019 Cybersecurity Market Report, https://cybersecurityventures.com/cyber-security-market-report/

2 https://www.idtheftcenter.org/wp-content/uploads/2019/02/ITRC_2018-End-of-Year-Aftermath_FINAL_V2_combinedWEB.pdf

What's My Liability?

"That's a big question we hear from firms regardless of whether they've been attacked," said Stan Sterna, vice president and risk control specialist for Aon. "There are actually no uniform federal laws on business cybersecurity. But there is a patchwork of state and federal rules." Under certain state laws, CPAs can face liability for cybersecurity breaches that expose personal information.

All 50 states have rules for handling breach notifications and for what remediation measures need to be taken. Breach requirements depend on where the client resides – not where your firm is located. We encourage you to learn the dynamic requirements of states that apply to you.

A recent amendment to the Texas Identity Theft Enforcement and Protection Act[3] takes effect on Jan. 1, 2020. It requires that breach notices must be made to affected individuals and the Texas attorney general within 60 days after a determination has been made that a breach of system security involving sensitive personal information has occurred.

3 Tex BC. Code Ann. § 521.053, https://statutes.capitol.texas.gov/Docs/BC/htm/BC.521.htm#521.053

A recent amendment to the Texas Identity Theft Enforcement and Protection Act takes effect on Jan. 1, 2020.

The attorney general must also be notified if the breach affects more than 250 Texas residents. The data breach notification law has been amended several times since its passage in 2009. It requires notification of affected individuals in the event a data breach results in the disclosure of unencrypted personal information consisting of an individual's first name or first initial, last name and certain personal information, such as Social Security and driver's license numbers.

Federal Rules and Law

The Safeguards Rule is enforced by the Federal Trade Commission and applies to all companies defined as financial institutions under the Gramm-Leach-Bliley (GLB) Act. Businesses that prepare tax returns fall within this definition. Under the rule, businesses are required to develop a written information security plan that describes their program to protect customer information. There are five additional requirements. Learn about the rule and implement applicable compliance protocols.[4]

Do clients have standing to sue a CPA firm if they did not suffer damages as a result of a data breach? At the federal level, the circuit courts are split as to what constitutes sufficient standing to sue in cyber breach cases. Some courts hold that companies may be liable for damages if client or employee data is stolen, even if the theft causes no harm; instead, it's sufficient to merely allege that the information was compromised. This broad interpretation will only further increase the risk of cyber liability claims.

Two recent decisions illustrate these differences:

- The Sixth Circuit court, citing the defendant's offer for free credit monitoring as evidence, joined the Seventh and Ninth Circuits in holding that a cyber victim's fear of future harm is real and provides sufficient standing to sue. This particular ruling specifically undermines the defense that if no actual cyber fraud or identity theft occurred, the victim has not been damaged and has no standing to sue.[5]
- However, in another case, the Fourth Circuit held that a plaintiff must allege and show that their personal information was intentionally targeted for theft in a data breach and that there is evidence of the misuse or accessing of that information by data thieves.[6]

The division among the circuit courts as to standing is not likely to be resolved unless and until the U.S. Supreme Court decides a case on the issue.

New Cybersecurity Regulation Sets the Stage for Other States to Follow

In response to several highly publicized consumer data breaches, in 2017 the New York State Department of Financial Services enacted 23 NYCRR 500, "Cyber Requirements for Financial Services Companies," with which all affected firms must now comply. These "first-in-the-nation" data security regulations establish the steps that covered entities must take to secure customer data. The regulations are designed to combat potential cyber events that have a reasonable likelihood of causing material harm to a covered entity's normal business operations.

Specifically, insurers, banks, money services businesses and regulated vital currency operators doing business in New York with 10 or more employees and $5 million or more in revenues must comply with the new rules. Under the provisions, companies must:

- Conduct a cybersecurity risk assessment, prepare a cybersecurity program subject to annual audit and establish a written policy tailored to the company's individualized risks that are approved by senior management;
- Appoint a chief information security officer (CISO) responsible for the cybersecurity program, who regularly reports on the integrity, security, policies, procedures, risks and effectiveness of the program, and about cybersecurity events;
- Establish multi-factor authentication for remote access of internal servers;
- Encrypt nonpublic information (PII) and regularly dispose of any nonpublic information that is no longer necessary for conducting business (unless required to be retained by law);
- Prepare a written incident response plan that effectively responds to events and immediately provides notice to the superintendent of the New York Department of Financial Services of any breaches where notice is required to be provided to any government body, self-regulatory agency or any other supervisory body or where there is a "reasonable likelihood" of material harm to the normal operations of the business;
- Implement a written policy addressing security concerns associated with third parties who provide services to the covered entity, which contain guidelines

4 https://www.ftc.gov/tips-advice/business-center/guidance/financial-institutions-customer-information-complying

5 *Galaria v. Nationwide Mutual Insurance Co.*, Nos. 15-3386/3387 (6th Cir. Sept. 12, 2016) (unpublished)

6 Beck, et. al. v. McDonald, et. al., No. 15-1395, (4th Cir. February 6, 2017)

- for due diligence or contractual protections relating to the provider's policies for access, encryption, notification of cybersecurity events impacting the covered entity's nonpublic information and representations addressing the provider's cybersecurity policies relating to the security of the covered entity's information systems or nonpublic information;
- Annually file a statement with the New York Department of Financial Services certifying compliance with the regulations.

Meanwhile, the California Consumer Privacy Act of 2018 (CCPA) goes into effect on Jan. 1, 2020. The CCPA represents a significant expansion of consumer privacy regulation. Its GDPR-like statutory framework gives California consumers the right to:

- Know what categories of their personal information have been collected;
- Know whether their personal information has been sold or disclosed, and to whom;
- Require a business to stop selling their personal information upon request;
- Access their personal information;
- Prevent a business from denying equal service and price if a consumer exercises their rights per the statute;
- A private cause of action under the statute.

What is the Impact of These New Regulations on CPA Firms?

Whether or not a CPA provides professional services for an entity covered by the New York Department of Financial Services or the CCPA, these new rules are important. Regulation in one state frequently results in regulation in other states. Both the New York and California cybersecurity regulations have served as a template for other states establishing cyber security legislation.

The regulations also create a framework for plaintiffs' attorneys to follow when alleging that a company (regardless of whether it is a covered entity) should have done more to protect private information, keep consumers informed and prevent a data breach, or that a CPA firm should have detected data security issues while providing professional services.

Take Preventative Action Now

"If someone sues your firm because of a data breach, you may have a stronger case if you can show that you've taken reasonable measures to help prevent an attack or theft," Sterna advised. "Setting up systems to assist in prevention is an important aspect of managing cybersecurity risk."

Three Tips to Get You Started

Start with an assessment. What are your cybercrime defenses? Do you have gaps in your data security procedures? Do you have controls in place? How do you document incidents when they happen? What is your response plan when incidents occur?

"Mapping where you stand today and your vulnerabilities is the best way to understand your next steps," Sterna said. AICPA's cybersecurity risk management reporting framework helps you assess existing risk management programs. The Private Companies Practice Section

cybersecurity toolkit can also help you understand the most common cybersecurity threats.

Implement best practices. At a minimum:

- Use encryption wherever appropriate to protect sensitive data; this includes laptops, desktops and mobile devices; failing to do so threatens your data and your reputation;
- Train employees to recognize threats and safeguard equipment and data;
- Develop and practice your response plan for various situations, such as a ransomware attack, hack or ID theft;
- Back up your data so you'll still have access to it if it's lost or stolen;
- Keep your equipment physically secure in your office and on the road.

Get an outsider's perspective. What better way to learn your firm's vulnerabilities than to hire an expert for penetration testing? Through a penetration test, a third-party consultant will perform a test tailored to your firm's needs and budget.

They'll provide insights on your firm's vulnerabilities and educate you about solutions for protecting your practice. A consultant can also help you implement regular drills that test your firm's response in the case of various attack scenarios.

Legal and Insurance Considerations

CPA firms should consult with their legal counsel to assess the firm's risk of first/third party data security claims and assess vendor data security coverage. The existence and adequacy of data security utilized by third party vendors (including contract tax return preparers) is often overlooked.

CPA firms should also consult with their insurance agent or broker to review their current cyber policy to ascertain the adequacy of coverage.

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FEATURE

THE SECTION 199A FINAL REGULATIONS – IMPORTANT CLARIFICATIONS, PART 1

WHAT IS A QUALIFIED TRADE OR BUSINESS?

By Steve Beck

I.R.C. § 199A enables individuals, certain trusts and estates (collectively, "individuals") to deduct up to 20% of their combined qualified business income (QBI) from a domestic business operated as a pass-through (i.e., Subchapter K partnerships, Subchapter S corporations, sole proprietorships and disregarded entities) (collectively, RPEs). This deduction is hereafter referred to as the 199A deduction.

The basic effect of the 199A deduction is to reduce the maximum individual income tax rate on combined QBI of RPEs from 37% to 29.6% (i.e., 37%, multiplied by 80%). Therefore, it helps to partially bridge the gap between the maximum 37% income tax rate applying to individuals and the lower 21% income tax rate applying to corporations. The 199A deduction, however, applies only for tax years beginning after 2017 and before 2026.

Today's CPA included an article titled, "Pass-Through Entities Not Left Out of Tax Reform," in the May/June 2018 issue that discussed the 199A deduction based on the provisions of the Internal Revenue Code (I.R.C.), which was the only guidance available at the time of publication. That article noted many issues that remained outstanding at the time. Since then, the Treasury Department and Internal Revenue Service (collectively, Treasury) have issued final regulations (the 199A regulations), which clarify important issues regarding the 199A deduction. T.D. 9847 (Feb. 12, 2019).

This article is the first of a two-part series discussing important provisions of the 199A regulations. This article focuses on the important clarifications in the 199A regulations addressing whether an individual or RPE is engaged in a qualified trade or business (QTB), which is required to have any QBI eligible for the 199A deduction.

A second article will address the provisions in the 199A regulations that provide tax return preparers with opportunities for assisting their clients with maximizing the amount of the 199A deduction and potential pitfalls that could eliminate the amount of their clients' 199A deduction.

The QTB concept is important in determining whether a client is eligible for the 199A deduction. The amount of the 199A deduction is generally calculated based on 20% of the individual's QBI from a QTB. Thus, in order to have any QBI eligible for the 199A deduction, the individual (or RPE in which the individual owns an interest) must be engaged in a QTB.

A QTB is any trade or business, except for the trade or business of performing services as an employee and a specified service trade or business (an SSTB). I.R.C. § 199A(d)(1). Thus, there are three important concepts for determining whether an individual or RPE is engaged in a QTB:

- What is a trade or business for purposes of I.R.C. § 199A?
- What constitutes services as an employee?
- What constitutes an SSTB?

These three concepts are discussed in the following three sections of this article.

What is a Trade or Business for Purposes of I.R.C. § 199A?

The term "trade or business" is not defined under I.R.C. § 199A. The 199A regulations, however, define a "trade or business" as an activity qualifying as such under I.R.C. § 162 (other than working as an employee). Treas. Reg. § 1.199A-1(b)(14). I.R.C. § 162 permits taxpayers to deduct all the ordinary and necessary expenses paid or incurred in carrying on trade or business that are reasonable in amount.

The Preamble to the 199A regulations (the Preamble) notes that the I.R.C. § 162 definition of trade or business is derived from a large body of existing case law. This case law provides that whether the activities of a taxpayer constitute a trade or business requires an examination of the facts and circumstances of the particular case. Higgins v. Comm'r, 312 U.S. 212, 217 (1941).

In addition, courts typically apply two factors in determining whether an activity rises to the level of a trade or business. First, the taxpayer's activities must be considerable, regular and continuous to constitute a trade or business. See Comm'r v. Groetzinger, 480 U.S. 23 (1987). Second, the taxpayer must enter into and carry on the activity with a good faith intention to derive a profit or with the belief that profit can be derived from the activity. See id.

> **Courts typically apply two factors in determining whether an activity rises to the level of a trade or business.**

Significant questions have arisen regarding whether rental real estate activities qualify as a trade or business for purposes of the 199A deduction. In response, the Preamble notes that the relevant factors for determining whether a rental real estate activity constitutes an I.R.C. § 162 trade or business include the:

- Type of rented property (whether commercial or residential);
- Number of properties rented;
- Daily involvement of the owner or the owner's agents;
- Types and significance of any ancillary services provided under a lease; and
- Terms of the lease (e.g., a net lease, as opposed to a traditional lease, and a short-term or long-term lease).

In promulgating the 199A regulations, Treasury ultimately declined to provide any bright-line standard regarding whether a particular rental real estate activity is a trade or business for purposes of the 199A deduction. However, Treasury released Notice 2019-07, which contains a proposed Revenue Procedure detailing a proposed safe harbor (the safe harbor), under which an individual or RPE would be able to treat a rental real estate business as a trade or business solely for purposes of the 199A deduction.

The Rental Real Estate Safe Harbor

The proposed Revenue Procedure would provide that a rental real estate activity that satisfies the standards of the safe harbor would be deemed to constitute a trade or business for purposes of the 199A deduction. Conversely, the standards of the proposed Revenue Procedure would not prohibit an individual or RPE engaged in rental real estate activities from qualifying for the 199A deduction in situations in which the safe harbor standards are not satisfied.

The safe harbor applies to a "rental real estate enterprise" (RREE), which is an interest in real property held for the production of rents. An RREE may consist of an interest in multiple properties. An individual or RPE relying on the safe harbor must hold the interest directly or through a disregarded entity.

Taxpayers must either treat each property held for the production of rents as a separate enterprise or all similar properties held for the production of rents (except for certain excluded properties) as a single enterprise. For purposes of the aforementioned treatment, commercial and residential real estate may not be part of the same enterprise, and taxpayers may not vary their treatment from year to year unless there has been a significant change in facts and circumstances.

The safe harbor provides that an RREE will be treated as a trade or business for purposes of the 199A deduction if the following three requirements are satisfied. First, the individual or RPE conducting the RREE must maintain separate books and records to reflect the income and expenses for each RREE.

Second, the RREE must involve at least a certain threshold of rental services for each year and the required frequency for satisfying that threshold varies depending on the tax year at issue. For tax years prior to 2023, at least 250 hours of "rental services" must be performed each year with respect to the RREE. In contrast, for tax years after 2022, the aforementioned standard of at least 250 hours of "rental services" must generally be satisfied in any three of the prior five consecutive tax years ending with the tax year at issue.

If, however, the RREE has been conducted for fewer than five years, the 250-hour threshold must be satisfied for each of the prior years in which the RREE has been conducted to satisfy the safe harbor for a tax year after 2022.

"Rental services" for purpose of the 250-hour threshold include:
- Advertising to rent or lease the real estate;
- Negotiating and executing leases;
- Verifying information contained in prospective tenant applications;
- Collection of rent;
- Daily operation, maintenance and repair of the property;
- Management of the real estate;
- Purchase of materials; and
- Supervision of employees and independent contractors.

These rental services may be performed by owners or by employees, agents and/or independent contractors of the owners. However, the following do not constitute "rental services" for purposes of the safe harbor:
- Financial or investment management activities, such as arranging financing;
- Procuring property;
- Studying and reviewing financial statements or reports on operations;
- Planning, managing or constructing long-term capital improvements; or
- Hours spent traveling to and from the real estate.

Third, the taxpayer or RPE must maintain contemporaneous records, including time reports, logs or similar documents, regarding the following:
- Hours of all services performed;
- Description of all services performed;
- Dates on which such services were performed; and
- Who performed the services.

The safe harbor also requires that these records must be made available for inspection at the request of the IRS. The safe harbor provides, however, that this contemporaneous records requirement is not applicable to taxable years beginning prior to Jan. 1, 2019.

Certain rental real estate arrangements are excluded from the safe harbor. These excluded arrangements consist of real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on the safe harbor) as a residence for any part of the year under I.R.C. § 280A and real estate rented or leased under a triple net lease. A triple net lease for this purpose includes a lease agreement that requires the tenant or lessee to pay (all or a portion of the) taxes, fees and insurance, and be responsible for maintenance activities for (all or a portion of) a property in addition to rent and utilities.

The safe harbor provides useful certainty for taxpayers who can document satisfaction of the 250-hour threshold. However, the documentation required under the safe harbor may impose additional administrative complexity on rental real estate businesses. For this reason, taxpayers who are confident they can establish that their rental real estate operations involve regular, continuous and considerable activities carried on for profit under the I.R.C. § 162 common law standards may choose to forego the additional documentation complexity that would be needed to obtain the protections of the safe harbor.

Learn More About Section 199A

To provide a more detailed review of the Section 199A regulations, TXCPA offers a number of CPE programs in this area. To learn more and register, go to the TXCPA website at tscpa.org and search on Section 199A regulations.

Common Control Rental Property

The 199A regulations also provide a special rule that enables an individual or RPE to treat certain rental or licensing of tangible or intangible property as a trade or business for purposes of I.R.C. § 199A, even though that activity would not otherwise rise to the level of an I.R.C. § 162 trade or business.

This special rule applies only if the property is rented or licensed to a trade or business that is subject to "common control." Treas. Reg. § 1.199A-1(b)(14). "Common control" for this purpose means that the same person or group of persons, directly or indirectly, owns 50% or more of the issued and outstanding shares of the corporation or capital and profits interests in the partnership. Treas. Reg. §1.199A-4(b)(1)(i).

Thus, under this principle, a rental activity that neither rises to the level of an I.R.C. § 162 trade or business nor qualifies under the safe harbor may still be treated as a QTB if the property is rented to a QTB that is controlled by the same person or group of persons. This special rule enables individuals to include rental income as QBI in situations in which the individuals own their operating

business in one entity and own the related real property used by that operating business in a separate entity for liability protection purposes.

What is an Employee for Purposes of I.R.C. § 199A?

As mentioned previously, a QTB does not include the performance of services as an employee. Treas. Reg. § 1.199A-5(a)(3), (d)(1). Thus, no items of income, gain, loss and deduction from performing services as an employee constitute QBI. Treas. Reg. § 1.199A-5(d)(1). Accordingly, no individual may claim a 199A deduction for wage income, regardless of the amount of that individual's taxable income. Treas. Reg. § 1.199A-5(a)(3).

Whether wages are earned as an employee is determined based on the proper classification of the worker for federal employment tax purposes. Treas. Reg. §1.199A-5(d)(2). Thus, misclassification of a worker as an independent contractor is irrelevant.

In addition, an individual is presumed to be an employee for purposes of the 199A deduction if that individual was previously properly treated as an employee for federal employment tax purposes by the employer and that individual is subsequently treated as other than an employee by that employer with regard to the provision of substantially the same services directly or indirectly to that employer (or a related person). Treas. Reg. §1.199A-5(d)(3).

This presumption continues for three years after the individual is no longer treated as an employee and applies regardless of whether the individual provides services directly or indirectly through an entity. The presumption, however, may be rebutted upon a showing that, under federal tax common law standards, the individual is performing services in a capacity other than as an employee.

What is an SSTB?

SSTB Categories

An SSTB involves the performance of services in the following statutorily designated fields:

- Health;
- Law;
- Accounting;
- Actuarial science;
- Performing arts;
- Consulting;
- Athletics;
- Financial services; or
- Brokerage services.

An SSTB also involves the performance of services that consist of investing and investment management, trading and dealing in securities, partnership interests or commodities. I.R.C. §199A(d)(2)(B). All of the aforementioned fields of services that are explicitly listed as constituting an SSTB are hereafter referred to as the "listed categories."

In addition, an SSTB includes any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees. I.R.C. §199A(d)(1). This "reputation or skill" category initially caused considerable concerns, but those concerns are significantly addressed by the 199A regulations, as discussed below.

The regulatory descriptions of the listed categories are relatively straightforward and thus are not discussed here. Instead, this article focuses on the meaning of the "consulting" and "reputation or skill" categories, because they have been the source of greater uncertainty.

"Consulting"

"Consulting" means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Treas. Reg. §1.199A-5(b)(2)(vii). Consulting also includes providing advice and counsel regarding public advocacy or lobbying with the intention of influencing decisions made by governmental agencies or legislators.

Consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses. For this purpose, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided.

In addition, consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services.

The 199A regulations contain three examples distinguishing between situations that constitute consulting for purposes of the 199A deduction and those that do not. First, if a business advises clients regarding making their personnel structures more efficient, without providing any temporary workers to the clients or receiving compensation based on the client's use of temporary workers, that business involves consulting services for purposes of SSTB status. Treas. Reg. §1.199A-5(b)(3), Ex. 8.

The 199A regulations contain three examples distinguishing between situations that constitute consulting for purposes of the 199A deduction and those that do not.

Conversely, if the business merely involves providing temporary workers to clients for a fixed fee, that business may not involve consulting services, even if the temporary workers provide consulting advice to the clients. Treas. Reg. §1.199A-5(b)(3), Ex. 9.

Lastly, if a business involves licensing software to customers for a flat price, that business may not involve consulting services, even if the business involves advising customers regarding the particular software that may best fit the customers' needs. Treas. Reg. §1.199A-5(b)(3), Ex. 10.

"Reputation or Skill"

In addition, an SSTB includes any trade or business in which the principal asset is the reputation or skill of one or more of its owners or employees. I.R.C. §199A(d)(1). This "reputation or skill" category initially caused a lot of concern that it would be interpreted broadly to cause a wide range of service businesses to be considered an SSTB even though they were not specifically identified by Congress. The 199A regulations alleviate these concerns.

The reputation or skill category means any trade or business that consists of any of the following activities (or any combination thereof):

- A trade or business in which a person receives fees, compensation or other income for endorsing products or services;
- A trade or business in which a person licenses or receives fees, compensation or other income for the use of an individual's image, likeness, name, signature, voice, trademark or any other symbols associated with the individual's identity; or
- Receiving fees, compensation or other income for appearing at an event or on radio, television or another media format. Treas. Reg. §1.199A-5(b)(2)(xiv).

For these purposes, a person is considered as "receiving fees, compensation or other income" if that person receives a partnership interest or S corporation stock and the corresponding allocable share of income, deduction, gain or loss from the partnership or S corporation. Treas. Reg. §1.199A-5(b)(2)(xiv)(D).

Notably, the 199A regulations provide that the reputation or skill category "means" (as opposed to "includes") the aforementioned personal likeness-type activities. Thus, the 199A regulations appear to limit the scope of the "reputation or skill" category to those specific personal likeness-type activities specifically described therein.

Attribution of SSTB Status

The 199A regulations also contain a rule through which a trade or business that would ordinarily be eligible for QTB treatment is instead treated as an SSTB, but only to the extent that it provides goods or services to a commonly owned SSTB. Treas. Reg. §1.199A-5(c)(2). Common ownership for this purpose includes the direct or indirect ownership of 50% or more of both trades or businesses by related persons within the meaning of I.R.C. §§ 267(b) or 707(b).

The 199A regulations clarify that the treatment of the otherwise qualifying trade or business as an SSTB is only with respect to the related persons who comprise the common ownership interest in the two businesses. Thus, if a business is owned by two persons (Alison and Brenda), Alison owns more than 75% of the business and 100% of an SSTB, Brenda owns only 25% of the business and none of the SSTB, and the business derives all of its income from performing non-SSTB services for the SSTB, that business will be treated as an SSTB as to Alison, but not Brenda.

The 199A regulations contain an example illustrating a situation in which SSTB status is attributed to a non-SSTB business that derives its income from a commonly controlled SSTB. The example involves a partnership (Law Firm) that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees.

All three of the partnerships are owned by the same people (the original owners of Law Firm). Because Partnership 2 provides all of its property to Partnership 1, and Partnership 3 provides all of its services to Partnership 1, Partnerships 1, 2 and 3 would be treated as one SSTB for purposes of I.R.C. § 199A. Treas. Reg. § 1.199A-5(c)(2)(iii)(A).

If, however, Partnership 2 rents only 50% of the building to Partnership 1 and the other 50% is rented to unrelated third party tenants, only 50% of Partnership 2's leasing activity would be treated as an SSTB. The other 50% would be eligible for treatment as a QTB. Treas. Reg. § 1.199A-5(c)(2)(iii)(B).

Claiming the 199A Deduction

The 199A regulations provide a great deal of additional clarity regarding the threshold issue of whether a client is engaged in a QTB and is, therefore, potentially eligible to claim the 199A deduction. Specifically, the 199A regulations provide a potential safe harbor that, if finalized, will provide taxpayers in the rental real estate business with protection in qualifying for the 199A deduction.

Once a client has satisfied the eligibility requirements for the 199A deduction, the next challenge is applying the 199A regulations in the manner that maximizes the amount of the client's 199A deduction. The next article in this series will discuss the manner in which the 199A regulations provide professionals with opportunities to assist their clients in doing so.

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CPE ARTICLE

GILTI – COSTLIER FOR NON-C CORPORATE SHAREHOLDERS

By Rolando Garcia and Angela Qian

Tax professionals with clients involved in cross-border activities have had to deal with the international tax provisions enacted by the Tax Cuts and Jobs Act (TCJA)[1]. Last year, 2018, was arguably a frustrating year for both practitioners and clients due to the timing in which both the Internal Revenue Service (IRS) and the Treasury Department rolled out guidance and proposed regulations, creating an aura of haste.

As 2018 unfolded, the focus shifted from the Section 965 transition tax (Section 965(a)) to the Global Intangible Low-Taxed Income (GILTI), Section 951A provision of the TCJA. Congress felt that, without such an inclusion regime, the participation exemption system (Section 965(c)) created by the TCJA "could incentivize taxpayers to allocate income – in particular, mobile income from intangible property – that would otherwise be subject to the full U.S. corporate tax rate to controlled foreign corporations (CFCs) operating in low- or zero-tax jurisdictions.[2]"

CURRICULUM: Tax

LEVEL: Basic

DESIGNED FOR: Tax professionals

OBJECTIVES: To describe and provide guidance on the Global Intangible Low-Taxed Income (GILTI) Section 951A provision of the Tax Cuts and Jobs Act

KEY TOPICS: GILTI inclusion regime requirements, calculations, impact of the GILTI rules on shareholders, Section 962 election and operational strategies

PREREQUISITES: None

ADVANCED PREPARATION: None

What is GILTI?

The GILTI inclusion regime requires any U.S. shareholder (whether such ownership is direct or indirect as through a partnership, S corporation or trust) of a CFC and who owns stock in the CFC on the last day of the CFC's tax year is subject to U.S. federal income tax on the owner's pro-rata share of the CFC's GILTI (Section 951A(a)). A CFC is any foreign corporation in which U.S. shareholders own more than 50% of the foreign corporation's stock by value or vote (Section 957(a)).

Prior to enactment of the GILTI regime, foreign earnings and profits of a CFC were permanently deferred until distributed, except for certain types of income; e.g., Subpart F income (Section 951(a)). After passage of the TCJA, while these foreign earnings and profits of a CFC are still permanently deferred until distributed, GILTI is now included as one of the exceptions to that rule, along with those in Section 951(a).

Mathematically, GILTI is the excess (if any) of the shareholder's net CFC tested income for the tax year over the shareholder's net deemed tangible income return (DTIR) for the tax year (Section 951A(b)). These are, of course, defined terms.

Tested income is the gross income of the foreign corporation less the following enumerated items:

- U.S. effectively connected income (IRC Sec 952(b));
- Subpart F gross income (Section 952(a));
- Gross income excluded, due to high foreign taxes exception (Section 954(b)(4));
- Any dividend received from a related person (Section 954(d)(3));
- Any foreign oil and gas extraction income (Section 907(c)(1)); and
- Deductions (including taxes) properly allocable under (Section 954(b)(5)).

The net DTIR is the excess, if any, of 10% of the aggregate of the shareholder's pro-rata share of the qualified business asset investment (QBAI), over the amount of interest expense taken into account in determining net CFC tested income (Section 951A(b)(2)).

The QBAI is the average of the corporation's aggregated adjusted basis as of the close of each quarter of the tax year in specified tangible property used in trade or business of the CFC and of a type with respect to which a deduction is allowable under Section 167 (Section 951A(d)(1)). The adjusted basis is determined by using the alternative depreciation system (Section 951A(d)(3)(A)). Table 1 on the following page includes examples of the GILTI calculation.

Up to this point, the methodology described above is identical for U.S. shareholders of CFCs, whether they be C corporations, pass-through entities, trusts or individuals. A U.S. C corporation, however, is entitled to a deduction equal to 50% of GILTI amount, with this deduction percentage decreasing from 50% to 37.5% after December 31, 2025 (Section 250(a)(3)). In addition, a C corporation with a GILTI inclusion will be eligible for an 80% deemed foreign tax credit (Section 960(d)(1)).

Like all of the foregoing GILTI concepts, this 80% amount follows suit in that it brings in additional concepts and calculations. A C corporation will be deemed to have paid foreign income taxes equal to 80% of the product of (i) the C corporation's inclusion percentage (defined later) multiplied by (ii) the aggregate tested foreign income taxes paid or accrued by CFCs (Section 960(d)(1)).

The inclusion percentage is the ratio of (A) the corporation's GILTI divided by (B) the aggregate amount of the C corporation's pro-rata share of each CFC's positive tested income with respect to the corporation (Section 960(d)(2)).

These deemed taxes will increase the GILTI inclusion in the same way as the Section 78 gross-up. As a result, the amount grossed up is equal to the entire amount of the inclusion percentage and aggregate tested foreign income taxes, even though only 80% are used when computing the deemed-paid credit.

Thus, after all the dust is settled, the GILTI rules generally impose a U.S. corporate minimum tax of 10.5 percent (50% x 21%) and, to the extent foreign tax credits are available to reduce the U.S. corporate tax, may result in no additional U.S. federal income tax being due.

Non-C Corporation U.S. Shareholders Pay More

U.S. shareholders that are not C corporations are not entitled to the 50% deduction or the deemed paid foreign tax credit (Section 250(a)(1)(A)). In addition, GILTI may very well be taxed at the highest U.S. marginal federal income tax rate of 37%. In total, non-corporate shareholders face taxation on GILTI at a 37% rate without the benefit of a credit for any foreign taxes imposed on the CFC's GILTI.

Because of this unbalanced impact of the GILTI rules to non-C corporation U.S. shareholders, it is important that these taxpayers with investments in foreign corporations assess the U.S. federal income tax impact of the GILTI provisions on their foreign investments and consider whether it may be beneficial to take advantage of one of the planning ideas discussed below.

Use of a Domestic C Corporation Blocker

A non-C corporation U.S. shareholder may want to consider transferring its interest in its CFC to a U.S. C corporation. There should be no adverse U.S. income tax consequences if the transfer is made pursuant to Section 351, which provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange, such person or persons are in control (as defined in § 368(c)) of the corporation (Section 351(a)).

A U.S. C corporation holding company for CFCs would be particularly beneficial where the CFCs have foreign tax credits that could essentially eliminate the U.S. corporation's U.S. tax liability, as described above. Going forward, the non-C corporation U.S. shareholder would not be taxed on the GILTI until distributed by the U.S. holding company to the shareholder in the form of dividends, so the U.S. taxation of the GILTI would essentially be deferred until distributed by the U.S. C corporation to its shareholder, at ostensibly qualified dividend rates.

Having said this, some collateral issues to consider include:

- Uncertainty as to future CFC stock sale;
- Adverse foreign country consequences of transferring CFC stock to a U.S. corporation;
- Section 877A exit tax planning; and
- Viability for U.S. persons residing in a foreign country, where foreign country tax will be prohibitive if the CFC is held through a U.S. corporation.

Elect Section 962 Treatment

Section 962 provides a special rule that allows U.S. individual shareholders, including U.S. individual partners of partnerships and U.S. individual shareholders of S

TABLE 1. GILTI CALCULATION EXAMPLES

	CFC1	CFC2	CFC3		
Net CFC Tested Income					
Gross Income	12,000,000	8,500,000	9,000,000		
Less: Deductions allocable to gross income under 954(b)(5)	(6,000,000)	(11,000,000)	(7,000,000)		
	6,000,000	(2,500,000)	2,000,000		
Ownership %	100%	100%	100%		
	6,000,000	(2,500,000)	2,000,000		
				Net Tested Income	5,500,000
Net Deemed Tangible Income Return					
Qualified Business Asset Investment:	Average qtrly	Average qtrly	Average qtrly		
Specified Tangible Property	30,000,000	35,000,000	30,000,000		
Pro-rata share of tangible property from a partnership	0	0	0		
	30,000,000	35,000,000	30,000,000		
Ownership %	100%	100%	100%		
	30,000,000	35,000,000	30,000,000		
Applicable %	10%	10%	10%		
	3,000,000	3,500,000	3,000,000		
Interest expense taken into account in determining the shareholder's net CFC tested income for the tax year to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income	(100,000)	(100,000)	(100,000)		
	2,900,000	0	2,900,000		
				Net deemed tangible income return	5,800,000
				GILTI Income	0

	CFC1	CFC2	CFC3		
Net CFC Tested Income					
Gross Income	11,000,000	8,500,000	9,000,000		
Less: Deductions allocable to gross income under 954(b)(5)	(6,000,000)	(10,000,000)	(3,000,000)		
	5,000,000	(1,500,000)	6,000,000		
Ownership %	100%	100%	100%		
	5,000,000	(1,500,000)	6,000,000		
				Net Tested Income	9,500,000
Net Deemed Tangible Income Return					
Qualified Business Asset Investment:	Average qtrly	Average qtrly	Average qtrly		
Specified Tangible Property	30,000,000	35,000,000	30,000,000		
Pro-rata share of tangible property from a partnership	0	0	0		
	30,000,000	35,000,000	30,000,000		
Ownership %	100%	100%	100%		
	30,000,000	35,000,000	30,000,000		
Applicable %	10%	10%	10%		
	3,000,000	3,500,000	3,000,000		
Interest expense taken into account in determining the shareholder's net CFC tested income for the tax year to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income	(100,000)	(100,000)	(100,000)		
	2,900,000	0	2,900,000		
				Net deemed tangible income return	5,800,000
				GILTI Income	3,700,000

corporations, to elect to be taxed on subpart F amounts included in their gross income at corporate rates and to get the benefit of Section 960 foreign tax credits with respect to such income, similar as for a U.S. C corporation (Section 962(a)); 962 is an annual election (Section 962(b)).

The purpose behind Section 962 is "to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be *no heavier than they would have been had they invested in an American corporation doing business abroad.*" (S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. at 798.)

Following through on its prognostication that the "Treasury Department and the IRS intend to modify §1.962-1(b)(1)(i) to provide that, in computing the amount of tax due as a result of a Section 962 election, the Section 965(c) deduction may be taken into account,[3]" the IRS issued proposed regulations indicating the GILTI deduction under

Section 250 would be available for an individual who makes a Section 962 election[4].

The benefits to non-C corporation U.S. shareholders of making a Section 962 election, therefore, are (1) GILTI is subject to U.S. tax at the 10.5% corporate rate, given that the aforesaid Section 250 50% deduction is allowed, rather than the higher 37% U.S. individual tax rate and (2) U.S. tax on GILTI may be offset by foreign tax credits.

It is critical to note that, despite the general rule that distributions from previously taxed earnings and profits will not trigger additional income tax (Section 959(a)), this rule does not apply if you make the Section 962 election (Section 962(d)). So, taxpayers who make the Section 962 election get taxed once at corporate tax rate when they report GILTI and again when the CFC distributes cash to the shareholder. Based on the *Smith* decision cited below, there is no assurance that the CFC distributions will be eligible for qualified dividend rates.

In addition to quantifying this option, other issues to consider include whether GILTI is subject to the net investment 3.8% income tax, as well as the Tax Court decision in *Barry M. Smith v. Commissioner*, which stands for the proposition that distributions from the CFC to the U.S. C corporation holding company and then on to the individual shareholder are not deemed dividends for purposes of potentially characterizing them as "qualified" dividends (*Barry M. Smith v. Commissioner,* 151 T.C. No. 5 (2018)).

The issue in this context is the tax characterization of the cash distribution. This issue arises whenever the CFC is located in a non-treaty jurisdiction, such that dividends paid by such a CFC do not qualify for a qualified dividend rate under Section 1(h)(11). When an actual distribution is made from such a CFC, the question is whether the distribution should be treated as coming from the CFC and hence be classified as ordinary income or instead as coming from the deemed C corporation created by the Section 962 election and thus be classified as qualified dividends.

In *Smith*, the taxpayer made Section 962 elections with respect to its Subpart F income inclusions from CFCs and thus later argued that the distributions were from a deemed domestic corporation and, therefore, should be taxed as a qualified dividend subject to the reduced 20% tax rate. The position of the IRS was the taxpayer received the distribution from a foreign corporation. The tax court rejected the taxpayer's argument, noting that Section 962 did not deem a domestic corporation to exist for federal tax purposes. (Id.)

Owning Foreign Operations in Pass-Through Form

It may also make sense to have non-C corporation U.S. shareholders set up foreign operations through foreign entities that they elect to treat as pass-throughs for U.S. federal income tax purposes under the check-the-box rules. Of course, this presupposes that the foreign entity is not a "per se" corporation, generally an entity that has no restrictions on the transfer of shares (Section 301.7701-2). Reg. §301.7701-3 allows entities "not classified as a corporation" to "elect its classification for federal tax purposes." The election, made on Form 8832, allows entities to be treated as (1) associations, (2) partnerships or (3) disregarded entities for U.S. income tax purposes (Id).

This would render a change of the foreign corporation's status from CFC to a foreign partnership or foreign disregarded entity and no longer subject to GILTI, as GILTI is applicable only to CFCs. As a result, all income from the foreign entity will need to be picked up annually, but taxes paid or accrued become creditable. The reader will recall that such credits are unavailable under the GILTI regime unless the U.S. shareholder is a C corporation or makes a Section 962 election.

If this option is selected, there may be a couple of overriding tax implications to factor into the analysis. In essence, the foreign corporation is treated as liquidating and distributing its assets to its parent. This may require the application of IRC §311(b) (relating to the deemed sale of assets at FMV in a corporation) or IRC §1248 (relating to the distribution of E&P and tax pools of a foreign corporation to a U.S. C corporation). In fact, if the election is effective after Dec. 31, 2017, the unrealized appreciation of the CFC is considered additional income on the deemed liquidation, which may cause a one-time high GILTI inclusion (Section 1248). In addition, the tax effect in the local country must be considered.

Operational Strategies

While the above represent options available at the practitioner level, the foreign corporation can make some strategic decisions that may contribute to the tax cause of its U.S. shareholder, whether the shareholder is a non-corporate or corporate shareholder.

Increase QBAI. The reader will recall that any GILTI inclusion will be reduced by 10% of QBAI. Several ways that QBAI can be increased by the CFC include:

- Purchasing property that has been previously leased;
- Merging a loss CFC that holds QBAI with a profitable CFC; and
- Making a Section 338(g) election upon acquisition of stock in a CFC, which will effect a stock purchase as an asset purchase to attain a higher basis in eligible assets.

Avoid CFC or U.S. Shareholder Status. The reader will recall that a CFC is a foreign corporation owned more than 50% by vote or value by U.S. shareholder(s). A U.S. shareholder is a U.S. person who owns 10% or more by vote or value of a foreign corporation (Section 951(b). Taking the Section 318(a) attribution rules into account, it may be possible to attain %'s below either one of these thresholds. Additionally, Section 957(c) creates a U.S. person exception for some residents of Puerto Rico and other U.S. possessions with respect to certain corporations organized in these jurisdictions.

Take Away

The new GILTI regime creates an entirely new category of taxable income potentially affecting all taxpayers who are U.S. persons with ownership in a CFC. As a result of GILTI, income of a U.S. shareholder's CFCs is now part of the U.S. shareholder's annual U.S. federal income tax analysis. The effect of GILTI on non-corporate taxpayers who are U.S. shareholders of CFCs is particularly harsh. Such taxpayers would be prudent to evaluate their exposure under GILTI and investigate planning and restructuring alternatives.

Clearly, no single approach applies to every existing or planned foreign investment, and taxpayers will want to structure their operations only after contemplating and modeling all the relevant factors that will impact their ownership in foreign corporations.

Footnotes

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017)
2. See Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017) ("Senate Explanation")
3. Notice 2018-26, 2018-16 IRB 480
4. Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 8188, 8229 (Mar. 6, 2019).

About the Authors

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CPE ARTICLE: GILTI – COSTLIER FOR NON-C CORPORATE SHAREHOLDERS

By Rolando Garcia and Angela Qian

Today's CPA offers the self-study exam for readers to earn one hour of continuing professional education credit. The questions are based on technical information from the preceding article. If you score 70 or better, you will receive a certificate verifying you have earned one hour of CPE credit – granted as of the date the test arrived in the TXCPA office – in accordance with the rules of the Texas State Board of Public Accountancy (TSBPA). If you score below 70, you will receive a letter with your grade.

1. A controlled foreign corporation (CFC) is any foreign corporation in which U.S. shareholders own more than _____ of the foreign corporation's stock by value or vote.

A. 75%
B. 50%
C. 25%
D. 10%

2. Two of the benefits to non-C corporation U.S. shareholders of making a Section 962 election are:

A. Global Intangible Low-Taxed Income (GILTI) is subject to U.S. tax at the 10.5% corporate rate, given that the Section 250 50% deduction is allowed, rather than the higher 37% U.S. individual tax rate
B. U.S. tax on GILTI may be offset by foreign tax credits
C. Both A and B
D. Neither A nor B

3. The focus shifted from the __________ transition tax to the GILTI Section 951A provision of the TCJA as 2018 unfolded.

A. Section 907
B. Section 954
C. Section 957
D. Section 965

4. In total, non-corporate shareholders face taxation on GILTI at a 37% rate without the benefit of a credit for any foreign taxes imposed on the CFC's GILTI.

A. True
B. False

5. A C corporation with a GILTI inclusion will be eligible for a deemed foreign tax credit of:

A. 50%
B. 60%
C. 70%
D. 80%

6. Ways that QBAI can be increased by the CFC include:

A. Purchasing property that has been previously leased
B. Merging a loss CFC that holds QBAI with a profitable CFC
C. Making a Section 338(g) election upon acquisition of stock in a CFC, which will effect a stock purchase as an asset purchase to attain a higher basis in eligible assets.
D. All of the above

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7. The GILTI rules generally impose a U.S. corporate minimum tax of:

A. 10.5%
B. 12.5%
C. 15.5%
D. 25%

8. The Tax Court decision in _______________ stands for the proposition that distributions from the CFC to the U.S. C corporation holding company and then on to the individual shareholder are not deemed dividends for purposes of potentially characterizing them as "qualified" dividends.

A. *Barry M. Smith v. Commissioner*
B. *Ronald A. Caselli v. Commissioner*
C. *Bradford J. Sarvak v. Commissioner*
D. None of the above

9. Section 957(c) creates a U.S. person exception for some residents of Puerto Rico and other U.S. possessions with respect to certain corporations organized in these jurisdictions.

A. True
B. False

10. A single approach can apply and should be used for every existing or planned foreign investment.

A. True
B. False

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Stephen Hanebutt, CPA
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This firm is not a CPA firm
972-422-4530
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Michael J. Robertson, CPA
Texas Sales and Mixed Beverage Tax Solutions
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